

TAX in
*the NEWS***EVEN AUTOMAKER IS HURT BY THE SUBPRIME MORTGAGE MESS**

General Motors took a \$39 billion hit to earnings in the third quarter of 2007 by establishing a valuation allowance against certain deferred tax assets in the United States, Canada, and Germany. GM reported that one significant factor in creating the need for the valuation allowance was the problems related to its GMAC Financial Services Residential Capital mortgage business.

Although the increase in valuation allowance is not a cash-flow item, the \$39 billion directly reduced GM's 2007 reported

net income. Look for this item in GM's 2007 income tax footnote as a tax rate reconciling item. A hit to net income of \$39 billion is a very large number, even for a company the size of GM. In comparison, GM's aggregate 2006 loss was only \$2 billion. The reported losses of 2008 and 2009 likely triggered major hits to valuation allowances for many companies.

Some observers believe that increases in valuation allowances are a harbinger of bad times to come for a company. This certainly turned out to be true for GM.

TAX in
the NEWS**FINANCIAL ACCOUNTING EFFECTS OF TAX UNCERTAINTIES**

Companies take positions in their tax returns that may not ultimately survive the scrutiny of the IRS or other tax authorities. If a taxpayer loses the benefit of a favorable tax position after a future audit, the loss of this tax benefit may unfavorably affect the company's financial statement tax expense in that future year. The additional tax cost will become part of the current tax expense, yet the income this tax is related to would have been reported in the initial year. This result wreaks havoc with a company's effective tax rate.

To avoid this increase in effective tax rate, companies may book a reserve or "cushion" for the uncertain tax position in the initial year. That is, rather than book the entire tax benefit (and thus reduce tax expense in the current year), the company may book only a portion (or none) of the tax benefit. If the company later loses the actual tax benefit upon audit, to the extent the additional tax imposed is charged against the reserve (or "cushion"), the additional tax does not affect the future-year tax expense. If the company's tax position is not challenged in the future (or the company successfully defends any challenge), the reserve can be released. This release reduces the current tax expense in the future (release) year and lowers the company's effective tax rate in that year.

Prior to 2006, *FAS 5, Accounting for Contingencies*, addressed the accounting for uncertain events in the financial statements. Some of the FAS 5 rules addressed the use of a required reserve related to taxes. Even with FAS 5, the FASB was concerned that companies too freely used the tax reserve as a "cookie jar" to shift earnings from one period to another. To add more structure to the accounting for tax reserves, in July 2006 the FASB released Financial Interpreta-

tion No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. This was the most significant change to the accounting for income taxes since the adoption of FAS 109. The approach required under ASC 740-10 (FIN 48) results in significantly more disclosure about uncertain tax positions by companies. This provision significantly changes the rules for accounting for uncertain tax positions.

Application of ASC 740-10 (FIN 48) essentially is a two-step process. First, a tax benefit from an uncertain tax position may be recognized in the financial statements only if it is more likely than not that the position would be sustained on its technical merits. That is, audit or detection risk cannot be considered. This first step determines whether *any* of the tax benefit is recognized. If the uncertain tax position meets the more likely than not threshold, the second step is to determine the amount of the tax benefit to report (i.e., the measurement step).

An uncertain tax position is measured as the largest amount that has a cumulative probability exceeding 50 percent of being the final outcome of the position. That is, the measurement is based on the probabilities associated with the position not being challenged, or being challenged with a negotiated settlement or litigation. All the relevant facts and circumstances as of the financial statement reporting date should be used in determining the probability of the ultimate outcome.

The recognition and measurement of uncertain tax positions must be reassessed at each reporting date. ASC 740-10 (FIN 48) requires a reconciliation of the beginning and ending balances of the unrecognized tax benefits and a discussion of potential changes in these unrecognized tax benefits that might occur over the next 12 months.