FIN 48 and Tax Compliance

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Overview

- 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

- 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

- 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

- 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

- 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)

[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)

- 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

- 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

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
- α($100-$x$) is T's expected tax liability

D=$0 signals to G that T has a strong position
(Prop. 2: $x \geq x_S$)

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

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
- $\alpha(\$100\text{-}x)$ is T's expected tax liability

D=$40 fully reveals *x* to G

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

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

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)

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
- $\alpha(\$100\text{-}x)$ is T's expected tax liability

D=$100 signals to G that T has a weak position (Prop. 4: $x \leq x_W$)

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

- *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

- 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