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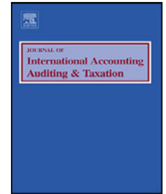

FIN 48, uncertainty and transfer pricing: (Im)Perfect together?

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ABSTRACT

The nexus of Financial Accounting Standards Board Interpretation No. 48: Accounting for Uncertainty in Income Taxes (FIN 48) requirements and a company's transfer pricing practices has created significant reporting and disclosure issues for transnational corporations (TNC) in the United States and its major trading partners. Of interest are changes in TNC disclosures of uncertain tax positions and unrecognized tax benefits, both generally and specific to transfer pricing, and whether TNCs increased advance pricing agreement activities to mitigate transfer pricing-related uncertainty. This study found that FIN 48 implementation led to significant increases in the types and amount of information provided in annual report footnotes about the uncertain tax positions of TNCs, and the quantification of their related unrecognized tax benefits. FIN 48 increased both the quality and quantity of tax-related reporting in the annual reports of its adopters, making their transactions more transparent and understandable to the external users of their annual reports. FIN 48 also seems to have led to an increase in TNC interest in negotiating advance pricing agreements with their own and with related tax authorities in order to mitigate the effects of one of the largest and most uncertain tax positions, cross-border transfer pricing transactions.

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1. Introduction

> In a series of surveys among U.S. finance and tax directors during the last year, the reporting requirements under FIN 48 are seen as among the most challenging aspects of their work. It ranks alongside transfer pricing as presenting the most consistently complex and demanding aspect of the work of tax departments. (Anonymous, 2008)

The nexus of Financial Accounting Standards Board (FASB) Interpretation No. 48: Accounting for Uncertainty in Income Taxes[2] (FIN 48) requirements and a company's transfer pricing practices has created significant reporting and disclosure issues for transnational corporations (TNCs) in the United States (U.S.) and elsewhere. The rationale driving FIN 48 is the standardization of the reporting of uncertain tax positions (UTPs) and related unrecognized tax benefits (UTBs), leading to improvement in the overall quality and transparency of corporate financial reporting.[3] Many significant UTPs experienced by TNCs during their normal operations are related to the cross-border income shifting due to transfer pricing transactions, the characterization of specific transactions as not affecting reportable income or as tax exempt, and management decisions

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2 FIN 48 is now found in ASC 740-10-05, 25, 30, 35, 40, 45, 50, and 60 of the FASB Codification.
3 See Frischmann et al. (2008) for an excellent history, development, and implementation of FIN 48.

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that earmark certain income as not taxable by a foreign tax authority (August, 2008). How has FIN 48 changed the disclosure of these UTPs in terms of their frequency, content, and details provided?

Before FIN 48 and the subsequent issuance of Schedule UTP (IRS, 2010), tax authorities dealing with U.S.-based TNCs had little or no information as to which TNC issues might be uncertain, and the monetary amounts of those UTPs. These now mandatory disclosures in the financial reports and tax returns will assist tax authorities in identifying those issues to be assessed further in a transfer pricing audit, and in uncovering evidence of any significant income-shifting activities. FIN 48 also provides external users of financial statements with increased comparability among TNCs of their income tax liabilities and UTPs with the potential to affect future profits.

The relationship between FIN 48 and TNC transfer pricing activities has not been studied, given that FIN48 implementation was not mandatory until 2008 for all TNCs following U.S. GAAP, regardless of the parent TNC's home country. The International Accounting Standards Board (IASB) does not yet provide specific guidance to TNCS about UTPs and does not require UTP disclosure, so FIN 48 does not directly affect TNCs with IFRS-based financial reports.[4] However, all TNCs must consider FIN 48 implications as the FASB and IASB move toward convergence of their accounting standards. The IASB expects to release an exposure draft on UTPs once its revisions of *IAS 12 Income Taxes*, and *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*, are complete.

The first of two areas of interest in this study are TNC disclosures of UTPs and UTBs, both generally and specific to transfer pricing. The disclosures are analyzed as to their content matter, frequency, size, and changes over time. The second area of analysis is whether TNC advance pricing agreement[5] (APA) activities increased to mitigate transfer pricing-related uncertainties. Disclosures are first assessed both pre- and post-FIN 48 implementation in terms of their dollar impact. A content analysis of these disclosures further addresses the quantity, quality, content and materiality of FIN 48-related information provided by the TNCs in the sample. Finally, actions that TNCs may have taken to mitigate the uncertainty of transfer pricing-related UTPs, specifically APA negotiations, are analyzed before and after FIN 48 implementation. The population consists of U.S. TNCs and Australian, Canadian and Japanese TNCs with subsidiaries in the U.S. These countries' tax authorities comprise the Pacific Association of Tax Administrators (PATA), a group formed in 1980 to combat income shifting, improve cross-border information flows, discuss transfer pricing-related issues, and forge more conciliatory relationships[6]. This relationship may also facilitate the negotiation of APAs by TNCs in these countries. As will be explained in Section 3.3, *Derivation of the Study Sample*, only GAAP-based U.S. and Japanese TNCs were affected by FIN 48 requirements and, therefore, comprise the final sample for the disclosure analysis. For the analysis of APA activity, however, all TNCs from the four PATA countries who negotiated APAs with any of the four tax authorities make up the APA sample.

The next three sections present a brief introduction to FIN 48 reporting, transfer pricing, and APAs respectively. The methodology is then discussed, followed by an analysis of the findings, ending with conclusions and recommendations for future research.

2. FIN 48 and transfer pricing

2.1. FIN 48 in brief

In brief, FIN 48 explains how a company should account for UTPs and UTBs in its financial statements as required in FAS Statement No. 109: Accounting for Income Taxes (FASB, 1992)[7]:

> 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. (FASB, 2006, Para. 2, 1)

FIN 48 requires TNCs to assess each tax position against a more-likely than-not (MLTN) threshold (recognition), and then to include in the financial statements all tax positions exceeding this threshold at the amounts determined to be more-likely than-not realized (measurement). This mandatory evaluation of every material tax position in a TNC's domestic and foreign tax returns should result in "increased relevance and comparability in financial reporting because all tax positions accounted for in accordance with Statement 109 will be evaluated for recognition, derecognition, and measurement using consistent criteria" (FASB, 2006, 2). To complicate matters, each previously evaluated UTP must be reevaluated if and when new information becomes available. Tax benefits from an unresolved UTP must be recognized or derecognized if those

[4] The IASB released an exposure draft on income taxes in 2009 which requires UTP reporting, but differs from FIN 48 in how to assess what constitutes a UTP.

[5] APAs are formal accords negotiated among a TNC and relevant tax authorities. An APA identifies the transfer pricing method that is acceptable to all parties for a multi-year period. It reduces the uncertainty surrounding transfer pricing transactions and reduces the risk of transfer pricing-related audits by the relevant tax authorities.

[6] For a history of PATA and its relationship to transfer pricing (see Borkowski, 2008, 2010).

[7] FAS109 is now found in ASC 740-10 of the FASB Codification. UTPs are defined in detail here.

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