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FASB Issues Proposed Interpretation on Accounting for Uncertain Tax Positions

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On July 14, 2005, the FASB issued an Exposure Draft of a proposed Interpretation, Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement No. 109. If adopted, the proposed Interpretation is the most significant tax accounting guidance the FASB has issued since FASB Statement No. 109 "Accounting for Income Taxes," (FAS 109) in 1992.

The FASB has proposed an asset recognition approach, applying a dual threshold to account for uncertain tax positions. The two thresholds are recognition and measurement, described in more detail below. Currently, uncertain tax positions are accounted for under the FASB Statement No. 5, "Accounting for Contingencies," (FAS 5) liability approach. Generally, FAS 5 provides that an estimated loss from a loss contingency should be accrued if it is probable that an asset has been impaired, or a liability was incurred and the amount of the loss can be reasonably estimated. The proposed Interpretation would apply to all open tax positions accounted for in accordance with FAS 109, including those acquired in business combinations.

The proposed Interpretation would be effective as of the end of the first fiscal year ending after Dec. 15, 2005. The proposed Interpretation was open to public comment, with comments due to the FASB by Sept. 12, 2005. Many accounting professionals familiar with the proposed Interpretation believe the FASB will delay the effective date to allow for sufficient time to address the comment letters and for companies to implement the proposed Interpretation. Changes may be made by the FASB to the pronouncement resulting from comments received.

For many companies, implementation of the proposed Interpretation will be a significant undertaking, involving a thorough analysis of all of the company's tax positions, not just the aggressive or controversial tax positions. This includes all taxing jurisdictions, i.e. federal, foreign and state.

Initial Recognition

The initial recognition of the effect of applying the proposed Interpretation would be a cumulative effect of a change in accounting principle (i.e., the amount would be shown as an item on the income statement between the captions "extraordinary items" and "net income").

Under the proposed Interpretation, the recognition of a tax benefit would occur when it is "probable" that the position would be sustained upon audit. The proposed Interpretation refers to the FAS 5 definition of probable (i.e., that which is likely to occur), which represents a level of assurance that is substantially higher than "more likely than not."

Generally, the "probable" threshold has been interpreted as a 70 percent or more likelihood of sustaining the tax position. The "more likely than not" threshold has been defined as a likelihood of sustaining the position of 50 percent or more.

The Board noted that, in determining if the "probable" threshold has been met, it should be assumed that the taxing authority will examine the tax position. Examples of specific facts and circumstances that may, in the absence of opposing evidence, demonstrate a probable level of confidence are as follows:

- Unambiguous tax law supporting the tax position.
- An unqualified "should prevail" level tax opinion from a qualified expert.
- Similar positions that have, obviously been presented in the tax return and have been either accepted or not disallowed or challenged by the taxing authority.

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If the tax benefit meets the "probable" threshold, the measurement of the tax benefit is based on the "best estimate" of the ultimate tax benefit that will be sustained upon audit by the taxing authority.

- Case law representing a favorable resolution of similar positions.

If the probable threshold is not met for a tax position, then none of the tax benefit would be recognized currently. The proposed Interpretation includes an example of a tax position that was not probable of being sustained on audit but the company's prior experience indicated the position would be settled for 10 percent of the claimed benefit. The proposed Interpretation provides that, because the probable threshold has not been met, none of the benefit should be recorded.

Recognition/Derecognition

Under the proposed Interpretation, a tax position that fails to meet the "probable of being sustained" threshold for initial recognition can be recognized in a later period in which the probable threshold is met. A tax benefit initially recognized when it meets the "probable of being sustained" threshold would be derecognized in the period in which the likelihood of the position being sustained drops below "more likely than not."

Measurement

If the tax benefit meets the "probable" threshold, the measurement of the tax benefit is based on the "best estimate" of the ultimate tax benefit that will be sustained upon audit by the taxing authority. The "best estimate" is not a probability-weighted estimate, but the single most likely outcome. A subsequent change in best estimate, with respect to a tax position taken in a prior period, should be treated as a discrete event occurring in the period when the change of judgment occurs.

Classification

The Board concluded that the liability arising from the difference between the tax position and the amount recognized and measured under the proposed Interpretation should be classified as a current liability if anticipated to be paid within one year or the operating cycle, if longer. Only a liability related to a taxable temporary difference, as defined in FAS 109, should be classified as a deferred liability.

Interest and Penalties

The proposed Interpretation notes that if the payment of interest on the underpayment of income taxes is required by the relevant tax law, the accrual of interest should be based on the difference between the tax benefit recognized in the financial statements and the tax position on the tax return. Interest shall be accrued in the period the interest is deemed to have been incurred. If a penalty applies to a tax position, the liability for the penalty should be recognized in the period the penalty is deemed to have been incurred. The board did not consider the classification of interest and penalties, and believes that topic would be more appropriately considered as part of the IASB convergence project, if at all.

Some of the public comments posted on the FASB Web site indicate a strong disagreement over a move to the "asset" recognition approach from the historical FAS 5 liability or impairment approach. The comments suggest that with additional guidance from the FASB the liability approach is the fundamentally more appropriate approach. Also, many of the comments suggest that the use of the higher probable standard and not the more likely than not standard will result in increased tax expense that will only need be reversed in subsequent periods as the statute of limitations expires. The companies that submitted comments were strongly opposed to an effective date that would require companies to adopt the proposed Interpretation for years ending Dec. 31, 2005.

While the final form of the proposed Interpretation is uncertain and it is not known when it will become effective, it is certain that companies will have new rules for accounting for income taxes, and will have to devote increased resources to determining the proper accounting for uncertain tax positions.

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