ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES UNDER FASB ASC 740 (FIN 48)
FIN 48

- Prior to FIN 48, FASB ASC 450 (SFAS No. 5), *Accounting for Contingencies*, provided the guidance for tax contingencies. Under this statement an enterprise identified uncertain tax benefits and determined the likelihood of their losing that benefit.


- December 1, 2008-FASB issued FIN 48-2, *Effective date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, that deferred the effective date for one year.

- October 1, 2008-FASB agreed to defer the effective date for an additional year for private pass-through entities based on the entity’s tax status and on 10-15-2008, they decided to extend the additional year deferral to all non-public entities. Now for years beginning after December 15, 2008.
December 30, 2008-FASB released FIN 48-3, **Effective Date of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes**, for certain nonpublic enterprises, including non-for-profit for fiscal years beginning after December 15, 2008. Under FIN 48-3, a non-public enterprise that elect to defer the application must explicitly disclose that fact as well as disclose its accounting policy for evaluating uncertain tax positions for each set of financial statements where the deferral applies.
FIN 48

- This interpretation was issued in June 2006, to clarify the accounting for uncertainty tax position under FASB ASC 740 (FASB Statement 109). This interpretation provides for consistent criteria in the recognition, derecognition, and measurement to enhance comparability.

- This interpretation applies to all tax positions for which FASB ASC 740 applies. This refer to a position on a previously filed return or a position that is expected to be taken on as future return that is reflected in measurement of the current or deferred taxes.
This would also include classification of a transaction, entity, or other position as tax exempt; a decision not to file a tax return; allocation of income or shifting income between jurisdictions; and exclusion of income from a return or the characterization of reported income.

The Board has adopted an asset approach to the initial recognition process in a two-step process with a recognition threshold and then a step to measure the benefit.
FIN 48

- First step-A tax benefit is recognized when it is *more-likely-than-not* of being sustained on an audit based on the merits of the position.

- Second step-To measure the appropriate amount of the benefit to be recognized based on a best estimate measurement of the maximum amount which is more likely than not to be realized.
FIN 48

- This process would require the presumption that the tax position would be evaluated during an audit and the possibility of an offset or aggregation with other positions should not be considered.
- The classification of deferred liability as either current or non current would be based on the one year or operating cycle criteria that is used for classifying other liabilities.
- If the difference due to aggressive tax position is insignificant, it can be ignored.
FIN 48

- If no recognition is made for aggressive tax positions, the matching concept and the concept of SFAS 109 are not being followed.
- A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred taxes.
All tax positions are subject to FIN 48, regardless of their nature of the position, but the 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 uncertainty of a tax position may relate to the timing of a deduction, the amount of the deduction, or the validity of the deduction. This would include:

- A decision not to file a return;
- An allocation of income or a shift of income between jurisdictions;
- The characterization of income, or
- A decision to exclude taxable income in a tax return, and;
- A decision to classify a transaction, entity, or other position in a tax return as tax exempt.
Subsequent Recognition and Measurement and Changes in Judgment

- **Recognition**-If the more-likely-than-not recognition threshold is not initially met, new information should be used by management to ensure that the maximum amount which is more likely that not to be realized at each reporting date will represent their best estimate at that date.

- **Derecognition**-A previously recognized benefit from a tax position that no longer meets the more-likely-than-not recognition threshold shall be derecognized by recording the income tax liability or reducing the deferred tax asset in the period in which it becomes more-likely-than-not that the tax position would not be sustained in an audit.
FIN 48

- Disclosures
  - FIN 48 expanded disclosure requirements that are one of the more controversial aspect of this interpretation. These disclosures are required at each annual reporting period unless a significant change occurs in an interim period.

- Interest and Penalties
  - Interest that may be charged on an underpayment of income taxes by law must also be recognized as a charge to interest in the financial statements in the period the interest is deemed to have been incurred based on the difference between the tax position recognized in the financial statements and the amount previously claimed or expected to be claimed in the tax return. If penalties may be applied, then the enterprise must recognize a charge to income in the period the penalty is deemed to have been incurred for the amount of the statutory penalty.
FIN 48

- FASB ASC 740 (SFAS No. 109) classifies all tax positions as either a permanent difference or a temporary difference when the tax basis and the financial statement basis are not the same for assets and liabilities:
FIN 48

- Permanent differences - Tax positions taken that create a difference between the tax basis and the financial statement basis when the difference created will not have future tax consequences. These differences do not create deferred tax assets or liabilities.

- Temporary differences - Tax positions taken that create a difference between the tax basis and the financial statement basis when the difference create either a deferred tax asset or a deferred tax liability.
FIN 48

- Under FIN 48, an additional measurement was added when the more likely-than-not measurement criteria was adopted to determine the “best estimate” required by the Interpretation. Now the user may have three measurements to consider instead of only to:

1. The financial statement basis
2. The best estimate tax basis
3. The as filed tax basis
FIN 48

- Financial Statement Basis
- Best Estimate Tax Basis
- As Filed Tax Basis
- Deferred Tax Asset or Liability for Temporary Differences
- FIN 48 Liability
FIN 48

- The difference between the financial statement basis and the best estimate tax basis under FIN 48 will create a deferred tax asset or liability for all temporary differences that were not excluded.
- The difference between the best estimate tax basis under FIN 48 and the as-filed tax basis will create an uncertain tax position (FIN 48) liability.
- **There will be no uncertain tax position (FIN 48) liability if the best estimate and the as-filed positions are the same.**
FIN 48

- The user simply takes the difference between the “as filed” tax basis and the financial statement basis time the effective tax rate to determine the deferred tax asset or liability for each temporary difference that was not specially excluded by the Statement.

- The asset or liability would then be classified as either current or non-current based on the classification of the balance sheet item, then it would be classified based on the timing of when it is expected to reverse.
Example

<table>
<thead>
<tr>
<th>Temporary Difference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statements-Depreciation straight-line method</td>
<td>$10,000</td>
</tr>
<tr>
<td>Best estimate-Accelerated depreciation over 5 years</td>
<td>$25,000</td>
</tr>
<tr>
<td>As filed-Accelerated depreciation over 3 years</td>
<td>30,000</td>
</tr>
</tbody>
</table>
## Solution

<table>
<thead>
<tr>
<th>Temporary Difference (using 30% tax rate)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax liability-non current</td>
<td>$4,500</td>
</tr>
<tr>
<td>Fin 48 liability-non-current</td>
<td>$1,500</td>
</tr>
<tr>
<td>Income tax expense deferred (Includes fines and penalties for position)</td>
<td>$6,000</td>
</tr>
</tbody>
</table>
Permanent type differences and excluded temporary differences defined under FASB ASC 740 would never create a deferred tax amount; they would only create FIN 48 liabilities. (Example: decision to exclude certain income from the return, or charge certain expenses)

The uncertain type position (FIN 48) liability created will be classified as current or noncurrent based on the timing of the expected cash flows. There will be no uncertain tax position (FIN 48) liability if the best estimate and the as-filed positions are the same.
Exercise

- During 2005 an enterprise accrued but did not pay $2 million in environmental remediation costs. They did not expect to take a deduction for these costs in its 2005 tax return.
- Statutory tax rate is 40%. They recognized the $2 million expense, reduced by $800,000 deferred tax benefit which it recognized as a deferred tax asset.
- In December 2005, the Company accelerated the deductibility in 2005 and took a current tax benefit of $800,000 and decreased the deferred tax asset.
- In 2007 the enterprise evaluated the deduction and determined that their position does not meet the most likely than not recognition threshold.
Solution

Entries:

2005
1. Deferred tax assets $800,000
   Deferred tax benefit $800,000
2. Deferred tax benefit $800,000
   Deferred tax assets $800,000

2007
Deferred tax asset $800,000
Fin 48 liability $800,000
FIN 48-Independence Rule

- A member could assist an attest client with its application of FIN 48 provided the member is satisfied that the client understands the reason why a specific tax position does or does not meet the more-likely-than-not threshold and the basis for the determination of the amount of related tax benefits. The complexity of the subject matter should be considered in meeting the requirements of Interpretation 101-3, but generally, the did not believe that the complexities of applying FIN 48 would preclude members from assisting clients with its implementation.
Recognition of the benefit of a tax position is required in the first interim period in which one of the following occurs:

1. The more-likely-than-not recognition threshold is subsequently met;
2. The tax matter is effectively resolved favorably;
3. The applicable statutes of limitation have expired.
FIN 48-Subsequent Recognition and Measurement and Changes in Judgment

- A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including interest and penalties) shall be recognized as a discrete item in the period in which the change occurs.
A tax position is considered to be effectively settled through examination when all of the following conditions have been satisfied:

- The taxing authorities has completed its examination.
- The enterprise does not intend to appeal or litigate any aspect of a particular tax position for the completed examination.
- Based on a taxing authority's widely understood policy, the enterprise considers it remote the taxing authority would subsequently examine or reexamine any of the positions once the examination process is complete.
FSP FIN 48-1, Definition of Settlement in FASB Interpretation 48

- A tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled.
Measurement

- New Method-Cumulative Probability
  - Uncertain positions are recorded using graduated chart
    - Once a level that is “more likely than not” sustainable has been reached, that amount is used with the remainder accounted for as a reserve.

<table>
<thead>
<tr>
<th>Potential Estimated Outcome</th>
<th>Individual Probability of Occurring (%)</th>
<th>Cumulative Probability of Occurring (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>$75</td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td>$35</td>
<td>40%</td>
<td>95%</td>
</tr>
<tr>
<td>$0</td>
<td>5%</td>
<td>100%</td>
</tr>
</tbody>
</table>

“More likely than not” sustainable at $75, so a tax benefit of $75 is recognized with the remaining $25 accounted for as a reserve.
Classification

- The amount of benefit recognized in the statement of financial position and the amount taken, or expected to be taken, on the tax return may be different. These differences represent unrecognized tax benefits. The unrecognized tax benefits and the related interest and penalties will generally result in recognition of a liability under FIN 48. Alternately, the amount of net operating loss carry forward or amount of refundable tax may be reduced.
Classification

- An enterprise that has a liability for unrecognized tax benefits, and presents a classified statement of financial position, must classify this liability separately from other tax balances based on the expected timing of the cash flow, based on one year of operating cycle. Such amount should not be combined with deferred tax liabilities or assets.
Classification

- Interest may be classified as either income tax expense or interest expense and penalties may be classified as either income tax expense or other expense, depending on the individual accounting policy of the reporting Company. This policy and the resulting amount of interest and penalties and the change in interest and penalties must be reported each period.
Disclosures

- FIN 48 has expanded disclosure requirements that are one of the more controversial aspects of this interpretation. An enterprise must disclose its policy on classification of interest and penalties in then footnotes to the financial statements. The following disclosures are required at each annual reporting period presented:
  - A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at minimum:
    - Gross amount of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period. Changes may not be netted, they must be disclosed as gross increases or decreases.
Disclosures

- Gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during the period. Since this is an annual amount each year, it may only have an increase.
- The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities.
- Reduction to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.
- On October 1, 2008, the FASB Board decided to exempt private companies from these tabular reconciliation requirements.
Disclosures

- The total amount of unrecognized tax benefit that, if recognized, would affect the effective tax rate.
  - On October 1, 2008, The FASB Board decided to exempt private companies from this disclosure requirement.
- The total amount of interest and penalties recognized in the statement of operations and the total amount of interest and penalties recognized in the statement of financial position.
Disclosures

- For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
  - The nature of the uncertainty.
  - The nature of the event that could occur in the next 12 months that would cause the change.
  - An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

- A description of tax years that remain subject to examination by major tax jurisdictions.

- The cumulative effect of adopting FIN 48 on retained earnings is required in the year of adoption, but not in subsequent years.
The Company files income tax return in Puerto Rico. The Company is no longer subject to income tax examination by authorities for years before 2004. The Department of Treasury commenced an examination of the Company’s income tax returns for 2005 through 2008 in the first quarter of the year 2009 that is anticipated to be completed by the end of 2010. A December 31, 2009, the Department of Treasury has proposed certain significant adjustments to the Company’s transfer pricing and research credit tax positions. Management is currently evaluating those proposed adjustments to determine if it agrees, but if accepted, the Company does not anticipate the adjustments would result in a material change in its financial position. However, the Company anticipates that it is reasonably possible that an additional payment in the range of $80 to $100 millions will be made by the end of 2010.
Illustrative Disclosure

The Company has adopted the provisions of FASB ASC 740, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. As a result of the implementation, the Company recognized approximately a $200 million increase in the liability for unrecognized tax benefits. A reconciliation of the beginning and ending amount of unrecognized tax benefits follows:
Illustrative Disclosure

Balance at January 1, 2009 $370,000,000
Additions based on tax positions
  related to current year 10,000,000
Additions for tax positions of
  prior years 30,000,000
Reduction for tax positions of
  prior years (60,000,000)
Settlements (40,000,000)
Balance at December 31, 2009 $310,000,000

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Illustrative Disclosure

Included in the balance at December 31, 2009, are $60 million of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but accelerate the payment of cash to the taxing authority to an earlier period.

The Company recognizes interest accrued related to the unrecognized tax benefits in the interest expense and penalties operating expenses. During years ended December 31, 2009 and 2008, the Company recognized approximately $60 and $50 million for the payment of interest and penalties accrued at December 31, 2009, and 2008, respectively.
The disclosures required by FIN 48 are considered tax accrual work papers and they will be subject to the authorities policy of restraint. Under the policy of constraint, an revenue agent would normally ask for FIN 48 work papers in rare and unusual circumstances.
ILLUSTRATIVE FOOTNOTE 2

The net deferred tax liability in the accompanying balance sheet includes the following amounts of deferred tax assets and liabilities:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax liability</td>
<td>$660,000</td>
<td>$650,000</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>(380,000)</td>
<td>(410,000)</td>
</tr>
<tr>
<td>Valuation allowance</td>
<td>120,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Net deferred tax asset</td>
<td>260,000</td>
<td>260,000</td>
</tr>
<tr>
<td>Net deferred tax liability</td>
<td>$400,000</td>
<td>$390,000</td>
</tr>
</tbody>
</table>

The deferred tax liability results primarily from the use of accelerated methods of depreciation of equipment for tax purposes. The deferred tax assets result from tax credit carry forwards, accruals of estimated warranty costs that are not deductible, differences in the bad debts written off for tax purposes and the amount allowed under tax law, and a difference in inventory basis due to overhead costs capitalized under tax law.

The tax credit carry forwards total $525,000 and will expire in 2018.
The valuation allowance was established to reduce the deferred tax asset to the amount that will more likely than not to be realized. This reduction is necessary due to uncertainty of the Company’s ability to utilize all of the tax credit carry forwards before they expire.

The components of income tax expense (benefit) related to continuing operations are as follows:

<table>
<thead>
<tr>
<th>Income taxes</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$359,000</td>
<td>$229,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>45,000</td>
<td>108,000</td>
</tr>
<tr>
<td></td>
<td>$404,000</td>
<td>$337,000</td>
</tr>
</tbody>
</table>

We are subject to income taxes in Puerto Rico. Significant judgments are required in determining our provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial position, results of operations, or cash flows in the period or periods for which that determination is made.
FASB ASC 740, Accounting for Income Taxes, establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns. Accruals for uncertain tax positions are provided for in accordance with the requirements of the standard. Under the Standard, we may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examinations by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The standards also provides guidance on derecognition of income taxes and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with the tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, or cash flows.
As of December 31, 2009 and 2008, we have $500,000 and $300,000, respectively of unrecognized tax benefits of which $150,000, if recognized, would affect our effective tax rate. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. Interest accrued totals $25,000 and $20,000 in 2009 and 2008, respectively, for uncertain tax positions of $240,000 and $200,000, respectively, on our balance sheets.

The aggregate changes in the balance of unrecognized tax benefits were as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, beginning of year</td>
<td>$150,000</td>
</tr>
<tr>
<td>Decrease related to settlements</td>
<td>(25,000)</td>
</tr>
<tr>
<td>Increases for tax positions related to the current year</td>
<td>10,000</td>
</tr>
<tr>
<td>Increases for tax positions related to prior years</td>
<td>15,000</td>
</tr>
<tr>
<td>Decreases for tax positions related to prior years</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Reduction due to lapsed statute of limitations</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Balance, end of year</td>
<td>$130,000</td>
</tr>
</tbody>
</table>
Operating loss carry forwards totaling $50,000 are being carried forward to reduce future taxable income. This operating carry forward expires in year 2014. We establish valuation allowances for our deferral tax assets if, based on the available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.
QUESTIONS???????