

Accounting & Disclosure for Uncertain Tax Positions

Just when you thought you were safe.....

.....FIN 48 is preparing to strike!

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FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48)¹ introduces a new approach to the accounting for uncertainty in income taxes and how they are to be reported in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 is effective for fiscal years beginning after December 15, 2006 and applies to all *tax positions* within the scope of Statement 109 – and that is a tall order². In addition, FIN 48 requires extensive disclosures about uncertain income tax positions, including a detailed roll-forward of tax benefits taken that do not qualify for financial statement recognition.

The term *tax position* 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.^[4]

Note: FIN 48 also applies to Real Estate Investment Trusts, Registered Investment Companies and other similarly tax favored pass-through entities^[1].

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Applying FIN 48 to Securitization Issuers

In addition to the common tax positions that can apply regardless of business type, Issuers also will need to consider the impact of FIN 48 on their tax positions related to the following:

- Sale versus Financing Treatment
- Mortgage REIT Qualification
- State Nexus, Apportionment and Allocation
- Accounting for:
 - Loans
 - Gain on Sale
 - Derivatives and Hedging
 - Origination Fees and Costs
 - Loan losses
 - Servicing Income and Assets
 - Retained Interests

The FIN 48 Methodology³

The evaluation of a tax position under FIN 48 entails a two-step process – first *recognition*, then *measurement*. Thereafter, any resulting unrecognized tax benefit(s) must be analyzed for applicable interest and penalties, properly classified in the balance sheet and appropriately disclosed.

Recognition

In its evaluation of the appropriate amount of the tax benefit to recognize, management must first determine the appropriate *unit of account* for the tax position. This process is a matter of judgment based on the individual facts and circumstances of the tax position evaluated in light of all available evidence.

Unit of Account

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.

FIN 48, paragraph B14.

¹ All "[x]" references herein are to the applicable paragraph of FIN 48.

² For additional background and a broader discussion of FIN 48 see *Heads Up July 14, 2006 – Vol. 12, Issue 7: Uncertain Tax Positions – FASB Issues Interpretation No. 48* – by Randal Sogoloff and Herbert Wong, Deloitte & Touche LLP.

³ For a step-by-step guide to implementing FIN 48 see Christopher Barton, *Implementing FIN 48: The Glass is Now Half-Empty*, 200 DTR J-1 (2006).

Once the *unit of account* has been determined, in order to recognize any tax benefit the enterprise must be able to conclude that it is **more-likely-than-not (MLTN)** that its tax position will be sustained, based on its **technical merits**, in a dispute with the appropriate taxing authorities assuming the taxpayer takes the dispute to the court of last resort[A2]. If the MLTN standard is not met, none of the tax benefit is recognized⁴.

More-likely-than-not

"The more likely than not standard is met when there is a greater than 50% likelihood of the position being upheld."

Treasury Regulation Section 1.6662-4(d)(2)

When evaluating whether a tax position meets the MLTN standard FIN 48 provides that[7]:

- The enterprise must presume that *the position will be examined by the appropriate taxing authority, and the taxing authority would have full knowledge of all relevant information.*
- The *technical merits* of the tax position must 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.
 - *Administrative Practices Taken Into Account* – FIN 48 also allows that past administrative practices and precedents of the taxing authority in its dealings with the enterprise or similar enterprises that are widely understood, shall be taken into account.
- Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.

Measurement

Once the enterprise has determined that it should recognize the tax benefits of its position it must then measure the amount of its *recognized tax benefit*. For this purpose, the enterprise shall consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement

(i.e., as opposed to decision by court of last resort) using the facts, circumstances, and information available at the reporting date[8]. The largest amount of its tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement is the amount of tax benefit to be recognized.

"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."

FIN 48, paragraph A3.

Interest and Penalties

FIN 48 requires interest expense to be recognized in the first period that it would begin to accrue according to the relevant tax law. The amount of interest to be recognized is computed by applying the statutory rate of interest to the difference between the tax position recognized under FIN 48 and the amount previously taken or expected to be taken in a tax return (the **Unrecognized Tax Benefit**).[15] In addition, an enterprise must recognize an expense for any applicable penalties in the period in which the enterprise claims or expects to claim the position in the tax return.[16]

Classification

The amount of Unrecognized Tax Benefit must be properly classified in the balance sheet – this generally is accomplished by creating a liability (the FIN 48 Liability), since it relates to a potential future obligation. In the case of a net operating carry-forward or a refund, the amount of such carry-forward or refund is reduced. The FIN 48 Liability would be classified as a current liability to the extent that payment (or receipt) of cash is anticipated within one year or the operating cycle, if longer. However, in no event shall the FIN 48 Liability be combined with deferred tax liabilities or assets. [17]

Disclosure

The disclosure requirements of FIN 48 are quite thorough and require detailed information with respect to the following:

- The policy on classification of interest and penalties⁶.
- A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period⁷,
- The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate,
- The total amounts of interest and penalties recognized in the statement of operations and in the statement of financial position,
- Detailed information related to positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date. The information must include: (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, and (3) an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
- A description of tax years that remain subject to examination by major tax jurisdictions[21].

FIN 48 and Sale versus Financing Treatment

Let's see how FIN 48 applies to MBank, a mortgage banker that regularly originates, sells and/or securitizes mortgage loans.

After listening to **Deloitte's Dbriefs Webcast⁸ – FASB Interpretation No 48, Accounting for Uncertainty in Income Taxes**, as part of an effort to get ahead of the FIN 48 curve, MBank's CFO decided it would be prudent to better understand how FIN 48 might apply to MBank's securitization activities. In performing the evaluation, the MBank team assigned to the project employed the following six step implementation process described in the Dbriefs:

- 1(a) – Identify the tax position
- 1(b) – Determine unit of account (as defined by FIN 48)
- 2 – Evaluate the tax position ("Recognition Threshold")

⁴ But see paragraph 10 for rules regarding "Subsequent Recognition, Derecognition, and Measurement".

⁵ See Paragraphs A19-30 for illustrative examples.

⁶ Pursuant to Paragraph 19 – Interest may be classified as either income taxes or interest expense. Penalties may be classified as either income taxes or another expense classification. The elections must be consistently applied.

⁷ At a minimum the tabular reconciliation shall include: (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 and (4) Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations

- 3 – Measure the tax benefit, if applicable (“Measurement Threshold”)
- 4 – Determine classification of the FIN 48 liability
- 5 – Accrue interest and penalties, if applicable
- 6 – Prepare financial statement disclosures

Transaction Background:

During the 4th quarter of 2006, MBank undertook a securitization of mortgage loans that it structured to both achieve sale treatment under FAS 140⁹ and support a tax position for financing treatment¹⁰. MBank chose not to elect REMIC¹¹ status. Two bond classes were issued in connection with the transaction; Class A and Class B with the excess interest retained by MBank (the residual). Each class receives interest payments based upon LIBOR. While the classes are entitled to pro-rata payments of principal, the Class B is subordinated to Class A with respect to losses. Since the mortgage loans include both fixed and adjustable rate loans – MBank was required to purchase interest rate caps to ensure the timely payment of investor interest in the event of a significant increase in LIBOR. The combination of interest protection, overcollateralization and subordination allowed the Class A to receive an S&P rating of AAA; interest protection and overcollateralization allowed the Class B to receive an S&P rating of BBB. As is consistent with its general practice, MBank chose to retain both the servicing rights and the residual interest.

1 (a) & (b) – Identifying the position/Determine unit of account

MBank decided to first focus upon its tax position related to its treatment of the securitization as a financing for income tax reporting purposes. MBank plans to similarly evaluate its other securitization related tax positions under FIN 48, including:

- Amortization of discount and premium on loans based upon the monthly reduction in aggregate loan balance.
- Carrying its loans at amortized cost tax basis and not mark-to-market.
- The timing of its bad debt deductions related to loan losses.
- Amortization of cap premium cost on a straight-line basis.

- Amortization of debt issuance costs based upon the monthly reduction in Class A and Class B principal balance.

As to unit of account – for purposes of its analysis, MBank has identified at least two possibilities that it will work to refine before implementing FIN 48. MBank, also has identified a pair of inter-related uncertainties that it believes must be evaluated.

MBank FIN 48 Evaluation of Securitization Transaction

- Tax position:
 - Characterization as a financing for tax purposes
- Possible units of account:
 - Securitization transactions characterized as financings for tax purposes by asset class and structure (i.e., characteristics vary)
- Possible uncertainties
 - Whether the Class A and B securities are debt for tax purposes?
 - Whether the benefits and burdens of owning the loans were retained by MBank?

2 – Recognition Threshold

Based upon its determinations in step 1, MBank undertook to resolve whether its 4th qtr 2006 securitization transaction that is treated as a financing for income tax purposes *more-likely-than-not* (MLTN) would be sustained upon examination by the taxing authority based solely on its technical merits if taken to the court of last resort. Together with its tax advisor, MBank performed an extensive analysis of the relevant tax criteria for distinguishing: i) between debt and equity instruments and ii) between sale and financing transactions¹².

After completing its analysis (based on the appropriate units of account), MBank was able to conclude that the Class A would be and the Class B MLTN be treated as debt for income tax purposes and that its securitization transaction that is treated as a financing for income tax purposes MLTN be sustained upon examination by the taxing authority and therefore would meet the **Recognition Threshold** of FIN 48. MBank summarized the pertinent facts and tax issues as well as the **technical merits** of its rationale and conclusion in a tax memo to be

shared with its auditors.

3 – Measurement Threshold

Following its conclusion that the **Recognition Threshold** had been met, MBank commenced its measurement analysis by first comparing and reconciling the amount of its gain under FAS 140 with the amount of its potential gain if the Class B were characterized as equity, resulting in the transaction being characterized as a sale of the Class B for income tax purposes.

(i) Determining amount of recognized tax benefit

Next, MBank considered the amounts and probabilities of the outcomes that could be realized upon ultimate settlement using the facts, circumstances, and information available. To assist in its evaluation, MBank’s management developed the following matrix to illustrate its analysis of the amounts it would ultimately accept in a negotiated settlement with the taxing authorities:

Gain Deferral Benefit	Deferral Disallowed	Individual Probability %	Cumulative Probability %
\$ 2,123	\$ –	0%	0
1,964	159	10%	10%
1,920	203	20%	30%
1,663	460	25%	55%
1,135	988	45%	100%

Based upon its findings, MBank concluded that the largest amount of its tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement was \$665 (\$1,663 at a 40% tax rate). Management then contrasted the gain deferral resulting from the application of FIN 48 to the gain deferral that it would have expected based on its planned tax return filing and determined that it would need to establish a FIN 48 liability of \$184 (\$460 at a 40% tax rate – see table below).

Based upon its findings, MBank summarized its recognized and unrecognized tax benefits and compared the journal entries it would expect to make on a FIN 48 and pre-FIN 48 basis as follows:

⁸ To join Dbriefs or listen to a playback of FASB Interpretation No 48, Accounting for Uncertainty in Income Taxes, July 31, 2006 – go to www.deloitte.com and click on Dbrief Webcasts at the bottom right side of the page.

⁹ For a comprehensive discussion of FAS 140 – see “Securitization Accounting – The Ins and Outs (And Some Do’s and Don’ts) of FASB 140, FIN 46R, IAS 39 and More . . .” by Marty Rosenblatt, Jim Johnson & Jim Mountain – Seventh Edition, July 2005 – hereafter “Securitization Accounting”

¹⁰ Commonly referred to as a “debt-for-tax” or “DFT” structure.

¹¹ A Real Estate Mortgage Investment Conduit. The related income tax rules for REMICs are contained in IRC § 860A through IRC § 860G.

¹² For a general overview of the tax criteria and considerations involved in this analysis, see “Can I have my cake and eat it too with debt-for-tax and a sale for GAAP?” – page 22, Securitization Accounting – infra 17.

Recognized Tax Benefits		Unrecognized Tax Benefits	
Book Basis	2,123	Tax Return	0
FIN 48 Basis	460	FIN 48 Basis	460
Difference	1,663	Difference	(460)
Tax Rate	40%	Tax Rate	40%
Recognized Tax Benefit	665	Unrecognized Tax Benefit	184

	As Filed		FIN 48	
	Dr	Cr	Dr	Cr
Current Income Tax Expense	0		184	
Current Income Tax Liability		0		
Fin 48 Liability				184
Deferred Income Tax Expense	849		665	
Deferred Income Tax Liability		849		665

4 – Determine classification

Since MBank presents a classified statement of financial position it will be required to appropriately classify its FIN 48 Liability.

MBank intends to report its securitization as a financing on its income tax return. Consequently, MBank will report ongoing taxable income from the securitization each year in an amount equal to the net income or loss it earns from the transaction¹³. Based upon its current projection at the original prepayment assumption of 12.5 CPR, MBank has determined that it will recognize approximately \$25 of its Unrecognized Tax Benefit during the next 12 months and therefore will characterize that \$25 as a current liability and the remaining \$159 as non-current.

5 – Accrue interest and penalties, if applicable

Although the time for accruing interest has not yet commenced¹⁴, MBank will monitor the amount of its outstanding FIN 48 Liability each reporting period to ensure the appropriate amounts of interest are recognized.¹⁵

6 – Prepare Disclosures

The last item for MBank to consider is its FIN 48 Disclosure requirements. Based upon its interpretation of paragraphs 21 of FIN 48, management has drafted the following disclosure:

	(000)
Unrecognized tax benefits, opening balance:	0
Increases – tax positions taken in prior periods:	0
Decreases – tax positions taken in prior periods:	0
Current period tax positions:	184
Settlements:	0
Lapse of statute of limitations:	0
Unrecognized tax benefits, ending balance:	184
Approximately \$25 of the above tax positions are expected to reverse during the next 12 month period due to the enterprises current tax accounting methodology.	

MBank will adjust its tabular rollforward of unrecognized tax benefits (illustrated above) as it continues to evaluate its other material tax positions.

Having satisfactorily completed its FIN 48 analysis of its tax position for characterizing the securitization as a financing for income tax purposes ... MBank will now move on to perform similar evaluations of its other tax positions... beginning with hedging.

For additional information relating to how Deloitte can help you with your implementation of FIN 48, please contact:

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¹³ The amount of such net income(loss) each year resulting from MBank's securitization being treated as a financing generally would equal the sum of: gross interest income on the loans, amortization of discount on the loans (i.e., attributable to the origination fees) and any earned under the cap contracts; reduced by the sum of the gross interest expense on the Class A and Class B, servicing expense, cap premium amortization expense, debt issuance costs amortization expense, etc.

¹⁴ Since, the time for reporting the transaction in MBank's income tax return has not yet occurred.

¹⁵ Based upon the MLTN conclusion with respect to MBank's tax position, penalties would not be expected to apply.

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