positions either should not be recognized or should be recognized only partially. Accordingly, the FASB issued a tax position standard to address this particular type of contingent liability (previously falling under the auspices of SFAS No. 5, now in ASC 450).

In applying the tax position standard, a firm takes a two-step approach. First, the firm determines whether the tax position has a *more likely than not* (greater than 50%) probability of being sustained upon an IRS examination. This determination requires substantial judgment and necessitates careful documentation for the financial statement audit and any IRS examination. If the tax position does not exceed this threshold, the firm cannot recognize the tax benefit for financial reporting purposes until one of the following three events occur:

▶ The position subsequently meets the *more likely than not* threshold.

▶ The firm favorably settles the tax issue with the IRS or in court.

▶ The statute of limitations on the transaction expires.

If the firm determines that a tax position meets the *more like than not* threshold, it then must measure the amount of benefit it can recognize for financial reporting purposes. This measure is the largest amount of tax benefit that exceeds a 50% probability of realization upon settlement with the taxing authorities. Further details of this measurement process and other procedures under the tax position standard become quite complex and are beyond the scope of this textbook.

EXAMPLE C:3-54 ▶ Lambda Corporation claims a $1 million deduction on its tax return, which provides a $350,000 tax savings, assuming a 35% tax rate. After some analysis and judgment, management determines the deduction has only a 45% chance of being allowed should the IRS audit Lambda's tax return. Assume for simplicity that Lambda has no deferred tax assets or liabilities. Assume further that Lambda's pretax book income and taxable income equal $20 million after taking the $1 million deduction. Thus, Lambda's tax liability is $7 million. Under the tax position standard, Lambda makes the following journal entry (ignoring potential penalties and interest):

Federal income tax expense	7,350,000	
Liability for unrecognized tax benefits		350,000
Federal income taxes payable		7,000,000

Suppose in a subsequent period Lambda negotiates a settlement with the IRS that allows $200,000 of the deduction, and Lambda pays $280,000 tax on the $800,000 disallowed portion. Ignoring penalties and interest, Lambda would make the following journal entry:

Liability for unrecognized tax benefits	350,000	
Cash		280,000
Federal income tax expense		70,000

EXAMPLE C:3-55 ▶ Assume the same facts as in Example C:3-54 except Lambda meets the *more likely than not* threshold. Lambda then measures the benefit more than 50% likely to be realized as $600,000 of the $1 million deduction taken. Thus, Lambda may not recognize $400,000 for financial reporting purposes and, accordingly, makes the following journal entry:

Federal income tax expense	7,140,000	
Liability for unrecognized tax benefits		140,000
Federal income taxes payable		7,000,000

BALANCE SHEET CLASSIFICATION

Deferred tax liabilities and assets must be classified as either current or noncurrent. If related to another asset or liability, the classification is the same as the related asset. For example, a deferred tax asset pertaining to a difference between book and tax bad debt expense is current because it relates to accounts receivable. On the other hand, a deferred tax liability pertaining to a difference between book and tax depreciation is noncurrent because it relates to fixed assets. If a deferred tax liability or asset does not relate to a particular asset or liability, it is classified as current or noncurrent depending on its expected reversal date. Once classified as current and noncurrent, all current deferred tax liabilities and assets must be netted and presented as one amount. Similarly, all noncurrent deferred tax liabilities and assets must be netted and presented as another amount.