



Accounting for Income Tax Uncertainties

New FASB Interpretation 48, which defines the threshold for recognizing the benefits of tax-return positions in the financial statements as “more-likely-than-not” to be sustained by the taxing authority, will affect many companies’ reported results and their disclosures of uncertain tax positions.¹ The FASB also released a Staff Position that requires lessors to apply the Interpretation 48 model in determining the timing and amount of expected tax cash flows in leveraged-lease calculations.²

“Uncertainty in income taxes,” as used in the title of the new Interpretation, refers to uncertainty about how some transactions will be treated under the tax law. This uncertainty leads to questions about whether tax positions taken or to be taken on tax returns should be reflected in the financial statements before they are finally resolved with the taxing authorities. Earlier authoritative literature provided no specific guidance. Some companies historically recognized tax positions only if they were “probable” of being ultimately realized, guided by views expressed by the SEC staff and consistent with the definition of an asset in FASB Concepts Statement No. 6.³ However, research by the FASB staff and comments on the FASB’s Exposure Draft suggested there was diversity in practice with respect to the recognition and measurement principles used and the scope of transactions to which such principles were applied. The new Interpretation should result in more consistent application.

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The Interpretation’s Scope

Interpretation 48 applies to all tax positions accounted for under Statement 109, including tax positions acquired in a business combination.⁴ A “tax position” for this purpose includes a current or future reduction in taxable income reported or expected to be reported on a tax

¹ FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, June 2006, available at www.fasb.org.

² FASB Staff Position No. FAS 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction, July 2006, available at www.fasb.org.

³ SEC Staff Speech by Randolph P. Green at the Thirty-First AICPA National Conference on Current SEC Developments, December 11, 2003, available at www.sec.gov; FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, December 1985, available at www.fasb.org

⁴ FASB Statement No. 109, Accounting for Income Taxes, February 1992, available at www.fasb.org.

return, the decision not to report a transaction in a tax return, and an assertion that a company is not subject to taxation. Because of the way a tax position is defined, the Interpretation applies to not-for-profit organizations, real estate investment trusts, regulated investment companies, and other entities that are potentially subject to income taxes if conditions specified by the tax law are not met. The Interpretation's recognition and measurement principles also apply to evaluating the potential treatment of tax planning strategies used to support the realizability of deferred tax assets.

Interpretation 48 applies to all tax positions, regardless of their level of uncertainty or the nature of the position. However, the Interpretation's recognition and measurement requirements are likely to have the most impact on positions for which current or future deductions may be disallowed or reduced in a tax examination. The Interpretation applies to situations where the uncertainty is about the timing of the deduction, the amount of the deduction, or the validity of the deduction.

The following tax positions are among those subject to the Interpretation.

- A deduction taken on the tax return for a current expenditure that the taxing authority may assert should be capitalized and amortized over future periods.
- A decision that certain income is nontaxable under the tax law.
- The determination of the amount of taxable income to report on intercompany transfers between subsidiaries in different tax jurisdictions.
- The calculation of the amount of a research and experimentation credit.
- The determination as to whether a spin-off transaction is taxable or nontaxable.
- The determination as to whether an entity qualifies as a real estate investment trust or regulated investment company.

- The determination as to whether an entity is subject to tax in a particular jurisdiction.

Tax benefits associated with positions that are highly certain and not likely to be questioned by the taxing authorities, such as deductions for ordinary salaries paid to employees, are unlikely to be affected by the Interpretation.

Recognition and Derecognition

Interpretation 48 supplements Statement 109 by defining the confidence level that a tax position must meet in order to be recognized in the financial statements. The Interpretation requires that the tax effects of a position be recognized only if it is "more-likely-than-not" to be sustained based solely on its technical merits as of the reporting date. In making this assessment, a company must assume that the taxing authority will examine the position and have full knowledge of all relevant information. The term "more-likely-than-not" means a likelihood of more than 50 percent. Each tax position is to be considered on its own, regardless of whether the related benefit is expected to be negotiated with the taxing authority as part of a broader settlement involving multiple tax positions.

The more-likely-than-not threshold represents a positive assertion by management that a company is entitled to the economic benefits of a tax position. If a tax position is not considered more-likely-than-not to be sustained based solely on its technical merits, no benefits of the position are to be recognized. Moreover, the more-likely-than-not threshold must continue to be met in each reporting period to support continued recognition of a benefit. If the threshold ceases to be met, the previously recorded benefit must be derecognized—that is, reversed. The benefit of a tax position that initially fails to meet the more-likely-than-not threshold should be recognized in a subsequent period if changing

facts and circumstances enable the position to meet the threshold, the matter is ultimately settled through negotiation or litigation with the taxing authority, or the statute of limitations has expired.

The Interpretation does not prescribe the type of evidence required to support meeting the more-likely-than-not threshold, stating that it depends on the individual facts and circumstances. A company's position may be supported, in whole or in part, by unambiguous tax law, prior experience with the taxing authority, and analysis that considers all relevant facts, circumstances, and regulations, including widely understood administrative practices and precedents of the taxing authority.

Tax positions supported by "administrative practices and precedents" are those positions which are accepted by the taxing authorities even though the treatment may not be specified by the tax law or the positions may be considered technical violations of the tax law. In an example from the Interpretation, the tax law in a particular jurisdiction may not establish a capitalization threshold below which fixed-asset expenditures may be considered deductions in the period of acquisition, but management may be able to conclude based on previous experience that the taxing authority has not historically disallowed current deductions for individual fixed-asset purchases below a specific dollar amount. The Interpretation permits such conclusions for what is expected to be a small number of tax positions that reflect widely known and consistently applied practices of the taxing authority. Another example in the Interpretation illustrates how administrative practices may affect evaluations of whether an entity may be subject to tax in a jurisdiction.

In some cases it may be unclear how a tax position should be defined. The unit of account for determining what constitutes an

individual tax position is a matter of judgment that should consider the manner in which a company prepares and supports its income tax returns and the approach expected to be taken by the taxing authority during an examination. The determination of the unit of account can significantly affect the amount of tax benefits recognized, particularly if a deduction or other benefit involves multiple issues that vary widely in their degree of uncertainty. For instance, a company may claim a research and experimentation credit for a qualifying research project that contains both expenditures that are highly certain to result in a benefit and expenditures that could be disallowed. If the unit of account is the research project, the company may not be able to conclude that the recognition threshold has been met because some of the benefit associated with the position is likely to be disallowed. Alternatively, if the unit of account is the individual expenditure, management may be able to conclude that the position associated with the highly certain expenditures meets the recognition threshold. We believe that because of this sensitivity, it may be appropriate in some cases to define the unit of account at the lowest level necessary to ensure that significant benefits with widely varying levels of uncertainty are not included in the same unit of account.

Measurement

The benefit recognized for a tax position meeting the more-likely-than-not criterion is measured based on the largest benefit that is more than 50 percent likely to be realized. The measurement of the related benefit is determined by considering the probabilities of the amounts that could be realized upon ultimate settlement, assuming the taxing authority has full knowledge of all relevant facts and including expected negotiated set-

tlements with the taxing authority. The Interpretation does not prescribe how to analyze the probabilities of individual outcomes.

In measuring the benefit, a company could first consider the amount and probability of sustaining the largest possible benefit (that is, the benefit claimed or expected to be claimed on the tax return). If the largest possible benefit is greater than 50 percent likely to be realized, the company would recognize that amount. If not, the company could determine whether the next largest benefit is greater than 50 percent likely to be realized, including the probability that a larger benefit could be realized. If the 50 percent threshold has not been reached, the company could continue to evaluate other outcomes in a similar manner until it identifies the largest amount of benefit that is greater than 50 percent likely to be realized.

The measurement process is applied only to tax positions that meet the more-likely-than-not recognition threshold. According to the Interpretation, a tax position that does not meet the recognition threshold is measured at zero, even if some part of the benefit associated with the position is more than 50 percent likely of being realized.

Changed Evaluations

New information about a tax position should trigger a reevaluation. The reevaluation could lead a company to derecognize a previously recognized tax position because new information indicates that it is no longer more-likely-than-not to be sustained, recognize a previously unrecognized tax position because it has become more-likely-than-not that the position would be sustained, or remeasure a previously recognized tax position. The effect of a changed evaluation related to a tax position taken in a prior annual period is

accounted for as a change in estimate and is recognized entirely in the interim period in which the change occurs. Changes in evaluations related to tax positions taken in prior interim periods within the same fiscal year are accounted for under Opinion 28 and Interpretation 18 as an adjustment to the estimated annual effective tax rate beginning in the period of the changed evaluation.⁵

Only information that is available at the reporting date (that is, the date of the company's most recent statement of financial position) should be considered in recognizing and measuring a tax position. A change in available facts subsequent to a company's reporting date but prior to issuance of the financial statements should be recognized in the period in which the change in facts occurs, even if that new information provides a better estimate of the ultimate outcome of an uncertainty. Nevertheless, companies should make appropriate disclosures in the notes to the financial statements if the impact of subsequent facts is considered material.

Liabilities and Their Classification

Recognizing a benefit from a tax position in the financial statements that is smaller than the tax effect of the related deduction reported in the company's tax return creates a tax liability or reduces the amount of a net operating loss carryforward or amount refundable from the taxing authority. Companies that present a classified statement of financial position should classify the liability as current or noncurrent depending on the anticipated timing of settlement. Amounts expected to be settled within one year of the balance-sheet date would therefore be classified as current liabilities. Interpretation 48 does not change the classification guidance for deferred taxes.

⁵ APB Opinion No. 28, *Interim Financial Reporting*, May 1973, and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, March 1977, available at www.fasb.org.

Example: Applying Interpretation 48

Company ABC is evaluating current-period interest cost associated with its convertible debt and is planning to take an interest deduction on its tax return and thereby reduce its income taxes payable by \$100 for the year. The Company discusses the tax position with its tax advisors, analyzes similar deductions specifically challenged and accepted by the taxing authority in previous examinations, and concludes that the cost qualifies as a valid interest deduction and is therefore more-likely-than-not to be sustained in an examination. Company ABC therefore concludes the interest deduction meets Interpretation 48's recognition criterion and the related tax benefit should be measured for financial reporting.

If the deduction is subsequently examined by the taxing authority, several outcomes are possible, because it is uncertain whether any deduction will be allowed and because

of the judgment involved in determining the appropriate market rate of interest (i.e., the amount of the interest deduction to be allowed on the tax return). Based on its previous experience in negotiating similar deductions with the taxing authority, Company ABC's management believes there is only a 30 percent likelihood that the entire benefit of \$100 would be allowed in an examination. However, management believes there is a 60 percent likelihood that at least an \$80 benefit would be sustained (i.e., a 60 percent probability that a maximum of \$20 would be disallowed). Management also believes there is a 40 percent likelihood that a taxing authority examination would deny the company any benefit for the position.

Interpretation 48 requires Company ABC to record an \$80 benefit in its financial statements because there is a 60 percent proba-

bility that a benefit of \$80 or more would ultimately be realized. Company ABC cannot report the full \$100 benefit claimed on its tax return in its financial statements, because there is only a 30 percent probability that the entire benefit would be allowed if examined by the taxing authority. A \$20 tax exposure liability should be recorded as an increase to income taxes payable, representing the difference between the benefit recognized under Interpretation 48 of \$80 and the benefit claimed on the tax return of \$100. This income tax liability would be classified as noncurrent if Company ABC does not expect to settle the amount with the taxing authority within one year of the balance-sheet date. Interest must be accrued on the \$20 liability beginning in the first period interest would begin to accrue under the tax law.

Deferred Taxes

Interpretation 48 will directly affect the calculation of income taxes payable and may also affect the measurement of deferred taxes. Deferred tax assets and deferred tax liabilities should be calculated based on the difference between the carrying values of assets and liabilities for financial-reporting purposes and the tax basis of those assets and liabilities as calculated using Interpretation 48.

For example, assume a company incurs costs of \$100 to repair equipment in its manufacturing plant, recognizing the expenditure as a current-year expense in the financial statements and a deduction in its current-year tax return. Management believes it is highly certain that the \$100 will ultimately be deductible. However, management also believes it is more-likely-than-not that the taxing authority will require the costs to be capitalized and amortized over four years. In this case,

the company must recognize an increase in income taxes payable for the tax effects of the \$75 deduction that management believes the taxing authority will disallow in the current year (i.e., the \$100 deduction claimed less one year, or \$25, of amortization). In addition, a deferred tax asset for the tax-effect of the \$75 deduction that is expected to be allowed over the next three years should be recognized because there is no corresponding asset for financial reporting purposes.

Interest and Penalties

Interest that the tax law requires to be paid on the underpayment of taxes should be accrued on the difference between the amount claimed or expected to be claimed on the tax return and the tax benefit recognized in the financial statements. The accrual for financial reporting should begin in the period in which accrual would begin under the tax law. An expense must be recognized

for the amount of a statutory penalty in the period for which the tax position has been taken or is expected to be taken on the tax return if a tax position does not meet the minimum statutory threshold to avoid the penalty. Classifying interest and penalties on the income statement is an accounting policy decision that should be consistently applied.

Disclosures

Interpretation 48 requires significant new annual disclosures in the notes to the financial statements. A significant additional requirement is a table disclosing the beginning and ending balances of unrecognized tax benefits. The following items must be separately presented in the table, which is required at the end of each annual period:

- The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.

- The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.
- The amount of decreases in unrecognized tax benefits relating to settlements with taxing authorities.
- Reductions to unrecognized tax benefits as a result of lapse of the applicable statute of limitations.

The table is required for unrecognized tax benefits on an aggregate, worldwide basis. No disaggregated information for individual tax positions or jurisdictions is required. Companies must also disclose the amount of unrecognized tax benefits that, if recognized, would change the effective rate. For example, recognition of an unrecognized tax benefit that corresponds to a recognized deferred tax asset because the deduction was expected to be available for tax purposes at a future date may not change the company's effective tax rate.

The Interpretation also requires qualitative and quantitative disclosures related to estimates of unrecognized tax benefits if it is "reasonably possible" the estimate will significantly change in the 12 months after the balance-sheet date. This disclosure must include the nature of the uncertainty, the nature of the events that could cause the change, and an estimate of the range of reasonably possible changes or a statement that an estimate of the changes cannot be made. Other provisions of the Interpretation require companies to disclose the classification of interest and penalties, the amount of interest and penal-

ties included in the income statement each period, and the amount of interest and penalties accrued in the statement of financial position. A description of open tax years by major jurisdiction is also required.

Effective Date and Transition

Interpretation 48 is effective as of the beginning of the first fiscal year beginning after December 15, 2006 (January 1, 2007 for calendar-year companies), with early application permitted if no interim financial statements have been issued. At adoption, companies must adjust their financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Positions that meet this criterion should be measured using the largest benefit that is more than 50 percent likely to be realized. The necessary adjustment should be recorded directly to the beginning balance of retained earnings in the period of adoption and reported as a change in accounting principle. Retrospective application is prohibited.

Over the coming months, companies will need to begin the process of reassessing their historical tax positions in order to successfully apply the new Interpretation. Companies with tax positions involving complex tax law or significant uncertainty may need assistance from outside tax experts. In many cases, we believe companies that have historically used a "probable" threshold for recognizing uncertain tax positions will find that the reassessment reduces the liability for unrecognized tax benefits at the date of adoption. Disclosures made in the period of adoption should enable financial-statement readers to

understand the company's new accounting policies and their effect on the financial statements. In reporting periods prior to adoption (including second-quarter 2006 interim reports), public companies should discuss the expected effects of adoption in MD&A and in accounting policy footnotes as required by SAB 74.⁶



Staff Position on Leveraged Leases

The new FASB Staff Position amends Statement 13 by requiring lessors to recalculate the rate of return and periodic income allocation for leveraged-lease transactions when there is a change or projected change in the timing of income tax cash flows related to the lease.⁷ The Staff Position requires lessors to use the model in Interpretation 48 to determine the timing and amount of expected tax cash flows in leveraged-lease calculations and recalculations.

The Staff Position applies to all leveraged leases, but was issued primarily in response to IRS challenges to tax positions in Lease In-Lease Out and Sale In-Lease Out transactions. Changes in the expected timing of tax cash flows can result in significant changes in the lessor's expected rate of return and timing of income recognition for two reasons. First, income related to a leveraged lease is required to be recognized by the lessor using a constant rate of return in periods in which the lessor's net investment balance in the lease is positive. Second, the tax benefits of accelerated tax depreciation together with interest expense deductions related to the

⁶ SEC Staff Accounting Bulletin No. 74, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In a Future Period*, available at www.sec.gov.

⁷ FASB Statement No. 13, *Accounting for Leases*, November 1976, available at www.fasb.org.



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interest on nonrecourse debt often exceed rental income from the lease in the early years of the transaction, affording the lessor the temporary use of funds through deferred tax balances.

The Staff Position clarifies that the assumed timing of income tax cash flows is an “important assumption” as that term is used in paragraph 46 of Statement 13 and must be included in leveraged-lease accounting calculations. Lease income must be recalculated under paragraph 46 for changes or projected changes in the timing of income tax cash flows related to a leveraged lease. However, recalculation is required only for changes or projected changes in the timing of income tax cash flows that are directly related to the leveraged-leasing transaction (for example, changes related to interpretations of tax law or the expected outcome of tax audit). Changes in the anticipated timing of tax benefits related solely to the effect of the lessor’s alternative minimum tax credits or projected tax losses generally do not trigger a required recalculation of a leveraged lease. In addition, a change in the projected timing of income tax cash flows does not trigger a reassessment of lease classification.

The Staff Position provides additional guidance on how recalculations should be performed. Any projected interest and penalties relating to settlement or potential settlement of a tax position related to the lease should *not* be included in the calculation of cash flows from a leveraged lease. Similarly, advance payments and deposits to taxing authorities toward potential settlement of a leveraged-lease tax position are not considered cash flows to be included in the leveraged-lease recalculation. Finally, *all* important assumptions in a leveraged lease must be updated based upon current information when a recalculation is performed under paragraph 46 of Statement 13.

The Staff Position is effective in the same period as Interpretation 48. At the date of adoption, the lessor is required to reassess projected income tax cash flows related to leveraged leases using the Interpretation 48 model for recognition and measurement. If this results in a change in the expected timing or amount of leveraged-lease income tax cash flows, the rate of return on the leveraged leases should be recalculated and the net investment in the leases adjusted as prescribed by Statement 13. Revisions to the net investment in a leveraged lease required when the Staff Position is adopted should be recorded as a direct adjustment to the beginning balance of retained earnings in the period of adoption and reported as a change in accounting principle. Consistent with the transition provisions of Interpretation 48, retrospective application of the Staff Position is not permitted. SAB 74 requires the expected effects of adopting the Staff Position to be disclosed in financial-reporting periods prior to adoption (including second-quarter 2006 interim reports).

The descriptive and summary statements in this presentation are not intended to substitute for the texts of any tax legislation, FASB pronouncements, or SEC regulations. Companies should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting, tax, and legal advisors.