Liabilities for Uncertain Tax Benefits
FIN 48 versus IAS 12

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Example

- A firm claims an uncertain tax benefit (normalized to $1) on its tax return.

- The firm believes that it is more likely than not that its tax return position would be sustained in court based solely on the technical merits.

- The firm believes that there is a 50 percent probability that the transaction will be audited.
• If the transaction is audited, the firm believes that
  there is a 48 percent probability that the entire benefit will be retained;
  there is a 12 percent probability that none of the benefit will be retained;
  there is a 40 percent probability that part of the benefit will be retained, uniformly distributed over the interval (0, 1).
• Under the stipulated facts, the expected payment to the tax authority is

• $50\% \times [(\$0 \times 48\%) + (\$1 \times 12\%) + (\$0.50 \times 40\%)] = \$0.16.$
Liability under IFRS (IAS 12) "Single most likely outcome" approach

- Liability is based on the *mode* of the distribution of outcomes.

- The taxpayer would record no liability under a literal application of this standard.

- Would the standard be applied literally if the distribution of outcomes is diffuse?
Liability under IFRS (IAS 12) "Probability weighted average" approach

- Liability is based on the mean of the distribution of outcomes, conditional on audit.

- Under the stipulated facts, the liability is

\[ \left[ (0 \times 48\%) + (1 \times 12\%) + (0.50 \times 40\%) \right] = 0.32. \]
Liability under GAAP (FIN 48)
Cumulative probability model

• The transaction passes the "more likely than not in court based on technical merits" test; otherwise, the liability equals the entire tax benefit.

• The liability is based on the median of the distribution of outcomes, conditional on the transaction being audited.

• The median retained benefit is $0.95 (48% chance of full retention plus 2% chance of retaining between $0.95 and $1.00).

• So the FIN 48 liability is only $0.05 in this example.
Summary

• The expected cash flow associated with an uncertain tax position reflects both the probability of audit and the mean of the distribution of retained tax benefits.

• IFRS records a liability either based on the mode or mean of the distribution of retained tax benefits, conditional upon audit.

• GAAP records a liability based on the median of the distribution of retained tax benefits, conditional upon audit, if the "technical merits" test is passed.

• None of these liability recognition rules necessarily corresponds to the expected cash flow.