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Financial Accounting Series

FASB Interpretation No. 48

Accounting for Uncertainty
in Income Taxes

an interpretation of FASB Statement No. 109



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of the Financial Accounting Foundation

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Summary

This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one of the following:

- a. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable
- b. A reduction in a deferred tax asset or an increase in a deferred tax liability
- c. Both (a) and (b).

An enterprise that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year or the operating cycle, if longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this Interpretation and its reported amount in the statement of financial position). This Interpretation does not change the classification requirements for deferred taxes.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation

allowance as described in Statement 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this Interpretation.

Reason for Issuing This Interpretation

In principle, the validity of a tax position is a matter of tax law. It is not controversial to recognize the benefit of a tax position in an enterprise's financial statements when the degree of confidence is high that that tax position will be sustained upon examination by a taxing authority. However, in some cases, the law is subject to varied interpretation, and whether a tax position will ultimately be sustained may be uncertain. Statement 109 contains no specific guidance on how to address uncertainty in accounting for income tax assets and liabilities. As a result, diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.

How This Interpretation Will Improve Financial Reporting

This Interpretation will result in increased relevance and comparability in financial reporting of income taxes because all tax positions accounted for in accordance with Statement 109 will be evaluated for recognition, derecognition, and measurement using consistent criteria. Finally, the disclosure provisions of this Interpretation will provide more information about the uncertainty in income tax assets and liabilities.

How the Conclusions in This Interpretation Relate to the Conceptual Framework

In developing the recognition and measurement guidance of this Interpretation, the Board considered the qualitative characteristics discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. Those characteristics emphasize that comparable information enables users to identify similarities in and differences between two sets of economic events. This Interpretation establishes a consistent threshold for recognizing current and deferred taxes.

When a position is taken in a tax return that reduces the amount of income taxes paid to a taxing authority, the enterprise realizes an immediate economic benefit. However, considerable time can elapse before the acceptability of that tax position is determined. This Interpretation requires the affirmative evaluation that it is more likely than not, based on the

technical merits of a tax position, that an enterprise is entitled to economic benefits resulting from positions taken in income tax returns. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements.

The Effective Date of This Interpretation

This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this Interpretation is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted.

FASB Interpretation No. 48

Accounting for Uncertainty in Income Taxes

an interpretation of FASB Statement No. 109

June 2006



Financial Accounting Standards Board
of the Financial Accounting Foundation

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June 2006

INTRODUCTION

1. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Statement 109 does not prescribe a recognition threshold or measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. Consistent with Statement 109, the term *enterprise* is used throughout this Interpretation because accounting for income taxes is primarily an issue for business enterprises. However, the requirements of this Interpretation apply to not-for-profit organizations. This Interpretation also applies to pass-through entities and entities whose tax liability is subject to 100 percent credit for dividends paid (for example, real estate investment trusts and registered investment companies) that are potentially subject to income taxes.

2. Diversity in practice exists in the accounting for income taxes. To address that diversity, this Interpretation clarifies the application of Statement 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. Additionally, this Interpretation provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

INTERPRETATION

Scope

3. This Interpretation applies to all tax positions accounted for in accordance with Statement 109.

4. The term *tax position* as used in this Interpretation refers to a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods.

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 tax assets. The term *tax position* also encompasses, but is not limited to:

- a. A decision not to file a tax return
- b. An allocation or a shift of income between jurisdictions
- c. The characterization of income or a decision to exclude reporting taxable income in a tax return
- d. A decision to classify a transaction, entity, or other position in a tax return as tax exempt.

Recognition

5. The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used in applying the provisions of this Interpretation shall consider the manner in which the enterprise prepares and supports its income tax return and the approach the enterprise anticipates the taxing authority will take during an examination.

6. An enterprise shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. As used in this Interpretation, the term *more likely than not* means a likelihood of more than 50 percent; the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any. The more-likely-than-not recognition threshold is a positive assertion that an enterprise believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date.

7. In assessing the more-likely-than-not criterion as required by paragraph 6 of this Interpretation:

- a. It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.
- b. Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the

- enterprise or similar enterprises are widely understood, those practices and precedents shall be taken into account.
- c. Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.

Measurement

8. A tax position that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement¹ using the facts, circumstances, and information available at the reporting date. As used in this Interpretation, the term *reporting date* refers to date of the enterprise's most recent statement of financial position.

Tax-Planning Strategies

9. When a tax-planning strategy is contemplated as a source of future taxable income to support the realizability of a deferred tax asset under paragraph 21(d) of Statement 109, paragraphs 5–8 of this Interpretation shall be applied in determining the amount of available future taxable income.

Subsequent Recognition, Derecognition, and Measurement

10. If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an enterprise shall recognize the benefit of the tax position in the first interim period that meets any one of the following three conditions:

- a. The more-likely-than-not recognition threshold is met by the reporting date.
- b. The tax matter is ultimately settled through negotiation or litigation.
- c. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

¹For further explanation and illustration, see the illustrative examples in paragraphs A19–A30.

11. An enterprise shall derecognize a previously recognized tax position in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination. Use of a valuation allowance² is not a permitted substitute for derecognizing the benefit of a tax position when the more-likely-than-not recognition threshold is no longer met.

12. Subsequent recognition, derecognition, and measurement shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. A tax position need not be legally extinguished and its resolution need not be certain to subsequently recognize or measure the position. Subsequent changes in judgment that lead to changes in recognition, derecognition, and measurement should result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.

Change in Judgment

13. 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 any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs. The provisions of paragraphs 35 and 38 in Statement 109 that pertain to intraperiod tax allocation are not changed by this Interpretation.

14. A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior interim period within the same fiscal year is an integral part of an annual period and, consequently, shall be reflected pursuant to the provisions of paragraph 19 of APB Opinion No. 28, *Interim Financial Reporting*, and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*.

Interest and Penalties

15. When the tax law requires interest to be paid on an underpayment of income taxes, an enterprise shall begin recognizing interest expense in the first period the interest would begin accruing according to the provisions of the relevant tax law. The amount of interest expense to be recognized shall be computed by applying the applicable statutory rate of interest to the difference between the tax position recognized in accordance with this Interpretation and the amount previously taken or expected to be taken in a tax return.

²The term *valuation allowance* in this Interpretation has the same meaning as in Statement 109.

16. If a tax position does not meet the minimum statutory threshold to avoid payment of penalties (considering the factors in paragraph 7 of this Interpretation), an enterprise shall recognize an expense for the amount of the statutory penalty in the period in which the enterprise claims or expects to claim the position in the tax return. If penalties were not recognized when the position was initially taken, the expense shall be recognized in the period in which the enterprise's judgment about meeting the minimum statutory threshold changes. Previously recognized interest and penalties associated with tax positions that subsequently meet one of the conditions in paragraph 10 of this Interpretation shall be derecognized in the period that condition is met.

Classification

17. As a result of applying this Interpretation, the amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits, which are the differences between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to this Interpretation. A liability is created (or the amount of a net operating loss carryforward or amount refundable is reduced) for an unrecognized tax benefit because it represents an enterprise's potential future obligation to the taxing authority for a tax position that was not recognized pursuant to this Interpretation. An enterprise that presents a classified statement of financial position shall classify a liability associated with an unrecognized tax benefit as a current liability (or the amount of a net operating loss carryforward or amount refundable is reduced) to the extent the enterprise anticipates payment (or receipt) of cash within one year or the operating cycle, if longer. The liability for unrecognized tax benefits (or reduction in amounts refundable) shall not be combined with deferred tax liabilities or assets.

18. A tax position recognized in the financial statements as a result of applying this Interpretation may also affect the tax bases of assets or liabilities and thereby change or create temporary differences. A taxable and deductible temporary difference is a difference between the reported amount of an item in the financial statements and the tax basis of an item as determined by applying the recognition threshold and measurement provisions of this Interpretation. A liability recognized as a result of applying this Interpretation shall not be classified as a deferred tax liability unless it arises from a taxable temporary difference.

19. Interest recognized in accordance with paragraph 15 of this Interpretation may be classified in the financial statements as either income taxes or interest expense, based on the accounting policy election of the enterprise. Penalties recognized in accordance with paragraph 16 of this Interpretation may be classified in the financial statements as either income taxes or another expense classification, based on the accounting policy election of the enterprise. Those elections shall be consistently applied.

Disclosures

20. An enterprise shall disclose its policy on classification of interest and penalties in accordance with paragraph 19 of this Interpretation in the footnotes to the financial statements.

21. An enterprise shall disclose the following at the end of each annual reporting period presented:

- a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:
 - (1) The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
 - (2) The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period
 - (3) The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
 - (4) Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations
- b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate
- c. The 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. 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:
 - (1) The nature of the uncertainty
 - (2) The nature of the event that could occur in the next 12 months that would cause the change
 - (3) An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made
- e. A description of tax years that remain subject to examination by major tax jurisdictions.

EFFECTIVE DATE AND TRANSITION

22. This Interpretation shall be effective for fiscal years beginning after December 15, 2006. Earlier adoption is permitted as of the beginning of an enterprise's fiscal year, provided the enterprise has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

23. The provisions of this Interpretation shall be applied to all tax positions upon initial adoption of this Interpretation. Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of this Interpretation. The cumulative effect of applying the provisions of this Interpretation shall be reported as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment does not include items that would not be recognized in earnings, such as the effect of adopting this Interpretation on tax positions related to business combinations. The amount of that cumulative-effect adjustment is the difference between the net amount of assets and liabilities recognized in the statement of financial position prior to the application of this Interpretation and the net amount of assets and liabilities recognized as a result of applying the provisions of this Interpretation.

24. An enterprise shall disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption. This disclosure is required only in the year of adoption.

**The provisions of this Interpretation need
not be applied to immaterial items.**

This Interpretation was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
George J. Batavick
G. Michael Crooch
Katherine Schipper
Leslie F. Seidman
Edward W. Trott
Donald M. Young

Appendix A

ILLUSTRATIVE GUIDANCE FOR APPLYING THIS INTERPRETATION

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Appendix A

ILLUSTRATIVE GUIDANCE FOR APPLYING THIS INTERPRETATION

Introduction

A1. This appendix, which is an integral part of the requirements of this Interpretation, provides illustrative guidance for applying the provisions of this Interpretation. The examples and related assumptions in this appendix are illustrative only; the examples are not all-inclusive and they may not represent actual situations. The tables in paragraphs A21 and A23 are intended to assist in understanding the provisions of this Interpretation. The Board does not intend to imply a documentation requirement by including these examples in this Interpretation.

Recognition Examples

Two-Step Process

A2. The application of this Interpretation requires a two-step process that separates recognition from measurement. The first step is determining whether a tax position has met the recognition threshold; the second step is measuring a tax position that meets the recognition threshold. The recognition threshold is met when the taxpayer (the reporting enterprise) concludes that, consistent with paragraphs 5–7 of this Interpretation, it is more likely than not that the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort.

A3. Relatively few disputes are ultimately settled in litigation, and very few are taken to the court of last resort. Generally, the taxpayer and the taxing authority negotiate a settlement to avoid the costs and hazards of litigation. As a result, the measurement of the tax position is based on management's best judgment of the amount the taxpayer would ultimately accept in a settlement with taxing authorities.

A4. This Interpretation requires that the enterprise recognize the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Recognition Determinations Are Made for Each Unit of Account

A5. An enterprise anticipates claiming a \$1 million research and experimentation credit on its tax return for the current fiscal year. The credit comprises equal spending on 4 separate projects (that is, \$250,000 of tax credit per project). The enterprise expects to have sufficient taxable income in the current year to fully utilize the \$1 million credit. Upon review of the supporting documentation, management believes it is more likely than not that the enterprise will ultimately sustain a benefit of approximately \$650,000. The anticipated benefit consists of approximately \$200,000 per project for the first 3 projects and \$50,000 for the fourth project.

A6. In its evaluation of the appropriate amount to recognize, management first determines the appropriate unit of account for the tax position. Because of the magnitude of expenditures in each project, management concludes that the appropriate unit of account is each individual research project. In reaching this conclusion, management considers both the level at which it accumulates information to support the tax return and the level at which it anticipates addressing the issue with taxing authorities. In this example, upon review of the four projects including the magnitude of expenditures, management determines that it accumulates information at the project level. Management also anticipates the taxing authority will address the issues during an examination at the level of individual projects.

A7. In evaluating the projects for recognition, management determines that three projects meet the more-likely-than-not recognition threshold. However, due to the nature of the activities that constitute the fourth project, it is uncertain that the tax benefit related to this project will be allowed. Because the tax benefit related to that fourth project does not meet the more-likely-than-not recognition threshold, it should not be recognized in the financial statements, even though tax positions associated with that project will be included in the tax return. The enterprise would recognize a \$600,000 financial statement benefit related to the first 3 projects but would not recognize a financial statement benefit related to the fourth project.

Change in the Unit of Account

A8. Presume the facts in the preceding example for year 1. In year 2, the enterprise increases its spending on research and experimentation projects and anticipates claiming significantly larger research credits in its year 2 tax return. In light of the significant increase in expenditures, management reconsiders the appropriateness of the unit of account and concludes that the project level is no longer the appropriate unit of account for research credits. This conclusion is based on the magnitude of spending and anticipated claimed credits and on previous experience and is consistent with the advice of external tax advisors.

Management anticipates the taxing authority will focus the examination on functional expenditures when examining the year 2 return and thus needs to evaluate whether it can change the unit of account in subsequent years' tax returns.

A9. Determining the unit of account requires evaluation of the enterprise's facts and circumstances. In making that determination, management evaluates the manner in which it prepares and supports its income tax return and the manner in which it anticipates addressing issues with taxing authorities during an examination. The unit of account should be consistently applied to similar positions from period to period unless a change in facts and circumstances indicates that a different unit of account is more appropriate. Because of the significant change in the tax position in year 2, management's conclusion that the taxing authority will likely examine tax credits in the year 2 tax return at a more detailed level than the individual project is reasonable and appropriate. Accordingly, the enterprise should reevaluate the unit of account for the year 2 financial statements based on the new facts and circumstances.

Recognition of a Liability upon Adoption

A10. On December 31, 2005, an enterprise accrued but did not pay \$1 million in environmental remediation costs. The enterprise did not expect to take a deduction for those costs in its income tax return. The enterprise has a statutory effective tax rate of 40 percent and recognized a \$1 million expense, reduced by a \$400,000 deferred tax benefit which it recognized as a deferred tax asset. The enterprise had sufficient future taxable income of an appropriate character and did not recognize a valuation allowance on the deferred tax asset. Also on December 31, 2005, the enterprise entered into a transaction that accelerated the deductibility of the environmental remediation costs into the current year. As a result, the enterprise took a current tax benefit of \$400,000, with a corresponding decrease to the deferred tax asset. The enterprise took this position in its 2005 income tax return. Upon adopting the provisions of this Interpretation on January 1, 2007, the enterprise evaluates the accelerated deduction of the environmental remediation costs and determines that the position does not meet the more-likely-than-not recognition threshold. The enterprise does not believe that previously recognizing those costs was an error (as defined in FASB Statement No. 154, *Accounting Changes and Error Corrections*) based on its historical accounting policy for considering tax law uncertainties.

A11. The enterprise does not expect that it will make any payments to the taxing authority related to the deduction of those accelerated costs within the next 12 months, which is the company's operating cycle. Accordingly, the enterprise would derecognize the tax benefit related to those accelerated costs by recognizing a \$400,000 increase in the noncurrent tax liability, with a corresponding increase in the deferred tax asset. The enterprise determines

that it has sufficient future taxable income of the appropriate character, and thus a valuation allowance is not necessary. Based on the provisions of the tax law, the enterprise would evaluate the tax position for accrual of interest and penalties.

Administrative Practices—Asset Capitalization

A12. An enterprise has established a capitalization threshold of \$2,000 for its tax return for routine property and equipment purchases. Assets purchased for less than \$2,000 are claimed as expenses on the tax return in the period they are purchased. The tax law does not prescribe a capitalization threshold for individual assets, and there is no materiality provision in the tax law. The enterprise has not been previously examined. Management believes that based on previous experience at a similar enterprise and current discussions with its external tax advisors, the taxing authority will not disallow tax positions based on that capitalization policy and the taxing authority’s historical administrative practices and precedents.

A13. Some might deem the enterprise’s capitalization policy a technical violation of the tax law, since that law does not prescribe capitalization thresholds. However, in this situation the enterprise has concluded that the capitalization policy is consistent with the demonstrated administrative practices and precedents of the taxing authority and the practices of other enterprises that are regularly examined by the taxing authority. Based on its previous experience with other enterprises and consultation with its external tax advisors, management believes the administrative practice is widely understood. Accordingly, because management expects the taxing authority to allow this position when and if examined, the more-likely-than-not recognition threshold has been met.

Administrative Practices—Nexus

A14. An enterprise has been incorporated in Jurisdiction A for 50 years; it has filed a tax return in Jurisdiction A in each of those 50 years. The enterprise has been doing business in Jurisdiction B for approximately 20 years and has filed a tax return in Jurisdiction B for each of those 20 years. However, the enterprise is not certain of the exact date it began doing business, or the date it first had nexus, in Jurisdiction B. Upon adoption of this Interpretation, the enterprise commences a review of all open tax years in all jurisdictions.

A15. If a tax return is not filed, the statute of limitations never begins to run; accordingly, failure to file a tax return effectively means there is no statute of limitations. The enterprise has become familiar with the administrative practices and precedents of Jurisdiction B and understands that Jurisdiction B will look back only six years in determining if there is a tax return due and a deficiency owed. Because of the administrative practices of the taxing

authority and the facts and circumstances, the enterprise believes it is more likely than not that a tax return is not required to be filed in Jurisdiction B at an earlier date and that a liability for tax exposures for those periods is not required upon adoption of this Interpretation.

Valuation Allowance and Tax-Planning Strategies

A16. An enterprise has a wholly owned subsidiary with certain deferred tax assets as a result of several years of losses from operations. Management has determined that it is more likely than not that sufficient future taxable income will not be available to realize those deferred tax assets. Therefore, management recognizes a full valuation allowance for those deferred tax assets both in the separate financial statements of the subsidiary and in the consolidated financial statements of the enterprise.

A17. Management has identified certain tax-planning strategies that might enable the realization of those deferred tax assets. Management has determined that the strategies will meet the minimum statutory threshold to avoid penalties and that it is not more likely than not that the strategies would be sustained upon examination based on the technical merits.

A18. Accordingly, those strategies may not be used to reduce the valuation allowance on the deferred tax assets. Only a tax-planning strategy that meets the more-likely-than-not recognition threshold would be considered in evaluating the sufficiency of future taxable income for realization of deferred tax assets.

Measurement Examples

Highly Certain Tax Positions

A19. An enterprise has taken a tax position that it believes is based on clear and unambiguous tax law for the payment of salaries and benefits to employees. The class of salaries being evaluated in this tax position is not subject to any limitations on deductibility (for example, executive salaries are not included), and none of the expenditures are required to be capitalized (for example, the expenditures do not pertain to the production of inventories); all amounts accrued at year-end were paid within the statutorily required time frame subsequent to the reporting date. Management concludes that the salaries are fully deductible.

A20. Because of the difficulty of defining an uncertain tax position, the Board decided that all tax positions are subject to the provisions of this Interpretation. However, because the deduction is based on clear and unambiguous tax law, management has a high confidence level in the technical merits of this position. Accordingly, the tax position clearly meets the

recognition criterion and should be evaluated for measurement. In determining the amount to measure, management is highly confident that the full amount of the deduction will be allowed and it is clear that it is greater than 50 percent likely that the full amount of the tax position will be ultimately realized. Accordingly, the enterprise would recognize the full amount of the tax position in the financial statements.

Measurement with Information about the Approach to Settlement (Scenario 1)

A21. In applying the recognition criterion of this Interpretation, an enterprise has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. The enterprise has considered the amounts and probabilities of the possible estimated outcomes as follows:

<u>Possible Estimated Outcome</u>	<u>Individual Probability of Occurring (%)</u>	<u>Cumulative Probability of Occurring (%)</u>
\$100	5	5
80	25	30
60	25	55
50	20	75
40	10	85
20	10	95
0	5	100

A22. Because \$60 is the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement, the enterprise would recognize a tax benefit of \$60 in the financial statements.

Measurement with Information about the Approach to Settlement (Scenario 2)

A23. In applying the recognition criterion of this Interpretation, an enterprise has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. There is limited information about how a taxing authority will view the position. After considering all relevant information, management’s confidence in the technical merits of the tax position exceeds the more-likely-than-not recognition threshold, but management also believes it is likely it would settle for less than the full amount of the

entire position when examined. Management has considered the amounts and the probabilities of the possible estimated outcomes:

<u>Possible Estimated Outcome</u>	<u>Individual Probability of Occurring (%)</u>	<u>Cumulative Probability of Occurring (%)</u>
\$100	25	25
75	50	75
50	25	100

A24. Because \$75 is the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement, the enterprise would recognize a tax benefit of \$75 in the financial statements.

Measurement of a Tax Position after Settlement of a Similar Position

A25. In applying the recognition criterion of this Interpretation, an enterprise has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. In a recent settlement with the taxing authority, the enterprise has agreed to the treatment for that position for current and future years. There are no recently issued relevant sources of tax law that would affect the enterprise’s assessment. The enterprise has not changed any assumptions or computations, and the current tax position is consistent with the position that was recently settled. In this case, the enterprise would have a very high confidence level about the amount that will be ultimately realized and little information about other possible outcomes. Management will not need to evaluate other possible outcomes because it can be confident of the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement without that evaluation.

Differences Related to Timing of Deductibility

A26. In year 1, an enterprise acquired a separately identifiable intangible asset for \$15 million that has an indefinite life for financial statement purposes and is, therefore, not subject to amortization. Based on some uncertainty in the tax code, the enterprise decides for tax purposes to deduct the entire cost of the asset in year 1. While the enterprise is certain that the full amount of the intangible is ultimately deductible for tax purposes, the timing of deductibility is uncertain under the tax code. In applying the recognition criterion of this Interpretation, the enterprise has determined that the tax position qualifies for recognition and should be measured. The enterprise believes it is 25 percent likely it would be able to realize immediate deduction upon ultimate settlement, and it is certain it could sustain a

15-year amortization for tax purposes. Thus, the largest year 1 benefit that is greater than 50 percent likely of being realized upon ultimate settlement is the tax effect of \$1 million (the year 1 deduction from straight-line amortization of the asset over 15 years).

A27. At the end of year 1, the enterprise should reflect a deferred tax liability for the tax effect of the temporary difference created by the difference between the financial statement basis of the asset (\$15 million) and the tax basis of the asset computed in accordance with this Interpretation (\$14 million, the cost of the asset reduced by \$1 million of amortization). The enterprise also should reflect a tax liability for the tax-effected difference between the as-filed tax position (\$15 million deduction) and the amount of the deduction that is considered more likely than not of being sustained (\$1 million). The enterprise should evaluate the tax position for accrual of statutory penalties as well as interest expense on the difference between the amounts reported in the financial statements and the tax position taken in the tax return.

Change in Timing of Deductibility

A28. Prior to the issuance of this Interpretation, an enterprise took a tax position in which it amortized the cost of an acquired asset on a straight-line basis over three years, while the amortization period for financial reporting purposes is seven years. At the date the enterprise adopts this Interpretation, it has deducted one-third of the cost of the asset in its income tax return and one-seventh of the cost in the financial statements and, consequently, has a deferred tax liability for the difference between the financial reporting and tax bases of the asset.

A29. Upon adoption, the enterprise evaluates the tax position in accordance with the provisions of this Interpretation. The enterprise determines that it is certain that the entire cost of the acquired asset is fully deductible, so the more-likely-than-not recognition threshold has been met. However, the enterprise believes that the largest benefit that is greater than 50 percent likely of being realized upon ultimate settlement is straight-line amortization over 7 years.

A30. Upon adoption of this Interpretation, the enterprise should eliminate the deferred tax liability, recognize a liability for unrecognized tax benefits based on the difference between the three- and seven-year amortization, and recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. Additionally, the enterprise should begin accruing interest and penalties, if applicable under the tax law.

Subsequent Events

A31. Enterprise A has evaluated a tax position at its most recent reporting date and has concluded that the position meets the more-likely-than-not recognition threshold. In evaluating the tax position for recognition, Enterprise A considered all relevant sources of tax law, including a court case in which the taxing authority has fully disallowed a similar tax position with an unrelated enterprise (Enterprise B). The taxing authority and Enterprise B are aggressively litigating the matter. Although Enterprise A was aware of that court case at the recent reporting date, management determined that the more-likely-than-not recognition threshold had been met. Subsequent to the reporting date, but prior to the issuance of the financial statements, the taxing authority prevailed in its litigation with Enterprise B, and Enterprise A concludes that it is no longer more likely than not that it will sustain the position.

A32. Paragraph 11 of this Interpretation notes that “an enterprise shall derecognize a previously recognized tax position in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination,” and paragraph 12 indicates that “subsequent recognition, derecognition, and measurement shall be based on management’s best judgment given the facts, circumstances, and information available at the reporting date.” Because the resolution of Enterprise B’s litigation with the taxing authority is the information that caused Enterprise A to change its judgment about the sustainability of the position and that information was not available at the reporting date, the change in judgment would be recognized in the first quarter of the current fiscal year.

Illustrative Disclosure

A33. The following example illustrates disclosures about uncertainty in income taxes. In this illustrative example, the reporting entity has adopted the provisions of this Interpretation for the year ended December 31, 2007:

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2001. The Internal Revenue Service (IRS) commenced an examination of the Company’s U.S. income tax returns for 2002 through 2004 in the first quarter of 2007 that is anticipated to be completed by the end of 2008. As of December 31, 2007, the IRS has proposed certain significant adjustments to the Company’s transfer pricing and research credits 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 to its financial position. However, the Company anticipates that it is reasonably possible that an additional payment in the range of \$80 to \$100 million will be made by the end of 2008.

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. As a result of the implementation of Interpretation 48, the Company recognized approximately a \$200 million increase in the liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007, balance of retained earnings. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	(in millions)
Balance at January 1, 2007	\$370,000
Additions based on tax positions related to the current year	10,000
Additions for tax positions of prior years	30,000
Reductions for tax positions of prior years	(60,000)
Settlements	<u>(40,000)</u>
Balance at December 31, 2007	<u>\$310,000</u>

Included in the balance at December 31, 2007, 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 would accelerate the payment of cash to the taxing authority to an earlier period.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 2007, 2006, and 2005, the Company recognized approximately \$10, \$11, and \$12 million in interest and penalties. The Company had approximately \$60 and \$50 million for the payment of interest and penalties accrued at December 31, 2007, and 2006, respectively.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Interpretation. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background

B2. Diverse accounting practices had developed with respect to the recognition and measurement of current and deferred tax assets and liabilities in financial statements. That diversity resulted from inconsistency in the criteria used to recognize, derecognize, and measure the economic benefits associated with tax positions.

B3. On July 12, 2005, the Board issued an Exposure Draft, *Uncertain Tax Positions*, that proposed guidance for the recognition, derecognition, and measurement of tax positions, as well as certain disclosure requirements. The Board received 118 comment letters on the Exposure Draft. On October 10, 2005, the Board held a public roundtable discussion on issues addressed in the Exposure Draft and comments received in the comment letters. The Board considered comments and concerns raised by respondents and constituents in its redeliberations of the issues addressed by the Exposure Draft in public meetings from December 2005 through May 2006. This Interpretation reflects the results of those deliberations.

B4. Prior to the issuance of this Interpretation, tax positions were sometimes recognized in the financial statements on an as-filed or to-be-filed tax basis, such that current or deferred tax assets and liabilities were immediately recognized when the related tax position was taken (or expected to be taken). In some cases, the ultimate realizability of any current or deferred tax benefit was evaluated and a valuation allowance was recorded.

B5. Tax positions were also sometimes categorized as uncertain, but not aggressive, and recognized on a best estimate basis or when the benefit met the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*. They were also sometimes deemed aggressive based on an enterprise's preestablished criteria and accounted for in accordance with the guidance on accounting for gain contingencies in paragraph 17 of FASB Statement No. 5, *Accounting for Contingencies*.

B6. Finally, tax positions were sometimes recognized based on a predetermined threshold of whether the positions would be sustained on examination and reduced by a liability for a contingent loss that was recorded either when the threshold was no longer met or when it became probable that a payment would be made to the taxing authority.

B7. In developing this Interpretation, the Board considered the following issues:

- a. Whether the financial statement recognition of a tax position should presume a review of an individual tax position during an examination by a taxing authority
- b. How the nature of evidence supporting a tax position should be used to establish recognition and measurement guidance.

B8. The Board considered the approaches currently used in practice to recognize and measure the financial statement consequences of tax positions and developed two kinds of alternative approaches: those that combine recognition and measurement into a single methodology and those that treat recognition and measurement separately. The Board considered:

- a. Measuring tax assets and liabilities at fair value or using fair-value-type measurement techniques, which combine recognition and measurement
- b. Three recognition approaches that require separate consideration of measurement:
 - (1) Recognition when a tax position has met a minimum statutory threshold and additional amounts are not anticipated to be paid to settle underpayment controversies
 - (2) Recognition and derecognition based on a single threshold
 - (3) Recognition when a tax position has met a specified confidence level and derecognition when the position falls below a specified confidence level.

Objective of This Interpretation

B9. This Interpretation provides guidance for recognizing and measuring tax positions taken or expected to be taken in a tax return that directly or indirectly affect amounts reported in financial statements. This Interpretation also provides accounting guidance for the related income tax effects of tax positions that do not meet the recognition threshold specified in this Interpretation.

Scope of This Interpretation

B10. The Board considered whether to apply the provisions of this Interpretation to all taxes (income taxes and other taxes), to all tax positions subject to Statement 109, or to some subset of tax positions deemed to be uncertain based on their attributes. The Exposure Draft

stated that the “proposed Interpretation would broadly apply to all tax positions accounted for in accordance with Statement 109, including tax positions that pertain to assets and liabilities acquired in business combinations. It would apply to tax positions taken in tax returns previously filed as well as positions anticipated to be taken in future tax returns.”

B11. Respondents to the Exposure Draft suggested that normal business transactions be excluded from the scope of the final Interpretation and that the final Interpretation apply only to tax positions characterized by (a) substantial uncertainty (such as tax shelters, tax motivated positions, and listed transactions) or (b) nontaxable or nondeductible differences between financial statements and tax returns (sometimes referred to as permanent differences).

B12. In its redeliberations, the Board considered whether to apply the provisions of this Interpretation to all income tax positions or some subset of income tax positions, specifically, **uncertain** tax positions. The Board concluded that limiting the application to only uncertain tax positions, or tax positions with specified attributes, would create a rules-based standard that would result in inconsistent application and would add complexity to the accounting guidance for income taxes. The Board does not anticipate that this Interpretation will have a significant effect on how enterprises account for tax positions that are routine business transactions that are clearly more likely than not of being sustained at their full amounts upon examination (see the example in paragraphs A19 and A20). Accordingly, the Board decided that this Interpretation should broadly apply to all tax positions.

Unit of Account

B13. The Exposure Draft indicated that the appropriate unit of account would be a matter of individual facts and circumstances evaluated in light of all available evidence. Respondents to the Exposure Draft requested that the Board provide additional guidance on the unit of account in the final Interpretation. The Board believes that it is not possible to provide definitive guidance that would address every circumstance on how to determine the unit of account. Because the individual facts and circumstances of a tax position and of an enterprise taking that position will determine the appropriate unit of account, the Board does not believe a single defined unit of account would be applicable to all situations.

B14. The Board decided to describe two factors that should affect the determination of the unit of account: the manner in which the enterprise prepares and supports its income tax returns and the approach the enterprise anticipates the taxing authority will take during an examination. Both factors would be expected to vary with the facts and circumstances of a

tax position and of the enterprise taking that position. In addition, consistent with other presumptions in this Interpretation, the Board believes that the determination of the unit of account should presume that taxing authorities will evaluate the position and have full knowledge of all relevant information.

Benefit Recognition Approach

B15. A tax position could result in or affect the measurement of a current or deferred tax asset or liability in the statement of financial position. Accordingly, the Board considered both a benefit recognition approach, under which only a tax position that meets a stated confidence level would be recognized in the financial statements, and an impairment approach, which would require a determination of the amount of incremental income taxes that an enterprise might have to pay. Under an impairment approach, the as-filed tax position would be recognized in the financial statements and a liability would be recognized when, at a stated confidence level, an incremental payment would be made to the taxing authority.

B16. The Board decided that there is conceptual support for both a benefit recognition approach and an impairment approach. However, the Board decided that an impairment approach, which presumes the existence of a benefit, would not be appropriate when an enterprise cannot conclude, to a specified confidence level, that it is entitled to the economic benefits of a tax position. Therefore, the Board decided to use the notion of a specified confidence level as a precondition for recognition in a benefit recognition approach.

Examination Risk

B17. The Board considered whether uncertainty about the examination of a tax position by taxing authorities (examination risk) should be a factor in the decision to recognize the effect of a tax position.

B18. Liabilities are required to be recognized when the obligating event has occurred. For current income tax liabilities, the obligating event is the generation of taxable income. Generally, income tax systems are founded on the principles of compliance, self-assessment, and self-reporting. That is, a taxpayer computes its taxable income and related tax liability and reports that information to taxing authorities as required by law. The enforcement powers of the taxing authority are secondary to the self-assessment and self-reporting requirements.

B19. Some Board members believe that basing the accounting for tax positions on examination risk—the risk that a taxing authority would examine a particular tax position—is analogous to reporting accounts payable based not on the amount owed but, rather, on the amount that would be ultimately paid if the creditor filed suit to collect the liability.

B20. The Board considered the guidance on unasserted claims in paragraph 38 of Statement 5. The Board does not believe that guidance is applicable to tax positions because a tax return is generally required to be filed based on the provisions of tax law. Accordingly, the Board concluded that this Interpretation should presume that a tax position will be evaluated by taxing authorities.

B21. The Board also considered the guidance in paragraphs 26 and 36 of Concepts Statement 6 on the characteristics of an asset and a liability. The Board noted that consideration of examination risk is not consistent with the characteristics of an asset or a liability. The Board also considered the views of respondents to the Exposure Draft who reasoned that considering examination risk is fundamentally inconsistent with a self-assessment tax system and that the possibility a position will not be examined is not relevant in determining if a tax position qualifies for financial statement recognition.

B22. Additionally, the Board noted that certain taxing authorities have recently revised, or are currently revising, their disclosure requirements for income tax returns. For instance, certain taxing authorities in the United States have recently required disclosures of certain reportable transactions and instituted other disclosure requirements, with other jurisdictions considering similar requirements. Thus, the Board concluded that to ensure a consistent assessment of tax positions, the recognition and measurement guidance in this Interpretation should presume that a tax position will be examined by taxing authorities who have full knowledge of all relevant information.

Approaches That Combine Recognition and Measurement

Fair Value Measurement

B23. Fair value combines all sources of uncertainty into a single number. Fair value measurement would result in an amount being recognized even when there is a low probability of realization associated with the asset or liability being measured. That is, fair value measurement incorporates what is known about the uncertainty of amounts and timing of possible outcomes at the reporting date into the measurement attribute. The fair

value measurement of income taxes would also need to consider the risk of examination as well as anticipate future changes in tax law. Because the Board concluded that the consideration of the risk of examination is not appropriate, a significant component of fair value would be unavailable.

B24. Finally, estimating fair value requires the consideration of time value, also referred to as discounting. Paragraph 5(b) of Statement 109 carries forward paragraph 6 of APB Opinion No. 10, *Omnibus Opinion—1966*, which does not permit accounting for deferred taxes on a discounted basis. The Board decided that this limited-scope Interpretation should not include a reconsideration of the prohibition against discounting. Therefore, the Board decided against further consideration of a fair value measurement attribute for financial statement measurement of uncertain tax positions.

Measurement Attributes That Use Fair Value Techniques

B25. The Board also considered a measurement attribute that uses some of the inputs to a fair value measurement but excludes discounting, anticipated changes in tax rate, and examination risk (an expected-outcome measurement).

B26. Some Board members believe that an expected-outcome measurement would be conceptually superior when uncertainty exists because that measurement would require consideration of all potential outcomes, including those with low probabilities of occurring. However, other Board members objected to a measurement approach that is similar to fair value but excludes factors that could be significant to a fair value measurement: discounting, changes in tax rate, and examination risk. The Board concluded that, at this time, it is preferable to separately evaluate tax positions for recognition against a recognition threshold and to provide separate measurement guidance for tax positions that qualify for recognition.

Approaches That Discretely Consider Recognition and Measurement

Two-Step Process

B27. Under an approach that separates recognition from measurement, a tax position is first evaluated for recognition based on its technical merits. Tax positions that meet a recognition criterion are then measured to determine an amount to recognize in the financial statements. The measurement would incorporate information about potential settlements with taxing authorities.

B28. This Interpretation requires the application of a recognition criterion separate from the determination of measurement because the Board believes that the evaluation of tax positions based on their technical merits relative to a specified confidence level improves the

consistency and comparability of financial reporting for income taxes. Additionally, the Board believes that a requirement to evaluate tax positions against a consistent benchmark is more operational than the other approaches it considered.

Alternative Recognition Thresholds

Minimum Statutory Threshold

B29. In deliberating the threshold for recognition of a tax position, the Board considered an approach that would require financial statement recognition when:

- a. A tax position meets the minimum statutory threshold to avoid the payment of penalties.
- b. It is not probable that an additional amount would be paid to the taxing authority to settle any underpayment controversies.

The Board rejected the confidence level expressed by that threshold because it believes that when fair value is not used as the measurement attribute for assets and liabilities, uncertainty should be reflected in a recognition threshold that is sufficiently high to indicate that the enterprise is entitled to the economic benefits of a tax position.

Probable Recognition Threshold

B30. The Board initially selected *probable* as that term is defined in paragraph 3(a) of Statement 5 as the recognition criterion. The Board initially concluded that probable expresses the appropriate confidence level for recognition of tax positions. Additionally, the Board believed that financial statement preparers, auditors, and regulators share a common understanding of the confidence level expressed by probable.

B31. Constituents expressed concerns with the probable recognition threshold. They stated that minor changes in an enterprise's confidence about a tax position could have a disproportionate financial statement effect when the recognition threshold is probable. In response to those concerns, the Board initially selected a dual-recognition threshold approach for recognition and derecognition. Under that approach, a tax position would be recognized when it met the probable recognition threshold and derecognized when it was more likely than not that the tax position would not be sustained. The Board also believed that this approach would be easier to apply than a single threshold of probable for both recognition and derecognition and that there would be greater consistency in application of a dual-recognition threshold and, thus, included that approach in the Exposure Draft.

B32. Many respondents to the Exposure Draft indicated that the probable recognition threshold would result in a systematic overstatement of tax liabilities because that threshold would not reflect anticipated cash flows. Additionally, based on comment letters and discussions at the public roundtable, the Board concluded that the confidence level expressed by probable is not consistently understood and applied by constituents. Respondents further expressed concern that a dual-recognition threshold would result in noncomparability when similar (or the same) tax positions that had been previously recognized no longer meet the probable recognition threshold but remain more likely than not, a point the Board acknowledged in the Exposure Draft. Respondents to the Exposure Draft also stated that a dual-recognition threshold would cause inconsistency between periods and a lack of comparability across enterprises.

More Likely Than Not

B33. In redeliberations, the Board adopted a single-threshold approach, with more likely than not as the recognition and derecognition criterion. The Board believes that approach will provide greater comparability and operationality as compared with the other alternatives the Board considered. Additionally, the more-likely-than-not recognition threshold addresses concerns about the overstatement of income tax expense that some constituents asserted would occur under a probable recognition threshold, and the more-likely-than-not recognition threshold will result in recognizing income tax benefits that more faithfully represent the amounts that will be ultimately realized.

Tax Opinions

B34. While the term *more likely than not* is used in both tax law and financial accounting, the Board does not believe that a legal tax opinion must be obtained to demonstrate that the more-likely-than-not recognition threshold is met. The Board believes that a tax opinion can be external evidence supporting a management assertion and that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law. Other evidence, in addition to or instead of a tax opinion, supporting the assertion also could be obtained; the level of evidence that is necessary and appropriate is a matter of judgment that depends on all available information.

Administrative Practices and Precedents

B35. In its redeliberations of the provisions of this Interpretation, the Board became aware of certain administrative practices and precedents under which taxing authorities do not object to a limited number of tax positions that may be deemed technical violations of the

tax law. The Board understands that those administrative practices and precedents are broadly understood by preparers, tax practitioners, and auditors. This Interpretation permits an enterprise to consider administrative practices and precedents, as applicable, in applying the provisions of this Interpretation.

B36. In determining whether a particular administrative practice or precedent will be applicable, an enterprise should presume that the tax position will be examined and that the taxing authority has the same information on the tax position that is available to the enterprise when asserting that a particular administrative practice or precedent would be applied by the taxing authority.

B37. The Board decided to permit the consideration of administrative practices and precedents to achieve greater consistency and comparability and to achieve more representationally faithful financial reporting in those limited circumstances in which taxing authorities permit what might be deemed technical violations of the tax law.

Subsequent Events

B38. In deliberating changes in judgment in this Interpretation, the Board decided that recognition and measurement should be based on all information available at the reporting date and that a subsequent change in facts and circumstances should be recognized in the period in which the change occurs. Accordingly, a change in facts subsequent to the reporting date but prior to the issuance of the financial statements should be recognized in the period in which the change in facts occurs.

B39. AICPA Auditing Standards, AU Section 560, "Subsequent Events," defines two different types of events subsequent to a reporting date. This evaluation under AU 560 does not take the perspective of a change in facts and resolution of uncertainty; rather, it evaluates whether or not information confirms the existence of a condition at a previous reporting date.

B40. The provisions of this Interpretation require an enterprise to evaluate uncertainty and changes in uncertainty in determining whether an enterprise is entitled to the benefits of a particular tax position. Thus, changes in facts that occur subsequent to a reporting date do not confirm the existence of a condition that previously existed; rather, they alter the judgment about whether an enterprise should continue to recognize the economic benefits of a tax position.

Measurement

B41. In deliberating the measurement requirements of this Interpretation, the Board considered the mechanics of resolving disputes with taxing authorities. Because many tax positions are settled based on qualitative evidence, the Board concluded that measurement should rely on management's experience in similar matters with the relevant taxing authority.

B42. The Board initially selected *best estimate*, as the term is used in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, to measure tax benefits that are within the scope of this Interpretation. The best estimate represents the single most likely amount in a range of possible estimated amounts. Some respondents to the Exposure Draft indicated that a best-estimate measurement might yield counterintuitive results, especially if there is a wide dispersion of possible estimated outcomes, each with a low probability of being ultimately realized. The Board agreed with those respondents and decided to modify the approach.

B43. This Interpretation specifies that a tax position that meets the threshold for recognition should be measured at the largest amount that is greater than 50 percent likely of being realized upon ultimate settlement. That measurement is based on an analysis of the distribution of potential outcomes (that is, potential realized tax benefits) and their related probabilities. In the case of tax positions, the distribution is bounded from below by zero and from above by the amount taken in a tax return. This Interpretation requires an enterprise to determine the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

B44. The Board believes that the measurement required by this Interpretation will result in consistent and comparable measurement of tax positions and in more representationally faithful reporting than a best-estimate measurement.

Subsequent Recognition, Derecognition, and Measurement

B45. The Board considered the view that once the recognition threshold is met, there should be no subsequent recognition, derecognition, or remeasurement of the recognized tax benefit until settlement. The Board rejected that view as inconsistent with the existing guidance for loss contingencies and Statement 109.

B46. In considering the subsequent recognition of tax positions that do not initially meet the more-likely-than-not recognition threshold and the subsequent measurement of tax positions, the Board initially considered whether specific external events should be required to effect a change in judgment about the recognition of a tax position or the measurement of

a recognized tax position. The Board concluded in the Exposure Draft that a change in estimate is a judgment that requires evaluation of all available facts and circumstances, not a specific triggering event. Some respondents to the Exposure Draft stated that the evidence supporting a change in judgment should be objectively verifiable and that a triggering event is normally required to subsequently recognize a tax benefit.

B47. During redeliberations, the Board considered whether a subsequent change in recognition or measurement should be reported only when a tax position is resolved with certainty. The Board does not believe that certainty is required and concluded that the recognition and measurement of a tax position at a reporting date should be based on management's best judgment given the facts and circumstances known at the reporting date. Unlike a Statement 5 approach to accounting for a loss contingency, information received subsequent to the reporting date should not be used to evaluate a tax position at the reporting date. Thus, finality or certainty of resolution of the tax matter is not necessary to subsequently recognize or measure tax positions. However, the Board also concluded that changes in judgment that lead to changes in recognition and measurement should result from the evaluation of new information. A change in judgment should not be based on a new evaluation or new interpretation of information that was available in a previous financial reporting period.

Change in Judgment

B48. During initial deliberations, the Board decided that the guidance in paragraph 194 of Statement 109 should also apply to changes in judgment about the realizability of tax benefits covered by this Interpretation. The Exposure Draft indicated that all changes in judgment about tax positions taken in previous interim or annual periods should be treated as a discrete item in the period of change in judgment.

B49. During redeliberations, the Board decided that changes in judgments about the recognition, derecognition, and measurement of income tax positions covered by this Interpretation should be made consistent with Opinion 28 and Interpretation 18. Accordingly, the financial statement effect of a change in judgment about tax positions taken in previous annual periods should be treated as a discrete item in the period of the change in judgment. The financial statement effect of a change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior interim period within the same fiscal year is an integral part of an annual period.

Interest and Penalties

B50. Statement 109 does not provide guidance on the classification of interest and penalties. In initial deliberations of this Interpretation, the Board considered whether to provide guidance on classification and concluded that the guidance should be more properly considered in its short-term convergence project on accounting for income taxes, if at all. Respondents to the Exposure Draft requested that the Board provide guidance on classification. The Board decided that the classification of interest and penalties should be treated as an accounting policy election. Additionally, to assist users of financial statements in understanding the accounting for income taxes, the policy election as well as the amount of interest and penalties recognized in the financial statements should be disclosed in the notes to the financial statements.

B51. The Board also considered recognition in the financial statements of a provision for the anticipated payment of interest or penalties or both. The tax law for many jurisdictions requires the payment of penalties when a specified confidence level is not met for a tax position and the payment of interest when there has been an underpayment of income taxes. Therefore, for completeness of the financial statements the Board decided that a liability should be recognized when it was deemed to be incurred based on the provisions of the relevant tax law. That is, consistent with accrual accounting, the financial statements should reflect interest beginning in the period that it would begin accruing according to the relevant tax law and should reflect penalties in the first period the tax position was taken in a tax return that would give rise to the penalty, based on the provisions of the relevant tax law.

B52. The Board also considered the basis for recognition of an expense for interest and penalties. The Board considered whether to require the accrual of interest on either:

- a. The amount of payment anticipated by an enterprise to settle an underpayment controversy; or
- b. The aggregate difference between the tax benefits of the as-filed tax position and the amount recognized in the financial statements.

Because the amounts are required to be paid pursuant to tax law, the Exposure Draft indicated that interest should be accrued by applying the applicable statutory rate of interest to the aggregate difference between the tax position recognized in the financial statements and the amount previously taken or expected to be taken in the tax return. The Board also concluded that penalties should be accrued if the position does not meet the minimum statutory threshold necessary to avoid payment of penalties.

B53. Respondents to the Exposure Draft expressed concern that the requirements for recognition of interest and penalties would lead to systematic overstatement of liabilities followed by subsequent reversals into income. During redeliberations, the Board considered whether recognition of interest should be based on management's best estimate of the amount that would ultimately be paid to the tax authority upon settlement. However, because the recognition threshold was reduced from probable to more likely than not during redeliberations, the Board concluded there would not be an overstatement of liabilities. Furthermore, accruing interest based on management's best estimate would be inconsistent with the approach required in this Interpretation for recognizing tax positions in the financial statements, and there should be consistency between the amount of interest or penalties or both recognized and the amount of tax benefits reported in the financial statements. Therefore, the Board decided to affirm the proposal in the Exposure Draft and require the accrual of interest expense based on the difference between the tax positions recognized in the financial statements and the amount recognized or expected to be recognized in the tax return.

Classification

B54. The Board considered whether the difference between the as-filed tax position and the amounts recognized and measured by applying this Interpretation should be classified as a deferred tax liability or as a current or noncurrent liability. The Board reasoned that the liability associated with that difference results from the reduction of an income tax paid or currently payable. Therefore, the amount should not be classified as a deferred tax liability unless the liability arises from a taxable temporary difference (for example, a difference between the tax basis of an asset or a liability as calculated using this Interpretation and its reported amount in the statement of financial position).

B55. In determining the appropriate classification of the liability representing the difference between the tax position and the amounts recognized and measured pursuant to this Interpretation, the Board considered the potential timing of any settlement with the taxing authority, the characteristics of the liability, and the guidance in ARB No. 43, Chapter 3A, "Working Capital—Current Assets and Current Liabilities," on the classification of tax liabilities.

B56. The Board noted that several years may elapse between filing a tax return and a settlement with taxing authorities. For example, it may take many months or years after filing for a return to be selected for examination, if selected at all. Additionally, after an examination is completed, the taxpayer may have many more months or years to appeal or litigate the revenue agent's findings.

B57. The Board initially concluded that the liability created from applying this Interpretation should be classified as a current liability under the guidance in ARB 43, Chapter 3A, reasoning that the liability is similar to a due-on-demand note. Because taxing authorities could issue an assessment and a demand for payment, the liability is appropriately classified as due on demand. However, some Board members indicated that this reasoning, and therefore the guidance in ARB 43, Chapter 3A, might apply only to the as-filed tax liability.

B58. The Board further reasoned that in a tax position that meets the more-likely-than-not recognition threshold, the enterprise would have already made a tax payment to the taxing authority (or accrued a liability). Therefore, classifying the liability recognized in accordance with this Interpretation as a current liability would result in working capital balances in the financial statements similar to the balances that would result if the tax position had been taken with a confidence level similar to the more-likely-than-not recognition threshold.

B59. Some respondents to the Exposure Draft stated that because the timing of payment is uncertain, the liability should be classified as current. The Board acknowledges that reasoning but also notes that long delays are possible and even likely between filing a tax return and an ultimate settlement. Therefore, the Board reasoned the most representationally faithful classification should be based on management's assessment of the timing of the ultimate payment to taxing authorities. The portion of the liability that is expected to be paid in the next year (or operating cycle, if longer) should be classified as a current liability.

Disclosure

B60. The Board considered additional disclosures in deliberating the provisions of the Exposure Draft and initially concluded that additional disclosures beyond those currently required by Statement 5 would not be necessary because the recognition threshold selected by the Board, probable, would capture the effects of uncertainty. During redeliberations, the Board focused on reducing the complexity in disclosure requirements for income taxes and reconsidered whether additional disclosures would be necessary in light of the change in the recognition threshold.

B61. In considering how this Interpretation might simplify disclosures for income taxes, the Board considered the disclosure requirements in Statement 5 and AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. The Board decided that codifying and enumerating required disclosures in this Interpretation will increase comparability and reduce complexity. Also, the Board believes that financial statement issuers will be better able to comply with existing disclosure requirements.

B62. In considering whether this Interpretation should require additional disclosures, the Board considered what information is decision useful to users of financial statements. During the course of this project, users requested a wide array of disclosures. The Board considered those requests in the context of the objectives of this project. Some Board members believe additional disclosures are not necessary because a more-likely-than-not recognition threshold is sufficiently high to capture the effects of uncertainty. Other Board members believe that the more-likely-than-not recognition threshold is not sufficiently high to capture the effects of uncertainty and that a tabular reconciliation of the beginning and ending balances of the liability for unrecognized tax benefits would be appropriate.

B63. The Board selected a tabular reconciliation of the amounts of unrecognized tax benefits at the beginning and end of the period. The Board believes that the tabular reconciliation will provide users with valuable information about a significant and sensitive estimate and changes in that estimate that are subject to significant measurement judgment.

B64. Some constituents asserted that requiring a tabular reconciliation is not appropriate because it would inappropriately provide a “roadmap” for taxing authorities. Those constituents analogized the relationship between a taxpayer and a taxing authority to the parties in a lawsuit. The Board considered but rejected those arguments for several reasons. First, the Board does not equate a taxing authority with a counterparty in a lawsuit. A counterparty in a lawsuit is acting in its own particular interest, while a taxing authority is acting in the broader public interest in regulating compliance with self-reporting income tax laws. Second, the Board concluded that requiring disclosures at the aggregate level does not reveal information about individual tax positions yet it provides information that users indicated would be decision useful. Third, the Board is aware that a taxing authority in the United States has recently instituted a detailed reconciliation requirement that provides information about differences between amounts reported in an enterprise’s income tax return and its financial statements. The Board believes that this reconciliation requirement and those like it are the sources of information that taxing authorities use to focus their examination.

Impact on Convergence with International Financial Reporting Standards

B65. The FASB decided to undertake this project to address the significant diversity in practice that currently exists in the application of Statement 109. The International Accounting Standards Board (IASB) has also considered the issue and has decided to provide guidance through its existing income tax project. In making that decision, the IASB acknowledges that the application of IAS 12, *Income Taxes*, could also result in diversity in practice similar to that in Statement 109.

B66. The IASB considered the FASB's decisions but noted that they are inconsistent with the proposed amendments to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, which was issued in June 2005. Under the IASB's approach, an entity has a stand-ready liability to pay more tax than that arising from the amounts submitted to the taxing authority. Consistent with the approach taken in the proposed amendments to IAS 37, the IASB's tentative conclusions do not utilize a probability-based recognition threshold. Rather, all uncertainty is reflected in the measurement of the tax assets and liabilities using a probability weighted average of all possible outcomes, assuming that the taxing authority will review the amounts submitted.

B67. Based on its current technical plan, the IASB does not plan to expose its approach to accounting for uncertainty in income taxes until late in 2006 and will not issue a final standard until 2007. The FASB does not believe that delaying the issuance of this Interpretation to 2007 would be appropriate based on the significant diversity in practice.

Nonpublic Enterprises

B68. The Board considered the impact of this Interpretation on nonpublic enterprises and whether differential recognition, measurement, disclosure, or transition requirements would be appropriate for nonpublic enterprises. The Board considered input from an organization that represents nonpublic enterprises and was advised that as a result of the changes made by the Board during redeliberations in the provisions for the recognition threshold and effective date, nonpublic enterprises would not need additional time beyond that provided to public enterprises to adopt the provisions of this Interpretation.

B69. The Board also notes that nonpublic enterprises will generally have until the end of the first year of adoption, unless they have an earlier contractual reporting requirement, such as debt covenant calculations or interim financial statements. Accordingly, the Board decided not to provide different recognition, measurement, disclosure, or transition requirements for nonpublic enterprises.

Effective Date and Transition

B70. The Board concluded that because of the number of tax positions taken in prior periods that are anticipated to be reexamined by preparers when this Interpretation is adopted, sufficient time should be provided to evaluate those prior positions. The Exposure Draft contained an effective date as of the end of the first fiscal year ending after December 15, 2005. During redeliberations, respondents requested a later effective date to complete their assessments of current and prior years' tax positions. Based on discussions with constituents, the Board decided that a period of six to nine months would be sufficient to apply this Interpretation.

B71. During its original deliberations, the Board considered retrospective application, a change in estimate effected by a change in accounting principle, and a change in accounting principle as possible ways to recognize the effect of initial adoption of this Interpretation. The Board rejected retrospective application as a transition alternative because of the many significant changes that have occurred in the business environment and regulatory tax environment in recent years. The Board also was concerned about the ability to identify in a retrospective application a discrete period in which a change in the perceived sustainability of a tax position may have occurred. During its original deliberations, the Board also considered accounting for transition as a change in estimate effected by a change in accounting principle. The Board rejected that alternative because Statement 109 does not specify a recognition threshold and there was significant diversity in practice prior to this Interpretation. The Board concluded that because of the significant diversity in practice and because the provisions of Statement 109 were sufficiently unclear, this Interpretation should be accounted for as a change in accounting principle.

B72. The Board decided that this Interpretation should be accounted for as a change in accounting principle as of the beginning of the fiscal year beginning after December 15, 2006, with the cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment does not include items that would not be recognized in earnings, such as the effect of adopting this Interpretation on tax positions related to business combinations. Early adoption is permitted provided the enterprise has not yet issued financial statements in the period of adoption.

Benefits and Costs

B73. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement a new standard are borne primarily by the reporting entity. The Board's assessment of the costs and benefits of issuing an accounting standard is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement an accounting standard or to quantify the value of improved information in financial statements.

B74. The Board's assessment of the benefits and costs of this Interpretation of Statement 109 was based on discussions with regulators, preparers, and auditors of financial statements and on consideration of the needs of users for more consistent application of that Statement. The Board acknowledges that this Interpretation may increase the costs of

applying Statement 109. The expected benefit of this Interpretation is improved financial reporting resulting from a more consistent application of Statement 109 in the recognition of tax benefits. Financial statements of different enterprises will be more comparable because the uncertain tax positions that are within the scope of this Interpretation and their related income tax effects will be accounted for more consistently.

Appendix C

IMPACT ON RELATED AUTHORITATIVE LITERATURE

C1. This appendix addresses the impact of this Interpretation on authoritative accounting literature included in categories (a), (c), and (d) in the GAAP hierarchy discussed in AICPA Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.³

C2. Statement 5 is amended as follows: [Added text is underlined and deleted text is ~~struck-out~~.]

a. Paragraph 2:

Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement.^{1a} Estimates are required in financial statements for many on-going and recurring activities of an enterprise. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition in paragraph 1. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 1, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

^{1a}Because FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, provides guidance on accounting for uncertainty in income taxes, this Statement no longer applies to income taxes.

b. Paragraph 39:

As a condition for accrual of a loss contingency, paragraph 8(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(a)), but the

³On April 28, 2005, the FASB issued the Exposure Draft, *The Hierarchy of Generally Accepted Accounting Principles*, which carries forward the GAAP hierarchy in SAS 69 with certain modifications.

range of possible loss is wide. For example, an enterprise may be litigating ~~an income tax matter~~ a dispute with another party. In preparation for the trial, it may determine that, based on recent ~~decisions~~ developments involving one aspect of the litigation, it is probable that it will have to pay ~~additional taxes~~ of \$2 million to settle the litigation. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay ~~taxes of an additional~~ \$8 million over and above the \$2 million. In that case, paragraph 8 requires accrual of the \$2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that ~~additional taxes~~ the additional amounts will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the \$2 million that was accrued.

C3. Statement 109 is amended as follows:

a. Paragraph 8(a):

~~A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year. A tax liability or asset is recognized based on the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, for the estimated taxes payable or refundable on tax returns for the current and prior years.~~

b. Paragraph 10:

Income taxes currently payable⁴ for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

- a. The amount of taxable income and pretax financial income for a year
- b. The tax bases of assets or liabilities^{4a} and their reported amounts in financial statements.

⁴References in this Statement to income taxes currently payable and (total) **income tax expense** are intended to include also **income taxes currently refundable** and (total) **income tax benefit**, respectively.

^{4a}Interpretation 48 provides guidance for computing the tax bases of assets and liabilities for financial reporting purposes.

c. Paragraph 289 (Glossary):

Temporary difference

A difference between the tax basis of an asset or liability computed pursuant to FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 11 cites 8 examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (paragraph 15), but those temporary differences (a) result from events that have been recognized in the financial statements and (b) will result in taxable or deductible amounts in future years based on provisions of the tax law. Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

C4. This Interpretation does not change the consensus reached in EITF Issue No. 93-7, “Uncertainties Related to Income Taxes in a Purchase Business Combination,” that all income tax uncertainties that exist at the time of or arise in connection with a purchase business combination should be accounted for pursuant to Statement 109. However, the EITF DISCUSSION section of Issue 93-7 is amended to reflect that Interpretation 48 now applies to recognition and measurement of uncertainty in income taxes recognized in accordance with Statement 109. The STATUS section of that Issue in *EITF Abstracts* will also be updated to state:

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, was issued in June 2006. Interpretation 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with Statement 109, including tax positions that pertain to assets and liabilities acquired in business combinations. Therefore, the guidance in this Issue that pertains to the recognition and measurement of deferred tax assets and liabilities at the date of a business combination is no longer necessary.

Interpretation 48 does not affect the guidance pertaining to the accounting for the effects of adjustments.

C5. Question 17 of the FASB Special Report, *A Guide to Implementation of Statement 109 on Accounting for Income Taxes*, is amended as follows:

~~Q—In a taxable purchase business combination, an enterprise allocates for tax purposes the purchase price to the assets acquired and liabilities assumed so as to maximize the potential income tax benefits from the combination. Although the enterprise has a basis under the tax law for the allocations claimed in initial filings with the tax authority, that enterprise believes that portions of the allocation will be denied by the tax authority and the amount assigned to goodwill will be increased. How shouldShould deferred income taxes at the date of the business combination be accounted for?based on (a) the tax basis of acquired assets and liabilities as claimed in initial filings or (b) the best estimate of the tax basis that will ultimately be accepted by the tax authority? What is the appropriate accounting in periods subsequent to the business combination for changes in the purchase price allocation for tax purposes? [30] [Revised 6/06]~~

~~A—The tax basis of an asset or liability is a question of fact under the tax law. The tax basis of most assets and liabilities is not subject to dispute and can be determined from initial filings with the tax authority. However, the tax basis of some assets and liabilities is unclear and will be determined by tax regulations, negotiations with the tax authority, appeals procedures, or, in some cases, litigation. The tax basis of those assets and liabilities may not be appropriately determined from initial filings with the tax authority because those filings are only the first step in the process to establish the tax basis. Deferred tax assets and liabilities at the date of a business combination should be based on management's best estimate of the tax basis of acquired assets and liabilities that will ultimately be accepted by the tax authority. The tax bases used in the calculation of deferred tax assets and liabilities as well as amounts due to or receivable from taxing authorities related to prior tax returns at the date of a business combination shall be calculated pursuant to FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. [Revised 6/06]~~

~~To illustrate, assume the following:~~

- ~~a. The enacted tax rate is 40 percent for all years.~~
- ~~b. An enterprise is acquired for \$1,000 in a taxable purchase business combination. The purchase price allocation that will initially be filed with the tax~~

authority, the expected final purchase price allocation for tax purposes, and the fair values for financial reporting are as follows:

	<u>Initial Allocation</u>	<u>Expected Final Allocation</u>	<u>Fair Value</u>
Depreciable assets	\$ 600	\$ 600	\$600
Identifiable intangible assets (4-year life)	400	—	\$400
Goodwill (10-year life)	—	400	—
	<u>\$1,000</u>	<u>\$1,000</u>	

- e. The acquiring enterprise has no temporary differences or operating loss or tax credit carryforwards.
- d. Amortization of goodwill is not deductible for tax purposes.

The amounts recorded for financial reporting to account for the purchase transaction are as follows:

Depreciable assets	\$ 600
Identifiable intangible assets	400
Deferred tax liability (40 percent of \$400)	(160) ⁶
Goodwill	160
	<u>\$1,000</u>

For some time after the business combination, the enterprise will compute taxable income based on the tax basis initially claimed for the acquired assets and liabilities even though it may expect that a different tax basis ultimately will apply. During that period, the enterprise will receive tax benefits that exceed the tax benefits that would have occurred had the expected tax basis been used to compute taxable income. The enterprise expects it will have to return that excess benefit to the tax authority. For reporting periods prior to the determination of the final tax basis, the enterprise should (a) recognize a liability for that excess tax benefit and (b) determine deferred taxes based on the expected final tax basis assigned to the purchased assets and liabilities.

⁶The deferred tax liability results from the \$400 temporary difference relating to identifiable intangible assets. That temporary difference is based on the best estimate of the tax basis of those assets (zero in this example) that will ultimately be accepted by the tax authority.

To illustrate, assume the following additional facts for the example above:

- a. Pretax income for financial reporting, taxable income, and taxes payable during year 1 for the combined enterprise are:

	<u>Financial Reporting</u>	<u>Tax Return</u>
Income before amortization expense	\$116	\$116
Amortization of intangible assets	-100	-100
Amortization of goodwill	<u>-16</u>	<u>—</u>
Pretax and taxable income	<u>\$-0</u>	<u>\$16</u>
Taxes payable (40 percent)		<u>\$-6</u>

- b. The deferred tax liability for the temporary difference related to identifiable intangible assets at the end of year 1 is \$120 (40 percent of \$300).
- c. The tax liability for the “excess” tax benefit during year 1 is \$40 (40 percent of \$100).

Income tax expense for year 1 is as follows:

Current tax expense:

—Taxes currently payable	\$-6	
—Liability for disallowance of “excess” tax benefit	<u>-40</u>	\$46
Deferred tax benefit for change in the deferred tax liability related to identifiable intangible assets from \$160 to \$120		<u>-(40)</u>
Total		<u>\$-6</u>

At or before settlement with the tax authority, management may change its assessment of the amount that will be realized upon ultimate settlement with the taxing authority, best estimate of the tax basis of acquired assets and liabilities. At the date of that change in judgment and at the date that the tax basis of the acquired assets and liabilities is settled, the enterprise should adjust its deferred tax asset or liability to reflect the revised tax basis and the amount of any settlement with the tax authority for prior year income taxes. The effect of that adjustment should be applied to increase or decrease the remaining balance of goodwill attributable to that acquisition. (If goodwill is reduced to zero, the remaining portion of that adjustment should be applied initially to reduce to zero other noncurrent intangible assets related to that acquisition. Any remaining benefits should be recognized in income.) [Revised 6/06]

To illustrate, assume that at the beginning of year 2 the tax basis of the acquired assets and liabilities is settled with the tax authority as follows:

Depreciable assets	\$—600
Identifiable intangible assets	—100
Goodwill	—300
	<u>\$1,000</u>

The following adjustments are necessary at the beginning of year 2 (assuming that the enterprise did not change its best estimate of the tax basis of the acquired assets and liabilities before settlement with the tax authority):

a.	Balance of the tax liability for “excess” tax benefits at the beginning of year 2	\$—40
	Settlement with the tax authority for taxes paid in year 1:	
	— Amortization deducted on tax return	\$100
	— Amount allowable ($\$100 \div 4$ years)	<u>—25</u>
	— Excess deduction	<u>\$ 75</u>
	— Taxes payable (40 percent)	<u>—30</u>
	Adjustment (to reduce liability to zero)	<u>\$—10</u>
b.	Balance of the deferred tax liability for the temporary difference related to identifiable intangible assets at the beginning of year 2	\$120
	Balance based on the final tax basis for tax purposes:	
	— Identifiable intangible assets for financial reporting	\$300
	— Tax basis of those assets	<u>—75</u>
	— Temporary difference	<u>\$225</u>
	— Deferred tax liability (40 percent)	<u>—90</u>
	Adjustment	<u>\$—30</u>
c.	Balance of goodwill at the beginning of year 2	\$144
	Adjustments:	
	— To eliminate the balance of the tax liability for “excess” tax benefits	\$—10
	— To adjust the deferred tax liability for the temporary difference related to identifiable intangible assets	<u>—30</u>
	Adjusted balance	<u>\$104</u>

