



Dbriefs U presents:

# Accounting for Income Tax Uncertainties — An Ongoing Challenge

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# Agenda

Introduction

Overview of rules and disclosures

Example

Challenging aspects

Disclosures

Why should you stay on top of this?

# Poll question # 1

Why does accounting for income taxes continue to be such a hot topic?

- Wall Street and others worry about managing earnings by manipulating tax expense
- Many material weaknesses are still related to income tax accounting
- Tax expense and tax balance sheet accounts are often significant
- Tax is recognized as a key risk area, especially for multinational corporations
- All of the above

# Poll answer # 1

Why does accounting for income taxes continue to be such a hot topic?

- Wall Street and others worry about managing earnings by manipulating tax expense
- Many material weaknesses are still related to income tax accounting
- Tax expense and tax balance sheet accounts are often significant
- Tax is recognized as a key risk area, especially for multinational corporations
- **All of the above**

# Accounting for uncertain tax positions

- Some tax positions are “black and white” while others are very “gray”
- Some tax positions are dependent on facts that may be uncertain
- Some tax positions are based on confusing tax law
- ASC 740 provides rules for recording these “gray” issues in your financial statements

# Initial recognition

ASC 740-10-25

- An uncertain tax position claimed (or expected to be claimed) in a tax return must be more likely than not (MLTN) of being sustained prior to recognition in the financial statements
- Assessment is based solely on technical merits
- Negotiated settlements with tax authorities cannot be considered
- Detection risk by taxing authority cannot be considered

Financial statement impact:

- Full tax reserve required for less than MLTN items
- Tax benefit may be booked if tax position meets MLTN threshold

# Subsequent recognition/derecognition

ASC 740-10-25-8 and 740-10-40-2

- If not initially recognized, tax benefit is subsequently recognized when MLTN threshold is met or when other required conditions are satisfied
- After initial recognition, if it becomes less than MLTN that the position will be sustained, the benefit of the tax position is derecognized

Financial statement impact:

- More volatility in quarterly tax expense

# Measuring the tax benefit

ASC 740-10-30-7

- For all positions (permanent and timing) that meet the MLTN recognition threshold, the amount of benefit to be recorded in the financial statements is the largest benefit that is more than 50% likely to be sustained

# Balance sheet

ASC 740-10-45-11 and ASC 740-10-45-12

- Recording the liability for unrecognized tax benefits
  - Liability must be recorded gross of offsetting tax benefits or tax effects
  - Temporary uncertain tax positions are reclassified from deferred taxes to the liability account
  - Liability should be classified based on the expected timing of payment
    - Amounts expected to be paid within one year are classified as current
    - All other amounts are classified as long term

## Financial statement impact:

- Significant balance sheet reclassification between current taxes payable, long term taxes payable, and deferred taxes as compared to prior rules
- Significant quarterly shifts expected

# Disclosures

- Disclose policy on classification of interest and penalties (ASC 740-10-45-25)
- Other disclosures (ASC 740-10-50-15)
  - (a) Tabular reconciliation of total amounts of unrecognized tax benefits at the beginning and end of the period
  - (b) Total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate
  - (c) Total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position
  - (d) Total amounts of unrecognized tax benefits that is reasonably possible will significantly increase or decrease within 12 months
  - (e) Description of tax years that remain subject to examination by major tax jurisdictions

# Disclosures – The moral of the story

- Footnotes in 2006 and prior years tell you general tax information about a company
- Footnotes in 2007 and forward tell you more – but it takes an educated reader to know exactly what the “more” really means
- SEC comments may influence the content of disclosures today and in future periods

## Poll question # 2

Which of the following is not true about the rules relating to accounting for uncertain tax positions?

- Applies to all uncertain tax positions in all jurisdictions
- Applies to all items involving taxes, including sales and property taxes
- Requires extensive documentation of uncertain tax positions
- Liabilities must be reviewed every quarter for potential recognition and measurement changes

## Poll answer # 2

Which of the following is not true about the rules relating to accounting for uncertain tax positions?

- Applies to all uncertain tax positions in all jurisdictions
- **Applies to all items involving taxes, including sales and property taxes**
- Requires extensive documentation of uncertain tax positions
- Liabilities must be reviewed every quarter for potential recognition and measurement changes

The rules for accounting for uncertain tax positions apply only to income taxes. Any uncertainties surrounding other tax items, like sales or property taxes, are still governed by ASC 450.

# Example – Unrecognized tax benefits

Identify, evaluate, and measure tax positions at 12/31/08

Uncertain Tax Position	Federal Tax UTB	State Tax UTB	Total UTB
Issue 1 – interest on foreign debt	\$ 18,900	\$ 3,510	\$ 22,410
Issue 2 – accrued professional fees	10,500	1,950	12,450
Issue 3 – M&E issues (error)**	0	0	0
<b>Totals as of 12/31/2008</b>	<b>\$ 29,400</b>	<b>\$ 5,460</b>	<b>\$ 34,860</b>

\*\*At 12/31/2007, the Company had a liability of \$7,805 (\$6,225 for tax, \$1,580 for interest) for errors related to M&E expenses which were not appropriately limited. The liability was released when the statute of limitation expired on 9/15/2008.

# Example – Impact on other balances

## Determine related impacts on deferred taxes and other accruals

Uncertain Tax Position	Federal	State	Interest	Total
Issue 1 – interest on foreign debt	\$ 18,900	\$ 3,510	\$ 1,038	\$ 23,448
Issue 2 – accrued professional fees	10,500	1,950	830	13,280
Issue 3 – M&E issues (error)	0	0	0	0
<b>Totals – 12/31/2008</b>	<b>\$ 29,400</b>	<b>\$ 5,460</b>	<b>\$ 1,868</b>	<b>\$ 36,728</b>

### Calculation of DTA (DTL) on FIN 48 amounts

DTA for temporary items (\$10,500 + \$1,950)				12,450
DTA for federal deduction on all state liabilities	5,460	35%	\$	1,911
DTL for federal liability on state DTA for temp item	(1,950)	35%		(682)
DTA for federal deduction of interest	1,868	35%		654
DTA for state deduction of interest	1,868	6.5%		121
DTL for federal liability of state DTA for interest	(121)	35%		(42)
			<b>Deferred tax asset</b>	<b>\$14,412</b>

# Example – Classification

Determine appropriate classification

## Balance Sheet Summary – 12/31/2008

Uncertain Tax Position	Liability – Noncurrent	Deferred Tax Asset – Noncurrent
Issue 1 – interest on foreign debt	\$ (23,448)	\$ 1,636
Issue 2 – accrued professional fees	(13,280)	12,776
Issue 3 – M&E issues (error)	(0)	0
<b>Balance at 12/31/07</b>	<b>\$ (36,728)</b>	<b>\$ 14,412</b>
	<b>Net liability</b>	<b>\$ 22,316</b>

# Example – Disclosures

Prepare tabular roll forward [740-10-50-15(a)]

	12/31/2008	12/31/2007
Unrecognized tax benefit – opening balance	\$ 24,900	\$ 0
Gross increases – tax positions in prior period	0	6,225
Gross decreases – tax positions in prior period	(8,300)	
Gross increases – tax positions in current period	24,485	18,675
Settlements	0	0
Lapse of statute of limitations	(6,225)	0
<b>Unrecognized tax benefit – ending balance</b>	<b>\$ 34,860</b>	<b>\$ 24,900</b>

# Example – Disclosures (cont.)

## Prepare other disclosures (740-10-50-15)

	Impact Tax Rate 15(b)	Interest and Penalties 15(c)	Early Warning 15(d)
Issue 1 – interest on foreign debt	\$21,812	\$ 1,038	No
Issue 2 – accrued professional fees**	504	830	No
	\$22,316	\$ 1,868	

\*\*Since Issue 2 relates to a temporary item, the only impact on the tax rate is interest (net of the related tax benefit)

# Challenging aspects

- Documentation
- Volatility
- Ignoring subsequent events
- Timing of releasing reserves (“effectively settled”)
- Adequacy of disclosures

# Challenging aspects – Effectively settled

ASC 740-10-25-9

- An enterprise shall evaluate all of the following conditions when determining effective settlement:
  - The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position
  - The enterprise does not intend to appeal or litigate any aspect of the tax position included in the completed examination
  - It is remote that the taxing authority would examine or reexamine any aspect of the tax position. In making this assessment management shall consider the tax authority's policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management shall presume the taxing authority has full knowledge of all relevant information in making the assessment on whether the taxing authority would reopen a previously closed examination.

# Tax footnotes and disclosures – A good read?

- What they used to tell you:
  - Is income taxed in jurisdictions other than the US?
  - Are some available tax credits being recognized?
  - Are there tax attributes that may expire unused?
- What they tell you now:
  - What jurisdictions and what years are still open for audits?
  - What are some of the company's more complex tax issues?
  - How much tax has not been paid on the gray areas?
  - How much tax may have to be paid out in the next 12 months?

## Poll question # 3

Besides accounting geeks like Kathy and Vickie, who cares about these disclosures?

- Shareholders
- IRS
- Wall Street analysts
- Company employees
- None of the above
- All of the above

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The answer is all of the above...but for different reasons.

# How investors use disclosures

- Investors may be looking for ways:
  - To compare information to other companies in order to get an idea of the level of risk associated with tax planning
  - To understand the potential impact on cash if the company loses any issues on audit
  - To evaluate the potential impact on the company's effective tax rate if the Company does sustain positions taken on returns

# How the IRS and other tax authorities use disclosures

- The IRS may evaluate the various components to determine where the company has determined on its own there may be risks:
  - Liabilities reflect the tax exposure
  - Accrued interest indicate the years the issue has been outstanding
  - Accrued penalties indicate the company's level of support for certain tax positions
- The IRS may evaluate the "early warning" disclosure to identify potential releases of reserves expected and determine if steps might be taken to prevent statute of limitations from expiring before issue is raised

# IRS comments on disclosures

- IRS official Robert Adams stated the following:
  - Taxpayer disclosures under FIN 48 are the "centerpiece of our revenue agent training this year." He described the FIN 48 disclosures thus far as "interesting," but said they "do not have the transparency to give a good view of U.S. tax liability" and said that agents will use the disclosures as another audit tool.
  - IRS's basic world view of the process, Adams said, is that FASB wrote the interpretation, the Securities and Exchange Commission is charged with enforcing it, and "IRS is very interested in the results."

# Recent SEC Comments on disclosures

## SEC Comment

“We note your disclosure regarding the \$100 million of unrecognized income tax benefits as well as accrued interest and penalties of \$40 million. Please revise future filings to clarify where you have classified these items on your balance sheet and tell us how your classification complies with paragraph 17 of FIN 48.”

## Company Response to SEC Comment

“For 2007 we had approximately \$30 million of unrecognized income tax benefits reflected in our U.S. and foreign income taxes payable, and an additional \$5 million in our Accrued liabilities – other, with the remainder of our unrecognized income tax benefits included in Other liabilities. In accordance with paragraph 17 of FIN 48, the amount of unrecognized tax benefits included in U.S. and foreign income taxes payable is expected to be resolved within 12 months of the reporting date. We will supplement future disclosures to incorporate this change.”

# SEC comments on early warning disclosures

“Please revise your disclosure to address whether it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date.

Identify the nature of any uncertainties, the nature of the events that could occur within the next 12 months that could cause the amounts to change, and provide an estimate of the range of the reasonably possible change or state that an estimate of the range cannot be made.”

# Why should you stay on top of this?

- Accounting requires qualitative and quantitative disclosures for uncertain tax positions
- Wall Street, the IRS, the SEC, and others now know more about the tax planning companies have employed in the past
- As a result, certain tax planning opportunities may be eliminated
- An interesting part of our jobs as tax professionals – and your future jobs – may be impacted

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