FIN 48
Accounting for Uncertainty and Insuring the Results

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One of the recent efforts to force companies to disclose potential pitfalls to investors is FIN 48, an accounting rule regarding uncertain tax positions. FIN 48 shines a spotlight on a company's contingent tax liabilities, requiring companies to disclose the aggregate amount of such reserves and how those amounts have changed. In addition, companies must disclose the particular tax positions that have a reasonable possibility of significant change over the next twelve months. Total reserves for unrecognized tax benefits are estimated at $78 billion. Calculation of a reserve is highly complex and ultimately very subjective, so even the most conscientious taxpayer runs a risk of getting it wrong. An innovative new technique enables companies to insure their FIN 48 positions, and avoid potential liability associated with a determination that their calculation was imprecise.

FIN 48 is a FASB interpretation of Statement 109, which requires companies to disclose the amount of tax benefits that a company has taken that may not ultimately be realized. The rule creates burdensome procedures for calculating reserves. A company must assume that every tax position will be examined by the relevant taxing authority and further assume that authority has full knowledge of all relevant information. If, under these circumstances, it is more likely than not that the government will prevail, then a full reserve must be posted for that position. The procedure does not allow for an assumption that the government will trade off some positions in exchange for concessions on others. Thus, if properly applied, the FIN 48 procedure may significantly increase a company's tax reserves.

In the first year in which FIN 48 is applied, the change in reserve affects retained earnings. Thereafter, increases to the FIN 48 reserves become a charge to income and a balance sheet liability. Tax reserves under FIN 48 are required for all "open" tax positions, which is generally three or more years following the filing of a tax return. For some companies, such reserves can have a material impact on their trailing twelve-month free cash flow or on their liquid assets. In tight financial markets, FIN 48 reserves could trigger technical defaults of loan covenants.

All public companies are currently required to comply with FIN 48 and it becomes applicable to private companies next year.

One of the most effective ways for companies to mitigate the risks presented by FIN 48 is to obtain FIN 48 insurance. Essentially, FIN 48 insurance will backstop a company's FIN 48 reserves by insuring that the covered uncertain tax positions will not create an ultimate tax exposure (including penalties, interest and perhaps defense costs and a "gross-up" – all discussed below) beyond the self-insured retention that will be based upon (but not necessarily equal to) the FIN 48 reserves for the insured tax positions.

For example, FIN 48 Insurance could insure all of a company's uncertain tax positions perhaps with a retention that is equal to the FIN 48 reserves. Alternatively, FIN 48 Insurance could insure several uncertain tax positions, perhaps supported by opinions, for which no FIN 48 reserve was established because management believes that, despite the uncertainty, it would not settle the positions for less than 100% of the tax benefit reported.

FIN 48 Insurance is an annual tax insurance policy, available to cover a company's annual measurement and recognition of multiple tax positions. The insurance is adjustable. Each year, subsequent to underwriting of any new tax positions, the insured can increase or decrease the amount of insurance.

The benefits of FIN 48 Insurance are:

1. It provides cash if adverse tax assessments exhaust the reserves/retention;
2. It adds credibility to the FIN 48 analysis, because an insurer has underwritten the adequacy of the reserves and put its own money at stake; and
3. It adds financial support to the position, if taken, that any change in reserves would not be material and that additional disclosure is not required.

The last benefit relates to one of the more onerous requirements of FIN 48. If there is a reasonable possibility that a tax reserve will change ***significantly*** over the next twelve months, then the company must disclose that particular tax position, identifying the specific tax issues at issue. Usually, a reserve is likely to change only because of an audit or the expiration of a statute of limitations. Hence, the additional disclosure of specific tax issues can become a self-fulfilling prophecy and "roadmap" to the taxing authorities. FIN 48, however, is not applicable to items that are immaterial.

FIN 48 Insurance compliments traditional (transactional) tax insurance – which tend to cover a discrete tax position (or set of related positions) under a six year policy. Neither, FIN 48 Insurance nor transactional tax insurance, however, cover reportable transactions (e.g., transactions that the IRS believes are either abusive or may be abusive and are required by Treasury regulations, as augmented by IRS notices, to be reported as such).

In today's climate of "increased transparency", volatility in tax reserves, liabilities and effective tax rates can spawn lawsuits. Yet, large tax reserves by a company will likely entice taxing authorities, coping with governmental budget deficits, to carefully scrutinize the company. We believe tax insurance, in general, and FIN 48 Insurance, in particular, may be especially suited to these times.

One insurance underwriter, specializing in this market, describes it thusly:

> *"The advent of annual, adjustable tax insurance solves one aspect of today's challenging need to rigorously manage financial risk. It is an important component of several niche insurance products that can provide "balance sheet certainty" despite contingent liabilities and subjective judgments that underlie any balance sheet."*