non-U.S. operations housed in branches of U.S. companies. Depending on how the enabling regulations (or subsequent statutory rules) are drafted and enforced, this could affect the cost-benefit calculations of a great many transactions routinely undertaken by multinationals in the course of building and optimizing their global operational footprint. The introduction of such changes could, in turn, provide incentives to companies to outsource activities under consideration before legislation, or to refrain from locating the activities in the United States when confronted with a front-end location choice that could entail such back-end costs. The introduction of such hindrances would indeed be ironic given President Obama’s stated objective of revising the Internal Revenue Code to provide incentives to U.S. multinationals to create and maintain jobs in the United States.

A. Introduction

The circumstances under which a company must record financial statement reserves for tax contingencies has been a significant source of confusion over the past few years. This confusion exists largely because the standards used to evaluate tax contingencies differ based on the type of tax involved, and because the standards do not apply uniformly to all organizations. The rules that address the establishment of reserves for income-based taxes are set forth in Statement of Financial Accounting Standard No. 109 and Financial Accounting Standards Board Interpretation No. 48, while the rules addressing the establishment of reserves for nonincome-based taxes are set forth in FAS 5. These standards, which constitute generally accepted accounting principles for U.S. companies, can be a world apart in practical application. In particular, FAS 5 allows companies to consider audit risk (that is, the risk that a taxing authority will actually choose to perform an examination and identify the error during such examination). Conversely, FIN 48 requires the assumption that the taxing authority will conduct an audit, identify the specific issue, and possess all relevant facts known by the company. The difference in standards with respect to income-based versus nonincome-based taxes is odd, particularly when considering that both types of taxes are often administered by the very same taxing authorities that apply similar examination techniques and penalties to both types of taxes.

This curious distinction in the rules may attract the focus of policymakers, especially given the seismic economic conditions, the need for financial statement transparency, and the fact that there appears to be no rational
policy basis for the differing FIN 48 and FAS 5 tax reserve standards. Companies that for generations were regarded as economic pillars are struggling to survive, while others are in bankruptcy or have been taken over by federal authorities. With the economy in such distress and losses mounting, income-based taxes are less likely to attract the attention of U.S. taxing authorities. Nonincome-based taxes, which already make up a large portion of U.S. tax receipts, are likely to be the main focus of tax examiners. For example, the IRS recently signaled its intent to increase its efforts on cross-border withholding and employment taxes. Accordingly, this discussion of the financial statement standards for the establishment of tax reserves is particularly timely.

B. Accounting Standards for Tax Reserves

1. Sample income statement. The table below depicts a sample income statement of a hypothetical company for illustrative purposes only.

<table>
<thead>
<tr>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Cost of revenues</td>
<td>300,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Selling, general, and administrative</td>
<td>500,000</td>
</tr>
<tr>
<td>Research and development</td>
<td>400,000</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>900,000</td>
</tr>
<tr>
<td>Other income (expense):</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>25,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(75,000)</td>
</tr>
<tr>
<td>Total other expense, net</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Income, before provision for income taxes</td>
<td>550,000</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>(230,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>$320,000</td>
</tr>
</tbody>
</table>

2. Nonincome-based taxes — FAS 5. FASB issued FAS 5 in March 1975, and set forth the principles for the establishment of loss reserves for contingencies. A financial statement reserve generally appears on the balance sheet as a liability, and recording the reserve results in a commensurate charge against income. A contingency is defined as an existing condition, situation, or circumstance involving uncertainty regarding possible gain or loss that will ultimately be resolved when one or more future events occur or fail to occur. For example, a loss contingency arises when a business learns of a potential liability that has not come to fruition. FAS 5 also applies, in theory, to losses that a business can reasonably expect to incur in the future. Reserves are not required for mere risks of future losses unless the risks somehow relate to the current or a prior financial statement period. Examples of loss contingencies expressly covered by FAS 5 include pending or threatened litigation and actual or possible claims and assessments; items such as group insurance costs, vacation pay, workers compensation, and disability benefits are excluded. Thus, at first blush, FAS 5 appears to cover all types of potential tax liabilities, and indeed, that was the case before the adoption of FIN 48.

The following two-part test must be satisfied to reserve for a contingent liability under FAS 5:

1. it must be probable, based on information available before the issuance of the financial statements, that a liability has been incurred as of the end of the most recent accounting period to which the statements relate; and
2. the amount of loss must be reasonably estimable.

The first prong implicitly requires that it be probable that one or more future events (for example, an audit) will occur and confirm the loss at issue. There is little guidance defining or interpreting the probable standard; FAS 5 merely states that the future event(s) must be "likely to occur." Nevertheless, it is clear that probable is a higher standard than remote (defined as a "slight" chance) and reasonably possible (defined as "more than remote but less than likely"). Beyond that, organizations are essentially left to their own devices to determine whether a contingent liability meets the probable standard. Webster's Ninth New Collegiate Dictionary defines probable as an event that is "likely to become true or real." Thus, there is a great deal of subjectivity in making such a determination, and FASB has acknowledged that the meaning of probable is not consistently understood and applied. The inconsistency with respect to reporting prompted the promulgation of a definitive standard (more likely than not) in the final version of FIN 48 (see discussion of FAS 109 and FIN 48 below).

With respect to potential litigation, claims, and assessments (including contingent nonincome tax liabilities), FAS 5 lists the following three critical factors to be

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3Contingencies can arise in the context of both gains and losses. FAS 5 prescribes standards for reserving for loss contingencies only. Gain contingencies, which were previously addressed in Accounting Research Bulletin No. 50 (Oct. 1958), generally may not be reflected as assets in an entity's financial statements.


5Id. at paras. 4(e)-(f), 7.

6Note that even if a reserve is not required because the probable standard is not met, the contingent loss will need to be disclosed to prevent misleading financial statements if there is a "reasonable possibility" that the loss was incurred. Id. at paras. 8-10.

7Id. at para. 8(a), note 4.

8Id. at para. 3.


10FIN 48, at paras. B30-B33.
weighed in determining if the establishment of a reserve and/or disclosure is required:

1. the period in which the underlying cause of action occurred;
2. the degree of probability of an unfavorable outcome; and
3. the ability to make a reasonable estimate of the amount of loss.11

The first and third factors are straightforward and well understood. The degree of probability of an unfavorable outcome, however, is more ambiguous. Several factors must be considered in approaching the probability prong, and the analysis creates a critical distinction from FIN 48. That is, *audit risk can be taken into account*. The specific factors listed in FAS 5 for this purpose include:

1. the nature of the litigation, claim, or assessment;
2. the progress of the case;
3. the opinions or views of legal counsel and other advisers;
4. the company’s experience in similar cases;
5. the experiences of other enterprises in similar cases; and
6. decisions by company management about how it intends to respond to the lawsuit, claim, or assessment.12

These factors could be reasonably interpreted to include elements of audit risk consideration; however, FAS 5 seems to address the issue directly. With respect to unasserted claims and assessments, FAS 5 explains that entities must determine the “probability that a suit may be filed or a claim or assessments may be asserted” and the possibility of an unfavorable outcome.13 Notably, FASB considered allowing audit risk considerations for purposes of FIN 48, but ultimately concluded that it was not an appropriate factor concerning *income tax* positions, and expressly distinguished FAS 5 on that point.14

3. Income-based taxes — FAS 109 and FIN 48. In 1992 FASB released FAS 109, which generally addressed accounting for income taxes. It did not, however, prescribe a minimum threshold for the recognition of uncertain tax positions for financial statement purposes. FIN 48 is an interpretation of FAS 109, not FAS 5. In fact, FIN 48 amended FAS 5 by removing all references to income taxes within FAS 5.15 However, FIN 48 did not alter the scope of FAS 5 on the issue of establishing reserves for other “tax assessments.” Accordingly, FAS 5 remains authoritative in the context of reserving for nonincome-based taxes (for example, sales and use taxes, property taxes, and payroll taxes).16 In other words, FAS 5 applies to contingent expenses, like payroll tax liabilities, that are taken into account in determining an organization’s pre-income-tax income. FIN 48 and FAS 109, on the other hand, only apply to the provision for income taxes in determining the organization’s bottom line. See the sample income statement above.

FASB issued FIN 48 with the intent of providing uniform guidance concerning the recognition and measurement of positions taken (or expected to be taken) on an organization’s tax returns. FIN 48 applies only to contingent liabilities concerning an organization’s income tax positions. FASB considered, and expressly decided against, applying FIN 48 to all taxes. Thus, FAS 5 remains the relevant authority in the context of nonincome-based taxes.17

Similar to FAS 5, FIN 48 describes the following two-step process for establishing reserves for contingent income tax liabilities:

1. Recognition: Does the organization’s income tax position satisfy the recognition threshold? If not, the organization will be required to reserve an amount.
2. Measurement: Assuming the position fails to meet the recognition threshold, how does the organization determine the amount to be reserved?

The recognition threshold is “more likely than not” (that is, a more than 50 percent likelihood based on the technical merits that a position will be sustained on examination if the dispute is taken to a court of last resort). The analysis is based on the facts and circumstances evaluated in light of all available evidence, considering the manner in which the company prepares its income tax returns and the approach that the taxing authority is expected to take during an audit.18 Notably, an organization must presume that the tax position will be examined, and that the applicable taxing authority will have full knowledge of all relevant information. In other words, audit risk expressly cannot be a factor in determining if the recognition threshold has been met.19

Administrative practices, however, may be considered. Thus, even if a position technically violates a tax law provision, the more likely than not threshold may be satisfied if the company concludes that the position is consistent with the taxing authority’s demonstrated administrative practices and precedents. For example, assume a company uses a capitalization threshold below which all amounts that otherwise must be capitalized are claimed as expenses on its income tax return in the year of purchase. Even if no relevant tax law provisions allowing for such a capitalization threshold exist, the fact that the taxing authority has allowed them in practice is relevant in determining whether the recognition standard is met.20

11FAS 5, at para. 33.
12Id. at para. 36.
13Id. at para. 38.
14Id. at para. B19-B20.
16FAS 5, at para. 69.
17FIN 48, at paras. 3, B2, and B9-B12.
18Id. at paras. 5, 6, and A2.
19Id. at para. 7a.
20Id. at para. A12-A13.
Measurement is required once an organization fails to satisfy the recognition threshold. For measurement purposes, the organization must reserve the largest amount of tax liability that has a greater than 50 percent likelihood of being realized on an ultimate settlement with a taxing authority that has full knowledge of all relevant information. This standard varies from the test used for the recognition prong; the measurement is based on a hypothetical settlement, as opposed to a resolution by a court of last resort. FASB explained that very few income tax cases are actually taken to courts of last resort to support this pragmatic measurement standard.21

C. Examples of the Application of FAS 5 and FIN 48

The examples set forth below are intended to illustrate the differences in the applications of FAS 5 and FIN 48. The legal analysis within each example is not intended to be exhaustive. All proper names are based on fictitious, hypothetical entities and individuals.

1. State wage withholding issues. MFG Co. (MFG) is headquartered in State A, but has substantial manufacturing operations in State A and State B. Both states impose income taxes on employee wages, are not contiguous states, and are not party to any reciprocal agreements negating the state tax obligations of nonresident employees. MFG sends several of its highly paid State A employees to assist with a plant expansion in State B. The employees spend approximately 100 days during year 1 in State B. MFG withholds and remits State A income tax withholding from the wages of these employees, but fails to withhold any State B income tax withholding. MFG timely files withholding tax returns to State A and State B. In December of year 4, MFG discovers that it was required to withhold State B taxes from the State A employees who worked in State B during year 1. Management does not believe that any of these employees filed State B income tax returns, and many of them are no longer employed by MFG. MFG calculates the amount of withholding taxes due to State B to be approximately $3 million, and State B has a three-year statute of limitations concerning tax assessments. State B has a severe budget crisis and would require MFG to remit the unwithheld taxes if it discovered the error. Nevertheless, management believes it is unlikely that State B will identify the issue on audit unless it chooses to voluntarily disclose, which it does not intend to do.

MFG must first determine if it meets the recognition threshold of FAS 5. The amount of the liability is precisely estimable and would be material to MFG’s financial statements. Because management believes it is not probable that State B will identify the error before the statute of limitations expires, however, the recognition prong is not satisfied. Thus, MFG need not reserve any amount for the potential $3 million payroll tax liability.

2. Spousal and dependent travel. A high profile CEO of a publicly traded U.S. company regularly uses the company jet for business travel, and often brings his spouse, two adult children, and their families along when traveling to resort destinations. The travel of the CEO’s spouse and children is appropriately characterized as entertainment travel under section 274(e)(2) and the related guidance. The company erroneously treats it as business travel, however, and neglects to properly impute compensation to the CEO and withhold $500,000 of related payroll taxes from her, based on the applicable standard industrial fare level rates. Further, the company fails to take a corporate deduction disallowance (tax effected value of $2 million) under section 274(e)(2), for the difference between the charter value of the flights for the entertainment passengers and the amount imputed to the CEO. Moreover, if the IRS identifies the payroll tax error on audit, the “double hammer” rule will apply, which will result in an additional deduction disallowance for the payroll taxes due as a result of spousal and dependent travel.22

The company discovers the error two years after the close of the calendar year in which the travel occurred. The amounts at stake are computed with certainty, and the company would almost certainly lose on the issues if identified under audit. Management believes, however, that neither the payroll tax nor deduction disallowance errors will be identified on examination by the IRS or state taxing authorities, and does not plan to voluntarily self-correct.

This example illustrates the differences in the FAS 5 and FIN 48 standards, particularly in a situation when the tax issues are intertwined. With respect to the payroll tax issue, under FAS 5, the company will not need to reserve any amount because it does not believe its error will be identified under audit. Thus, it is less than probable that the contingent payroll tax liability will actually be incurred. Conversely, regarding the corporate income tax issue, FIN 48 requires the company to assume that the taxing authority will identify the errors on audit. The company would almost certainly be required to reserve an amount for the contingent corporate income taxes because it would incur a liability if the relevant taxing authority had knowledge of the error and all relevant facts.

3. Voluntary disclosure. BNB Co. (BNB) provides group term life insurance for all of its 100,000 employees, but inadvertently fails to report any portion of the premiums as wages and does not withhold any amount for federal income tax withholding purposes. The taxable portion of the premiums, under section 79, amounts to $30 per year per employee. BNB discovers the error after two years of improper failing to report and withhold and decides to voluntarily disclose the $6 million of unreported employee income ($30 x 100,000 employees x 2 years) to the IRS. Rather than issuing 200,000 Forms W-2c for all of its employees for the two-year period that would result in 200,000 amended individual income tax returns, BNB voluntarily discloses the issue and enters into a verbal agreement with the IRS to execute a closing agreement that specifies that BNB (1) will pay the required tax under secondary liability, including a gross-up; and (2) will be relieved from penalties and the obligation to issue Forms W-2c to its employees. Because BNB identified and

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21Id. at para. 8, A3.

determining the ultimate liability that they will likely incur. Organizations to take various mitigating factors into account in often similar under both standards. FAS 5 and FIN 48 both allow rigid numerical formula prescribed in FIN 48, the end result is

The measurement prong is also satisfied because the amount of the payroll tax liability has been calculated and set forth in a draft closing agreement. Therefore, it is estimable and BNK must reserve for the amount that will likely be incurred. This estimate will include the cost of the tax gross-up, but not penalties and interest because it is unlikely that such amounts will arise.

4. Late deposit penalty. LM Inc. (LM) inadvertently deposited $250 million of payroll taxes related to employer equity option exercises four days late. The IRS issued computer generated notices imposing a 2 percent penalty of $5 million under section 6656. LM is objectively a good corporate citizen with strong internal controls and a lengthy track record of tax compliance with all levels of government. Nevertheless, LM’s procedures failed to timely catch one very large stock-based compensation event that necessitated the timely deposit of payroll taxes. LM dutifully and correctly reported the liability on Schedule B of Form 941, knowing that doing so would trigger the imposition of deposit penalties. After receiving the penalty notice, LM submitted a request for abatement on reasonable cause grounds under the statute, which the IRS denied. LM’s protest to IRS Appeals is pending. LM believes it has a strong case and that Appeals will make a significant concession because of its compliance history, self-reporting of the issue, and the unusual circumstances surrounding the event. LM is inclined to litigate the case if Appeals does not meaningfully reduce the penalty.

FAS 5 is the proper guidance to address the need to establish reserves because the underlying issue involves a payroll tax penalty and not corporate income taxes. Audit risk is not a consideration because LM disclosed the issue on its return, and the IRS imposed the penalty. The key questions for LM are whether and how much to reserve. After discussing the issue with its tax counsel, LM believes that Appeals will probably offer to settle with a concession of 60 percent to 80 percent. Accordingly, LM must establish a reserve within the range of $1 million to $2 million. Because of the favorable facts for LM, it is acceptable to record the liability at the lower end of the range.

5. Cross-border withholding. A U.S. corporation (USCO) pays a $150 million outbound royalty to a third-party foreign corporation to license intangible property for use in the United States. The third party is located in a country that does not have a tax treaty with the United States. USCO does not withhold the 30 percent tax imposed on the third party under section 881, thus violating USCO’s withholding obligation under section 1441. USCO similarly fails to send a Form 1042-S, “Foreign Person’s U.S. Source Income Subject to Withholding,” to the third-party recipient, and does not report its section 1461 withholding liability on Form 1042, “Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.” The IRS regularly audits USCO’s federal corporate tax returns. The IRS exam team has never audited USCO’s Form 1042 and Form 1042-S filings in the past, however, and although withholding taxes are an IRS Tier I issue, USCO’s management does not believe the IRS will audit its Form 1042 during the upcoming audit cycle. Further, even if the IRS does audit USCO’s Form 1042, the company does not believe the IRS will identify the error.

During the same year, USCO receives a $200 million inbound license payment from a different foreign company. The company neglects to withhold the required 15 percent foreign withholding tax of $30 million from the payment. On receiving the license payment without reduction for foreign withholding taxes, USCO searches the issue and determines that the licensee simply failed to recognize its withholding obligations under foreign law. The foreign licensee appears to be ignorant of the withholding error, although foreign tax should have been withheld from the license payment, and the foreign government would look to USCO to pay the tax if the error is ultimately discovered.

a. Outbound analysis. The amount that USCO failed to withhold on the outbound royalty payment is not an income tax to USCO within the scope of Fin 48 and FAS 109. USCO served as a withholding agent with respect to the payment, and the resulting liability imposed on the company is an operating expense for purposes of its income statement. Section 1461 makes USCO directly liable for the unwithheld tax, but the nature of the liability does not shift the character of the withholding tax to that of an income tax. Thus, USCO determines its obligation to reserve on the outbound royalty payment under FAS 5, and USCO may permissibly consider audit risk. Because management does not believe it is probable that the IRS will audit its Form 1042 or identify the error, USCO need not reserve any amount under FAS 5 for the $45 million in U.S. taxes that it failed to withhold, even though it knows it is technically liable for the amount.

23 Although section 1441 is located in subtitle A (“Income Taxes”), the amount required to be withheld is a tax on the income of the foreign recipient (not the payer) of the fixed or determinable annual or periodical (FDAP) royalty payment. In other words, the “income tax” is imposed on the foreign FDAP recipient under section 881; the liability imposed on the U.S. withholding agent under sections 1441 and 1461 remains a “withholding tax.”

24 Although section 1441 is located in subtitle A (“Income Taxes”), the amount required to be withheld is a tax on the income of the foreign recipient (not the payer) of the fixed or determinable annual or periodical (FDAP) royalty payment. In other words, the “income tax” is imposed on the foreign FDAP recipient under section 881; the liability imposed on the U.S. withholding agent under sections 1441 and 1461 remains a “withholding tax.”
b. Inbound analysis. The foreign tax not withheld from the inbound license payment is an income tax to USCO within the scope of FIN 48 and FAS 109. Under FIN 48, USCO must presume that taxing authorities know of all uncertain tax positions and all pertinent facts. Accordingly, it is more likely than not that USCO is subject to the $30 million foreign income tax and must record an income tax reserve for the amount under FIN 48.

6. State sales tax. SunPower Corp. (SunPower) manufactures and sells a product used in the production of solar panels. SunPower sells 20 percent of its inventory to end users in State A, which has a broad sales tax exemption for products used in the production of, or incorporated into, solar panels. To qualify for the exemption, the seller must obtain an exemption certificate from the purchaser that lists the purchaser’s state sales tax registration number and expressly states that the purchase will be used in the production of, or incorporated into, solar panels. Unless the seller maintains such documentation, it will be required to remit applicable sales tax. SunPower assumes, however, that all sales to purchasers in State A are automatically exempt from state sales tax, neglects to obtain the requisite exemption certificates, and fails to impose sales taxes on any of its State A sales. SunPower files State A sales tax returns and reports all transactions as nontaxable sales. Following an internal audit, SunPower discovers that it has made this error for the past two years on $10 million in sales. The State A sales tax rate is 5 percent. State A has never audited SunPower, and management does not believe it will do so for the year at issue. SunPower plans to secure exemption certificates (or otherwise tax) all future State A sales.

The $500,000 contingent liability is not an income tax and any reserves are, therefore, analyzed under FAS 5. SunPower does not need to reserve any amount because management does not believe that the company will be audited.

D. Conclusion

The distinctions between the standards for reserving for income-based versus nonincome-based tax liabilities, particularly with respect to the recognition thresholds under FAS 5 and FIN 48, can lead to dramatically varying results. FASB’s rationale for applying the FIN 48 recognition standard to income-based taxes — that examination risk is fundamentally inconsistent with a self-assessment tax system — seems similarly applicable to nonincome-based taxes. This appears to be the case because taxpayers must generally submit self-assessed returns for nonincome-based taxes as well as income-based taxes. The fact that the level of tax revenues from nonincome-based taxes now likely represents a significantly higher percentage of total tax revenues as a percentage of total receipts to the public fisc highlights this inconsistency. Further, different reserving standards for income-based taxes and nonincome-based taxes is unusual, given that the taxes are often administered by the same taxing authorities that apply similar audit techniques and penalties. Nevertheless, it does not appear that any change will occur in the near term, and the rules will continue to produce incongruous results in the reporting of contingent liabilities under FAS 5 and FIN 48.