BRIAN R. LYNN AND STAFFORD SMILEY

THE PRACTICAL IMPACT OF FIN 48—IS IT MOVING ABROAD?

I always avoid prophesying beforehand, because it is much better policy to prophesy after the event has already taken place.
-Winston Churchill

In June 2006, the Financial Accounting Standards Board issued FAS Interpretation No. 48 (FIN 48), which revised the rules governing how companies account for their uncertain tax positions.[1] This pronouncement fundamentally changed the accounting rules for tax positions by imposing a more-likely-than-not recognition standard on uncertain tax positions. The tax community responded with much weeping and gnashing of teeth. The Tax Executives Institute urged FASB to delay implementing FIN 48—to no avail.[2] Many practitioners and academics predicted that FIN 48 would have a major impact on different aspects of the tax system.[3] FIN 48 was expected to influence companies' financial statements, expand companies' disclosures about tax matters, and alter companies' dealings with the IRS.

FIN 48 took effect on 1/1/07 for calendar-year companies, so we are now midway through the first year. We thus are starting to see how FIN 48 is going to play out and what its practical effect might be. Some of the early predictions have turned out to be correct, while others have not. And many questions remain unanswered at this point. Overall, the feeling among many practitioners is that FIN 48 is not making the big impact that some predicted. This is mainly because (1) the financial statement adjustments from FIN 48 have been relatively small, (2) the IRS has maintained its "policy of restraint"—at least so far, and (3) the public FIN 48 disclosures have been less than revealing. As a result, the biggest impact from FIN 48 might be felt in the international arena. Foreign jurisdictions generally do not have a "policy of restraint" and can ask for tax accrual work papers. If the foreign jurisdictions become aware of this new potential resource and begin requesting FIN 48 work papers, companies may end up providing the road map to foreign countries, rather than the IRS.

Overview of FIN 48

FIN 48 addresses how companies must recognize, measure, and disclose the uncertain tax positions that they have taken on past tax returns or expect to take on future returns. Under FIN 48, a company's financials should reflect the expected future tax consequences of its tax positions, assuming full knowledge of the position and related facts by the IRS and other tax authorities. FIN 48 further requires companies to increase disclosure of their tax positions on their financial statements—including a tabular roll-forward of all unrecognized tax benefits.

FIN 48 applies only to income taxes (not all taxes) that are accounted for under FASB Statement No. 109 (FAS 109). FIN 48 therefore essentially amends FASB Statement No. 5 (FAS 5) "Accounting for Contingencies" so that it no longer applies to income taxes. FAS 5 still applies to other taxes, such as sales and use taxes, as well as most other contingent liabilities.

Under FAS 5, companies would recognize their claimed tax benefits and then create a reserve for their contingent tax positions based on how likely it was (probable, reasonably possible, or remote) that the position would give rise to a liability. FIN 48 reverses this framework and imposes an income-recognition model, which says that each tax position must have a more-likely-than-not chance of being sustained on the merits before the tax benefits can be recognized. Once a position passes this threshold, companies must measure the expected tax benefits using a complicated cumulative-probability approach. In addition, companies must book any interest and penalties associated with their uncertain tax positions.

FIN 48 also has a broad scope. It covers, for instance: (1) decisions to exclude income and

Mr. Lynn *is an associate with, and* Mr.Smiley *is a member of, Caplin & Drysdale, Chartered, Washington,* D.C.

transactions from the return, (2) decisions not to file returns in a specific tax jurisdiction (e.g., foreign countries), and (3) situations requiring the filing of amended returns or refund claims.

FIN 48 is effective for fiscal years beginning after 12/15/06. As a result, calendar-year companies are required to reflect any FIN 48 adjustments in their 1/1/07 retained earnings. Finally, FIN 48 needs to be implemented for quarterly reporting; thus, most calendar-year companies implemented FIN 48 in their Form 10-Q for the first quarter of 2007.

Initial answers

There are six FIN 48 questions that may be tentatively answered.

(1) Has FIN 48 Had a Big Impact on Companies' Financial Statements? Not really. FIN 48 has not impacted companies' financial statements as much as some people—including tax executives themselves—predicted it would. A few companies did make major adjustments to their retained earnings and unrecognized tax benefits when they implemented FIN 48, but they were the exception not the rule. And the adjustments did not all go in the same direction. There were almost as many positive retained earnings adjustments as negative adjustments.

Three James Madison University accounting professors recently published a study of the early indications of FIN 48's impact on financial statements.[4] They reviewed the first quarter Form 10-Qs for the Fortune 200 companies. Because of some adjustments, their ultimate sample size was reduced to 130 companies. The professors reported the impact of FIN 48 on each company's retained earnings, unrecognized tax benefits, and recognized interest and penalties.

The results were surprising. The big news is that the study shows that implementing FIN 48 had an immaterial or very small effect on most companies' retained earnings. Remember, one aspect of implementing FIN 48 was for companies to go through and retest all of their tax contingencies under the FIN 48 model. This means that all less-than-50% issues should be 100% reserved, and all other issues should be measured using FIN 48's cumulative-probability measurement system. Any change in reserve from this exercise should have been made as a retained earnings adjustment on 1/1/07. Many predicted that the retained earnings impact from these changes would be large, and it turns out to have been relatively minor. A few companies had major FIN 48 hits to retained earnings. Ford Motor Company, for instance, increased its retained earnings by $1.3 billion because of FIN 48. Conversely, Wyeth and Dow Chemical each reduced its retained earnings by roughly $300 million. Most companies, however, made little or no adjustments because of FIN 48. In fact, 88% of companies made retained earnings adjustments that equaled less than 1% of equity. Only three companies (out of 130) reported adjustments that exceeded 3% of equity. Thus, almost all companies had an immaterial FIN 48 adjustment to retained earnings.

This trend continues with unrecognized tax benefits. Some predicted that companies would have to report large unrecognized tax benefits when FIN 48 was implemented. Prior to this year, FIN 48 companies did not need to report their unrecognized tax benefits, so we do not have change figures. The nominal unrecognized benefit numbers do not jump off of the page as shockingly high. Almost all companies (125 out of 130) reported some unrecognized tax benefits. But most (92 out of 130) reported less than $1 billion in unrecognized benefits. Only eight companies reported more than $3 billion in unrecognized tax benefits. These reported figures show significantly smaller unrecognized benefits than a group of tax executives predicted in November 2006.[5]

Finally, companies reported few penalties and interest charges. While some firms reported large future interest and penalties (Merck reported $2.4 billion), most companies reported no penalties or interest or only small amounts. Eighty-one of the 130 companies surveyed reported less than $100 million in future penalties and interest.

[1] FIN 48 was issued in draft form on 7/14/05.

[2] Boyle, "TEI Urges FASB to Withdraw Exposure Draft" 109 Tax Notes 125 (Oct. 3, 2005).

[3] See, e.g., Kimmelfield, Horowitz and Davis, "Accounting for Uncertainty in Income Taxes—The Effect of FASB Interpretation No. 48" The Tax Executive (July-August 2006).

[4] Nichols, Briggs, & Baril, "And the Impact Is . . . First-Quarter Results From Adopting FIN 48" 116 Tax Notes 377 (7/30/07).

[5] Shaw, "Uncertainty Reigns Over Taxes: Controllers Are Wary About Accounting Guidance For Uncertain Tax Positions that was Supposed to Lessen Confusion and Varied Practices," (CFO.com, 11/7/06).

Why were these initial FIN 48 impact numbers so underwhelming? There are two main answers, and the truth is likely a combination. First, practitioners and other commentators (and the tax executives themselves) probably blew a little smoke in reacting to FIN 48. When new rules like FIN 48 are put in place, there is a tendency to overstate the impact. Second, the auditors might have been wary to impose FIN 48 too strictly on companies for the first application. FIN 48 is new and difficult for auditors as well, and auditors likely do not have systems and techniques in place to ensure to-the-letter compliance with FIN 48 at this early stage. It often takes some time for auditors to settle on an equilibrium about how new pronouncements will be enforced. We will learn more about FIN 48's true impact as time passes. In a few years, we should have a better understanding of how much FIN 48 really changed the tax-reporting landscape.

(2) **Do the Revised Tax Footnotes Create a "Road Map" for the IRS?** It is hard to answer this question looking only at a small sample of Form 10-Qs. But the general notion is that the post-FIN 48 tax footnotes will not provide substantial assistance to IRS examiners. It was first thought that public FIN 48 disclosures would reveal more detailed information about a company's tax positions and that the IRS could use this information to spot new issues in audits. Practitioners also worried that the IRS would know how strongly the company believed in each issue because the IRS would see the change in unrecognized tax benefits on an issue-by-issue basis. These concerns do not appear to be materializing. In other words, rumors of the death of vague tax footnotes have been greatly exaggerated.

The reason these worries are not panning out is that companies (and their auditors) are still grouping all of their issues together. In general, there has not been issue-by-issue reporting, companies are just giving total numbers. These total figures do not help the IRS spot issues. For instance, the IRS may find it interesting that a company's unrecognized tax benefits have doubled in the past year—and that may give the IRS a signal in the unusual case. But in the usual case, revealing the change in the total unrecognized tax benefit is unlikely to help the IRS.

Wal-Mart's tax footnote from its most recent Form 10-Q illustrates how the revised tax footnotes will not be a "road map" for the IRS. Wal-Mart's 6/1/07 Form 10-Q for the quarter ending 4/30/07 is at Exhibit 1 below. It reveals that implementing FIN 48 made Wal-Mart increase its unrecognized tax benefits by $236 million and reduce its opening retained earnings by $160 million. The footnote reads as there indicated.

Wal-Mart's disclosure is a good example of how a footnote can provide the requisite high-

EXHIBIT 1. Wal-Mart's Tax Footnote on its First-Quarter Form 10-Q

Wal-Mart Stores Inc.
Form10-Q

Period Covered	02/01/2007 - 04/30/2007
Filing Date	06/01/2007
Effective Tax Rate	34.4%(33.6% in 2007)

Accounting Changes: Adopted FIN 48 February 1, 2007; adoption resulted in $236 million increase in liability for unrecognized tax benefits related to continuing operations and $28 million increase in related liabilit y for interest and penalties; $160 million of those increases were accounted for as reduction to opening balance of retained earnings, $70 million as increase to non-current deferred tax assets, and $34 million as increase to current deferred tax assets; see Tax Credits.

Tax Credits: $779 million in unrecognized tax benefits related to continuing operations after FIN 48 implementation, including $529 million that would affect tax rate if recognized; company had $1.73 billion in unrecognized tax benefits which would be recorded as discontinued operations if recognized, including $1.67 billion related to a worthless stock deduction to be claimed for disposition of German operations in fiscal 2007.

Deferred Assets & Liabilities: $5.42 billion in deferred income tax and other liabilities.

Tax Controversy: Company expects tax audit resolutions could reduce unrecognized tax benefits by up to $130 million in next 12 months.

Other: Increased tax rate primarily due to increased state taxes and changes in mix of taxable income among domestic and international operations; company expects 34-35% annual effective tax rate for fiscal 2008.

level information without giving the IRS a road map. It is hard to see the IRS gaining any advantage in its audit by reading this footnote. The better analogy used by some is that the revised public disclosures provide the IRS with a "compass" rather than a "road map," but even that may be pushing it.

(3) Will the FIN 48 Work Papers Be Considered Tax Accrual Work Papers? In auditing a company's tax provision, the auditors receive several internal documents (and sometimes opinions) describing the company's tax issues. These documents—called tax accrual work papers—can show the soft underbelly of a company's tax positions; and naturally the company would prefer to not turn over the work papers to the IRS. Moreover, these work papers are often not privileged under the attorney-client privilege because giving them to a third-party (the auditor) generally waives the privilege. Companies can argue that some of the documents are protected by the work product doctrine—and probably will assert it more in light of *Textron*. Nevertheless, the IRS generally has the right to ask for a company's tax accrual work papers.

However, the IRS has a "policy of restraint" in the Internal Revenue Manual whereby it promises to ask for tax accrual work papers only in extraordinary circumstances or when a company does not disclose participation in listed transactions.[6] Thus, it is important for documents to be classified as part of the tax accrual work papers so that the documents fall under the IRS's policy.

Initially, there was concern that the FIN 48 work papers (e.g., the cumulative-probability analyses) would not be classified as tax accrual work papers. This would expose the documents to routine requests by the IRS for "all materials related to X transaction." The IRS recently decided, however, that FIN 48 work papers constitute tax accrual work papers.[7] This designation helps companies in that they do not have to draw lines around what are FIN 48 work papers and what are tax accrual work papers.

(4) Will the IRS Change its "Policy of Restraint" on Tax Accrual Work Papers Because of FIN 48? The IRS generally has the right to request tax accrual work papers. In the 1980s, a taxpayer challenged this right and the IRS prevailed in the *Arthur Young*[8] case in the Supreme Court. Taxpayers can withhold documents in the tax accrual work papers that are either attorney-client privileged or work product privileged (see discussion below), but taxpayers cannot withhold on other grounds. That said, the IRS does not routinely ask for companies' tax accrual work papers, partly because it would hamper the companies' ability to communicate honestly with their auditors. The IRS formalized this "policy of restraint" in the Internal Revenue Manual, but the policy is not absolute. The IRS has always had an exception for "extraordinary circumstances" and in 2002 the IRS amended the policy to say that it would ask for limited tax accrual work papers if a company did not disclose one listed transaction and all tax accrual workpapers if the company did not disclose multiple listed transactions.[9]

The IRS has been thinking about changing its policy of restraint over the past year. Why? It realized that FIN 48 would cause companies' tax accrual work papers to include more useful information (e.g., cumulative probability analyses, issue-by-issue penalty assessments) and it has decided to revisit the policy. This is also part of the IRS's recent focus on enforcement issues, led by former Commissioner Mark Everson.[10]

While the IRS has not changed the policy yet, several senior LMSB officials have indicated that the policy is under review. LMSB Commissioner Debbie Nolan (who is retiring in October) has publicly said that the Service is reviewing the policy, and LMSB Senior Advisor Bob Adams said in July that the IRS is still considering changes to the policy.[11] Other IRS officials—most notably Chief Counsel Don Korb—have downplayed the possibility in public comments. Our view is that the IRS will likely retain its current policy of restraint in the short term. The recent departure of Commissioner Everson and the pending retirement of Ms. Nolan will probably cause the IRS to wait on making a major change like this. If a change is made, it would likely be after a new Administration is in place and a new IRS Commissioner is confirmed.

[6] IRM section 4.10.20.3. The IRS's prior position on tax accrual work papers is at Announcement 84-46, 1984-1 IRB 18.

[7] LMSB-04-0507-044, Doc 2007-15353 (5/10/07)

[8] 465 U.S. 805 (1984).

[9] Announcement 2002-63, 2002-2 CB 72.

[10] For a discussion of enforcement in the international area, see the article by Carlow & Shepherd, elsewhere in this issue.

[11] Jaworski, "Panel Debates Effect of FIN 48 on Transparency, Compliance" 116 Tax Notes 237 (7/23/07).

(5) Can Companies Use Attorney-Client Privilege or Work Product to Protect Their Outside Advice on Transactions? Companies can protect some documents in their tax accrual work papers using attorney-client privilege or work product privilege, but it is difficult. The attorney-client privilege (and the corresponding tax-practitioner privilege in Section 7525) protect legal and tax advice given to clients. Many documents in the tax accrual work papers can fit under the privilege, although sometimes it is hard to distinguish "legal advice" from "tax return preparation."

The problem with companies trying to invoke the attorney-client privilege is usually one of waiver. When a client discloses privileged communications to third parties, the disclosure waives the privilege with respect to that document and can waive the privilege over the entire subject matter. This often happens with tax accrual work papers because the auditor will ask to see the opinions or other privileged documents on certain issues, and when the company gives the documents to the auditor it waives the privilege because the auditor is a third party. Sometimes taxpayers try to argue that there is no waiver because the auditor is part of the team and the auditor's review is really tax advice covered by Section 7525. But this argument has never succeeded in court.

The better alternative for protecting documents in the tax accrual work papers is the work product doctrine, which protects materials prepared or gathered by an attorney in anticipation of litigation. The idea behind this privilege is that lawyers need to be able to write down their litigation ideas and strategies in a zone of privacy, without having to turn over their ideas to their adversaries.[12] Unlike the attorney-client privilege, the work product privilege is a qualified privilege, which means that it may be overcome by a showing of "substantial need." The recent *Textron*[13] decision is a bright spot for taxpayers on this issue. Textron was able to protect a spreadsheet in its tax accrual work papers that included counsel's judgments, in percentage terms, about all of Textron's sensitive tax positions and the dollar amounts reserved for each position. Textron also protected earlier drafts of the spreadsheet and a memo written by its in-house attorneys reflecting their opinions on each issue. The district court held that these documents were prepared in anticipation of litigation and let Textron protect the documents under the work product doctrine. IRS Chief Counsel, Don Korb, already indicated that the IRS does not agree with the court's holding and will likely appeal.[14]

(6) Will Foreign Countries Start Asking for Tax Accrual Work Papers? For multinationals, the IRS is not the only relevant taxing authority. Most large companies have to interface with foreign tax authorities as well. Some commentators have noted that FIN 48 might pique foreign countries' interest in obtaining tax accrual work papers, because FIN 48 will require companies to have more substantive materials (memos, predictions, etc.) in the workpapers. One particularly sensitive area could be the existence of a permanent establishment (PE) in a foreign country. A company might have operations in a foreign country, but take the position that it has no PE in that country and pay no taxes there. If the company believes there is a risk that it would lose a PE challenge, this would be an uncertain tax position covered by FIN 48. If the company thinks that it is more likely than not that it would lose a PE challenge, it must fully reserve on this issue. Foreign countries may want to see the FIN 48 work papers to investigate how the company views its chances on the PE issue.

Transfer pricing is another area where FIN 48 could cause problems for companies under audit in a foreign jurisdiction. Companies often set up reserves to cover their potential transfer pricing adjustments. Prior to FIN 48, there was likely little documentation of the reserve calculations in a company's tax accrual work papers. With FIN 48, the tax accrual work papers involving transfer pricing will be more revealing for two reasons. First, companies who do not want to reserve for transfer pricing issues will have to convince their auditors that it is more likely than not that there will be no adjustment. To do this, companies may have to get opinions or take other actions that they would not have taken under FAS 5. FIN 48 also prohibits companies from factoring detection risk into the analysis. In other words, it does not matter if the foreign jurisdiction has insufficient resources and is unlikely to audit a company's transfer pricing. FIN 48 requires that all tax positions must have a more-than-50% chance of winning on the merits. Second,

[12] Adlman, 134 F.3d 1194, 1196 (CA-2, 1988).

[13] 100 AFTR 2d 2007-XXXX, (8/28/2007).

[14] Daily Tax Report (8/31/07).

FIN 48's cumulative-probability analysis will likely make the work papers relating to transfer pricing adjustments more detailed. Companies are supposed to schedule out the likelihood of each audit outcome as part of this exercise. Certainly, foreign countries would be interested to see this information in their transfer pricing exams.

In addition, most countries presumably do not have a "policy of restraint" similar to the IRS's policy. This means that foreign jurisdictions could request tax accrual workpapers from multinationals. Many countries' revenue authorities are likely unfamiliar with GAAP tax reporting in general, and FIN 48 in particular. Also, most foreign auditors probably do not know that these companies are required to create tax accrual work papers that have this level of detailed analysis and predictions. When foreign jurisdictions learn about these developments in tax reporting for U.S. companies, they might decide to request these records. If so, it could have a big impact on foreign examinations. Companies should be aware of this possibility and be careful about what documents become part of the tax accrual work papers. Even if the IRS does not ask for the work papers, foreign countries might request them.

Finally, note that these foreign tax jurisdictions theoretically could share the workpapers with the IRS under information sharing treaties. While this is a possibility, LMSB Special Advisor Bob Adams said in July that he is not aware of any such requests involving tax accrual workpapers.

Conclusion

FIN 48 has in some ways come in with a whimper. It has changed the rules on how to report tax contingencies and it has created a lot more documentation for companies and auditors to review in evaluating a company's tax contingencies. But FIN 48 has not made a major impact on most companies' financial statements or opening retained earnings. Moreover, the revised disclosures have not created a road map for the IRS, as many had feared. It is still early in the implementation process and we will have to see where the balance ultimately falls, but an initial look at FIN 48's impact shows that it has not changed the tax-reporting landscape as much as some thought that it might. The real impact could be in the international area, if foreign countries begin to request tax accrual work papers.

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