

FIN 48 and Tax Compliance

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Overview

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- We develop a strategic tax compliance model to examine the interaction between the taxpayer and the government that incorporates 2 main features:
 1. Tax law uncertainty; and
 2. Mandated disclosure (e.g. FIN 48) of the taxpayer's uncertainty
- We use our model to investigate how the strategic interaction between publicly-traded corporate taxpayers and the government changes as a result of FIN 48

Tax Law Uncertainty: An Example

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- To avoid a large capital gain on the sale of a subsidiary; Times Mirror engaged in “complex and unconventional” tax-free reverse triangular merger with Reed Elsevier (1998)
- IRS re-characterized the reorganization as a sale based on an argument that the transaction lacked economic substance and determined a deficiency of \$600m (2002)
- Tax court sided with the IRS and Times Mirror paid \$1b in taxes and interest and then appealed (2006)
- IRS initiated settlement; case was settled for \$750m (2007)

Accounting for Tax Uncertainty

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- Taxpayers sometimes file tax returns that include tax benefits from uncertain tax positions (i.e., tax-free reorganizations)
- The IRS might someday audit the return, challenge the position, and collect a tax deficiency
- The accounting problem is how to recognize and measure benefits from uncertain tax positions in the financial statements
- FIN 48 provides new rules for *recognizing* and *measuring* the benefit and requires the firm to *publicly disclose* any liability for unrecognized tax benefits

Common FIN 48 Conjectures

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- FIN 48 provides the government a “roadmap” that will reduce the expected payoff to taxpayers that claim uncertain tax positions
- A FIN 48 liability is overstated because accounting measurement does not consider the probability of an audit
- FIN 48 will cause fewer taxpayers to claim uncertain tax positions

Basic Model

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- A taxpayer (T) files a tax report with the government (G) that is low income ($r=L$) with a tax benefit of \$1 or high income ($r=H$) with a tax benefit of \$0
- T has private knowledge about its own 'facts and circumstances' that we model as the expected tax benefit (x) retained on audit
- G audits low income reports with a probability (α), incurs an audit cost (c), and collects a penalty (π) on T's expected tax deficiency ($1-x$)

Expected Payoff Matrix (Fig. 2)

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[T,G]	Audit	No audit
Low income report	$x - \pi(1-x), \pi(1-x) - x - c$	1, -1
High income report	0, -c	0, 0

Pre-FIN 48 (Prop.1)

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- Taxpayers with
 - strong positions ($x > x^*$) file low income reports
 - weak positions ($x < x^*$) file high income reports
- Government audits all, some, or no low income reports, depending on audit costs
- x^* , the taxpayer's 'cutoff rule', is higher when the probability of a government audit is higher

FIN 48 Model

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- We assume that
 - Taxpayers file a tax report with one uncertain tax position
 - Taxpayers report to one taxing jurisdiction
 - FIN 48 disclosures are truthful
 - Government observes the uncertain position in the tax report
- These assumptions given FIN 48 the best chance of affecting the interaction between the taxpayer and the government

FIN 48: Strong Positions

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3 Steps of FIN 48

- 1. Recognition** [$p(x)$]: Is T > 50% certain of sustaining \$100 tax benefit in court?
 - ✦ If no, \$100 liability
 - ✦ **If yes, then measure**
- 2. Measurement** [$m(x)$]: Recognize largest tax benefit with cumulative probability of 50% of being retained on audit (i.e., **\$100**) ←
- 3. Disclosure** [D]: **\$0 liability** (i.e., \$100-\$100)

Measurement Step

Tax position provides T a \$100 tax benefit with distribution of expected outcomes on audit as follows:

Tax Benefit Retained	Individual Probability	Cumulative Probability
\$100	55%	55% ★
\$60	25%	80%
\$0	20%	100%

- $x = \$70$, mean tax benefit retained
- $\alpha(\$100-x)$ is T's expected tax liability

D=\$0 signals to G that T has a strong position

(Prop. 2: $x \geq x_S$)

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Relative to pre-FIN 48:

All taxpayers with a strong position continue to file a low income report, while the probability that the government audits a low income report decreases

FIN 48: Intermediate Position

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3 Steps of FIN 48

- 1. Recognition** [$p(x)$]: Is T > 50% certain of sustaining \$100 tax benefit in court?
 - ✦ If no, \$100 liability
 - ✦ **If yes, then measure**
- 2. Measurement** [$m(x)$]: Recognize largest tax benefit with cumulative probability of 50% of being retained on audit (i.e., **\$60**)
- 3. Disclosure** [D]: **\$40 liability** (i.e., \$100-\$60)

Measurement Step

Tax position provides T a \$100 tax benefit with distribution of expected outcomes on audit as follows:

Tax Benefit Retained	Individual Probability	Cumulative Probability
\$100	20%	20%
\$60	55%	75%★
\$0	25%	100%

- $x = \$53$, mean tax benefit retained
- $\alpha(\$100-x)$ is T's expected tax liability

D=\$40 fully reveals x to G

(Prop. 3: $x_W < x < x_S$)

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Relative to pre-FIN 48:

All taxpayers with an intermediate position continue to file a low income report, while the probability that the government audits a low income report may increase or decrease

FIN 48: Weak Position

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3 Steps of FIN 48

- 1. Recognition** [$p(x)$]: Is T > 50% certain of sustaining \$100 tax benefit in court?
 - ✦ **If no, \$100 liability**
 - ✦ If yes, then measure
 - 2. Measurement** [$m(x)$]: not applicable, go directly to step 3
 - 3. Disclosure** [D]: **\$100 liability** (failed recognition in step 1)
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Measurement Step (N/A)

Tax position provides T a \$100 tax benefit with distribution of expected outcomes on audit as follows:

Tax Benefit Retained	Individual Probability	Cumulative Probability
\$100	20%	20%
\$60	25%	45%
\$0	55%	100%

- $x = \$35$, mean tax benefit retained
- $\alpha(\$100-x)$ is T's expected tax liability

D=\$100 signals to G that T has a weak position

(Prop. 4: $x \leq x_W$)

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Relative to pre-FIN 48:

Some taxpayers with a weak position stop filing a low income report, while the probability that the government audits a low income report increases

Key Insights from our Model

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- *Expected payoff from low income reports increases* for taxpayers with strong positions because FIN 48 disclosure deters audits
- FIN 48 liability is *understated* if median exceeds mean benefit [$m(x) > x$],
and α is high

Liability	=	Audit probability	×	Deficiency measure
Disclosed liability		1		1-median
Expected liability		α		1-mean

- Some taxpayers with weak positions file fewer low income reports as a result of FIN 48 while other taxpayers with weak positions have no change in their reporting strategy

Summary

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- Our model suggests overreaction to FIN 48
 - Higher expected payoffs to some taxpayers that claim uncertain tax benefits
 - Disclosed liability may understate the expected liability
 - Taxpayers whose circumstances only weakly support their positions sometimes continue to claim the uncertain tax benefit