FIN 48: Quantifying the unknowable

As FIN 48 enters its second year, Bob Reynolds discovers that it remains a thorn in the side of many corporate tax departments

During the last few weeks, many large US corporations have been reporting their end of year results. In the footnotes, the impact of FIN 48 is beginning to show. Take the investment bank Lehman Brothers as a typical example. "On December 1, 2007, we adopted FIN 48. The aggregate impact to opening retained earnings from the adoption of this standard was a decrease of approximately $178 million," said CEO Richard Fuld.

Paul Stebbins, CEO of the World Fuel Services Corporation, reporting the last quarter of 2007's figures, said: "The company's effective tax rate for the fourth quarter was 27.4%, as compared to 17.5% for the fourth quarter of 2006. The higher effective tax rate resulted from additional provision related to FIN 48 as well as a shift in the mix of the results of operations derived from our subsidiaries in tax jurisdictions with higher tax rates, principally the United States."

James Rutledge, of the environmental protection company Clean Harbors, said the adoption of FIN 48 had a significant effect on the company's performance. "Our effective tax rate for the year 2007 was 39% compared to only 12% in 2006. The increase year-over-year in our effective tax rate is mostly due to our recognising the full impact of US federal taxes this year and the effect of our implementing the FIN 48 accounting standard this year as well."

Lehman Brothers: FIN48 cost $178 million

In a series of surveys among US finance and tax directors during the last year, the reporting requirements under FIN 48 are seen as among the most challenging aspects of their work. It ranks alongside transfer pricing as presenting the most consistently complex and demanding aspect of the work of tax departments. The greatest difficulty has been putting a value on a potential liability which in the end may not be a liability.

Companies have been required to invest heavily in extra in-house and external support. New IT and accounting systems have been implemented at the cost of millions of dollars.

Inconsistent picture

But the picture is not a consistent one. While many businesses have faced multiple problems in implementing the accounting standard, others have emerged frustrated and challenged but essentially unscathed. It its first year, a transitional regime was implemented giving companies time to devise processes which would be the basis of their FIN 48 systems in future years.

The second year has imposed a far more rigorous standard. And after the experience of the 2006 returns, companies have not been allowed to alter the way they compute returns and present their figures. Advisers argue that all parties are still learning about how the standard works and that process will continue for several years.

FIN 48 is an accounting standard designed to give clarity to uncertain tax positions (UTPs). In practice, this means finding a way to quantify what is unknowable. A potential tax exposure to a business may come from a dispute with a tax authority. The company may think it has a watertight case but the revenue agency may take a different view.

Uncertain tax positions

In June 2006, the US accounting standards setter the Financial Accounting Standards Board (FASB) published its interpretation FIN 48. Its aim was to provide greater clarity and transparency on uncertain tax positions (UTPs). It stemmed from its statement 109 - Accounting for Income Taxes.

It established criteria for recognition, derecognition and measurement and improved tax risk disclosures of UTPs. In its first year transitional arrangements eased its path and, although corporations were concerned about how to manage the process to adopting FIN 48, none could anticipate its full impact.

The standard is at its most acute in transfer pricing issues where the potential tax exposure can only be guessed at. One leading transfer pricing lawyer in the UK said: "This is an area where two well intentioned people can take diametrically opposed positions and both be right. This is why a potential exposure can be unknowable."

In a survey conducted in December 2007 by Deloitte, 3,400 tax executives in US companies commented on the most difficult aspects of FIN 48. The largest group – almost 50%-said it added no value to their financial reporting and 30% said that its implementation had been more difficult than they had anticipated.

Significance of individual events

The most challenging aspect of FIN 48 has been evaluating the significance of individual events and finding some reliable method of measuring uncertain tax positions. It is up to the company with its advisers to decide what method it will use for evaluating such liabilities but that approach should be subject to external – often official scrutiny.

If a company believes that it is potentially exposed by tax litigation, a transaction or a dispute under FIN 48, it must record that potential exposure and any contingency it has made to cover any future liability. The Internal Revenue Service (IRS) has access to this filing. It may conclude that, despite protestations by the company that it will challenge a tax adjustment by the IRS, in practical terms the company believes that it is on shaky ground.

Most large public companies have contingencies for possible future tax exposure and therefore they may now need to report them. Tax lawyers say that companies – quite straightforwardly – will take a view on potential liabilities which will change according to circumstance. Previously, those contingencies would not be on the balance sheet because of a changing perception of the extent of the liability. FIN 48 overturns that position and obliges companies to report where they believe there will be a liability.

FASB has argued that its aim was greater transparency for shareholders and investors rather than to give tax authorities an extra weapon in their battles with companies over income tax. Nevertheless, the Internal Revenue Service (IRS) has made full use of the disclosures which now available.

FIN 48 lite

"We experienced what might be characterised as FIN 48-lite in its first year of operation but the full impact is being felt now and it is a major problem for US companies and foreign multinationals listed in the States," says one Washington, DC tax lawyer.

Companies are being required to make provisions for tax exposures which could run into billions of dollars. IRS has asked in the first year to see company workbooks for FIN 48 and is therefore questioning company positions on potential tax liabilities.

Richard Timbie

Richard Timbie, partner at US law firm Caplin & Drysdale, says that the standard test to determine whether the company could experience a liability is 50%. "This means that if after making a detailed assessment, the company believes that there is a potential exposure then it must record any liability or contingency. If it genuinely thinks that it has good grounds for defending a position – a 49% or less chance that it will fail – then it must have solid reasons which it can demonstrate."

There are three parties in the process. These are the company's tax department, its auditors and its tax lawyers. "The auditors have tended to take more conservative positions recently and sometimes the company and the auditors can be on opposite ends of an argument over potential exposure. That is the point at which lawyers come in to represent the company in discussions with the auditors."

Draconian adjustment

He quotes the example of a client which has recently experienced a tax audit by the IRS. "The IRS is proposing a draconian adjustment which could result in more than $1 billion worth of tax penalty and interest. The client has to decide how to show this exposure in its financial statements.

"The accountant will need to itemise what are called individual units of account – transactions, contingencies and so on. This is not clear-cut because some of the exposures will be over multiple years and there will be interplay between them. I will then need to advise the company on which of these items of account will need to be included in the report."

Helen Hubbard

Helen Hubbard, international tax controversies partner at Baker & McKenzie in Washington DC, says: "The experience of each company is unique. There is no standard encounter with FIN 48. Some companies have had nightmares while others have found the process time-consuming and demanding but ultimately emerged unscathed.

"I have no intuitive sense as to which companies will experience profound difficulty and which will not." She says that some businesses which have no reason to be concerned about FIN 48 experience a difficult process. Other companies, which perhaps, have a few skeletons in the closet emerge with no issues.

The relationship between the company's tax department and the auditor is critical, she argues. In some cases, the auditor has been relentless in its analysis and in others fairly undemanding. "The auditor must be brought right at the start of the process. This should mean that areas for potential conflict are minimised."

Hubbard adds that some businesses are reporting a significant increased effective tax rate as a result of FIN 48 whereas others have done well.

Not all advisers share her view. In London, Andrew Wiggins, of PricewaterhouseCoopers, says the first year has been tough but "companies now have all the systems in place to make it work for them. I believe that the burden of FIN 48 was in the implementation. Provided that the systems are sufficiently resilient, it should be easier from here onwards."

Rules driven

He adds: "US GAAP is famously rules-driven but I would argue that there is plenty or wriggle room for companies. The systems are now embedded in tax departments which should make compliance considerably easier and far less onerous. There is no doubt, though, that this has dominated the agenda for US companies."

The FASB has said the interpretation should result in increased relevance and comparability in financial reporting of income taxes because uncertain tax positions accounted for in accordance with statement 109 will be evaluated for recognition, derecognition, and measurement using consistent criteria. Also, it is believed the disclosure provisions of the interpretation should provide more information about the uncertainty in income tax assets and liabilities.

FIN 48 focuses on the benefit of tax positions and introduces a two-step process of recognition and measurement.

In the first step, recognition, an enterprise determines whether it is more-likely-than-not (MLTN) that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. If the MLTN threshold is not met, no benefit can be recognised for that tax position (100% reserve). If the MLTN threshold is met, then one proceeds to step two (measurement), which estimates the largest amount of benefit that is greater than 50% likely of being realised upon effective settlement.

The ambit of FIN 48 has not been restricted to the US. Subsidiaries of US-audited companies across the world have been obliged to comply with the process. KR Girish, head of tax in South India for KPMG, says that many multinational clients are reporting under FIN 48. "Most of our larger clients are registered with the Securities and Exchange Commission and listed on the New York Stock Exchange or NASDAQ. So they are obliged to conduct FIN 48. There are many open tax issues and so we spend up to two months a year with each client complying with the disclosure requirements.

Michael Olesnicky, a partner for Baker & McKenzie in Hong Kong, reports that Hong Kong and Chinese subsidiaries have been heavily involved in FIN 48 reporting.

He says he is concerned that FIN 48 is only the start of greater disclosures. "The US authorities could extend this in the first place to other taxes. FIN 48 refers only to income taxes. It could be extended to other corporate taxes such as VAT and stamp duty. Then other countries could choose to adopt FIN 48. This is something that tax authorities in places like Japan, Germany and Australia would welcome. There is much greater cooperation between tax authorities worldwide now. The OECD is currently engaged in a project explaining the role of tax intermediaries. I see this as part of that process to extend disclosure far beyond what we have been used to."

Hubbard says: "The process is evolving. The standard setters, the companies and the auditors are changing their views. I suspect it will be several years before it will achieve any sort of stability.

"It is arguable that FASB did not set out to achieve what it now has. Certainly, it is also involved in a process to integrate US GAAP with International Accounting Standards (IAS). There is nothing like FIN 48 in IAS and if FASB is fully committed to that process FIN 48 is probably incompatible with it."