

Regulatory Watch: FIN 48 Creates Unexpected Risks In Business Sales

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The Financial Accounting Standards Board's statement on "uncertainty in tax positions," FIN 48,¹ has itself created uncertainty in business sales, acquisitions, and mergers. Recent articles guide practitioners in complying with FIN 48's complex rules, and warn practitioners that their work papers could expose aggressive positions to the IRS.² However, none has explored in detail the impact that the FASB pronouncement may have on business acquisitions. FIN 48 greatly increases financial and legal risks for both the buyer and the seller of a business enterprise. Lawyers on both sides of the transaction will need to employ non-traditional language in the agreement in order to control these new risks.

Traditional Drafting Meets FIN 48

Before any deal for the acquisition of a business can be completed, the buyer must feel reasonably assured that the business is worth the purchase price. Buyers want to reduce the risk of unknown liabilities, and to minimize the chance that the income and assets of the business are less than represented. The buyer

usually controls these risks by negotiating a combination of disclosures, representation, warranties, and limitations in the purchase and sale agreement. These risk-allocation clauses are now employed with sufficient consistency that they have become standardized; model forms are readily accessible in the literature,³ and practitioners can meaningfully assert that certain representations are customary, or "market."

In particular, sellers consistently make available the target's financial statements and almost always represent that the financials have been prepared in accordance with GAAP (financial warranty).⁴ The wide acceptance of this representation by both buyers' and sellers' counsel, however, did not anticipate that GAAP would require compliance with FIN 48, which mandates that the target's financial statements incorporate, as balance sheet

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items, provisions for uncertain income tax positions. The effect of FIN 48 is that a seller who represents that a target's financials are GAAP-compliant also represents that it has correctly quantified its uncertain income tax positions in accordance with the FIN 48 rules. Errors in estimating the unrecognized tax liabilities associated with uncertain tax positions may constitute a breach of the financial warranty.

This may come as a surprise to sellers' counsel. The "market" representation concerning taxes is simply that all required returns have been filed for the pre-closing periods, that they are correct and complete in all material respects, and that all taxes have been paid.⁵ The seller's obligation to indemnify the buyer for breach of the tax warranty generally has been limited to the case where an audit is initiated by a tax authority and the audit results in an increase in tax liability for a pre-closing period.

In a sense, the financial warranty has always implied a tax warranty, because to the extent that taxes should have been paid or accrued and were not, the financial statements do not fairly present the target's results of operations or financial position. However, before FIN 48, the tax warranty implied by this financial warranty was merely a restatement of the explicit warranty concerning taxes, namely, that the seller will assume responsibility for taxes in all pre-closing periods. Since FIN 48, the financial warranty now implies a tax representation that is well beyond the scope of the traditional tax warranty. FIN 48 requires that the balance sheet include as liabilities uncertain tax positions (both for open past periods⁶ and a year into the future) and that these estimated liabilities be correctly measured in accordance with a complex set of rules. The seller who errs in identifying or estimating the liabilities that could result from uncertain tax positions therefore produces financials that are not GAAP-compliant. As a result, the buyer could be entitled to indemnity even if no audit is ever performed, and even if no additional tax is ever assessed.

Separately from this civil liability exposure, a public company that fails to comply with FIN 48 reporting and disclosure requirements could face sanctions under the securities laws. As a rule, these sanctions are not imposed for mere errors of judgment or mis-

takes in computation, but a knowing misstatement by a public company could result in both civil penalties and criminal sanctions for the company and its officers.⁷ While these sanctions do not extend to companies not required to report to the SEC, private companies that are being sold necessarily adopt the FIN 48 standard by making the financial warranty. Potential liability to a buyer, rather than imposition of penalties by the SEC, hence seems to serve as the mechanism of enforcing FIN 48 for private companies.⁸

FIN 48 Is a Disclosure Requirement

In view of its history, it is not surprising that FIN 48 should have the effect of strengthening a seller's representations and a buyer's remedies. FASB's purpose in adopting its Interpretation No. 48 was not to enhance tax compliance (although it may also have that effect) but rather to enhance disclosure to persons investing in business enterprises.

FIN 48 grew out of the infamous Enron and WorldCom scandals and the responsive Sarbanes-Oxley Act of 2002.⁹ Under that Act, Congress charged the SEC—which had long had authority¹⁰ to recognize financial accounting standards as "generally accepted"—with implementing regulations to restore public confidence in audited financial statements.¹¹ The Public Company Accounting Oversight Board (PCAOB), newly established under the SEC by Sarbanes-Oxley, took on responsibility for implementing specific rules under GAAP to increase transparency in financial reporting.¹² FASB, as a delegee of the SEC's oversight authority and pursuant to direction from PCAOB, then issued FIN 48 for the explicit purpose of increasing relevance, consistency, and reliability of financial reporting of income taxes.¹³

Despite public concern that FIN 48 may abet the IRS in overzealous tax enforcement,¹⁴ nothing in the history of FIN 48 suggests that improving tax collections is among its purposes. Its sole objective is to improve disclosure to investors. It is therefore entirely consistent with FIN 48's intention that civil liability may accrue to a seller who overstates the strength of a target's tax position, notwithstanding that the mistake may be inadvertent, and notwithstanding that no tax authority may have assessed any deficiency.

The Seller's Risk Is Misstatement

Prior to FIN 48, there was no specific guidance concerning the proper method for financial reporting of uncertain tax positions. While FASB 109 has, since 1992, required that estimated taxes payable be recognized as a current liability, taxpayers would usually report such tax liabilities at face value per their filed returns, and set aside additional reserves against potential tax liabilities only where they had taken aggressive or unusual positions. The magnitude of such reserves reflected management's best estimate of actual exposure, and there were no explicit standards for determining this amount. FIN 48, in contrast, requires that uncertainty in tax positions be reflected as actual (but unrecognized) liabilities.

The unrecognized tax liabilities that must be recorded under FIN 48 differ markedly from traditional reserves in three important ways. First, the taxpayer's estimate of each unrealized tax liability must not take into account the likelihood that the tax authority may never challenge the position; rather, the liability must be determined assuming that the tax authority will audit, and further, that the auditor will be aware of all relevant facts.¹⁵ Second, the taxpayer must adopt a "more likely than not" standard for determining whether any particular tax position is uncertain; if the position is not likely to be sustained, the full potential liability must be recorded.¹⁶ Third, the taxpayer must measure and quantify the liability in accordance with the algorithm set forth in the FIN 48 pronouncement.¹⁷ The net result is that FIN 48 requires a more exacting analysis—and hence introduces more opportunity for error—than was the case under the prior rules.

Conceptually, when a business enterprise takes a position on a tax return that reduces current or future income taxes, the entity realizes an immediate economic benefit. Whether the position will be respected by tax authorities, however, may not be known for several years—until either the position is challenged and resolved, or until the statute of limitations lapses. IRS rules allow practitioners to assert a tax position, even if the position is unlikely to be sustained on appeal, provided that the position is not frivolous and has a "reasonable basis."¹⁸ On the other hand, FIN 48 requires that with respect to every income tax position,¹⁹ the technical merits of the position must be analyzed, and the economic benefit

may be reflected in financial statements only if the benefit is more likely than not to ensue.²⁰

With respect to those uncertain tax positions (in all open years) that fall below the "more likely than not" threshold, the taxpayer under FIN 48 must quantify the resulting unrecognized tax liability in accordance with meticulous rules. The enterprise must also disclose the net total of all unrecognized tax benefits and liabilities, and provide a reconciliation of the net tax asset/liability at the end of each period to the beginning of the same period. Moreover, to the extent that changes in the net tax asset/liability are "reasonably possible" within the next twelve months, the entity must specify in its financial statements the nature of the uncertainty, the nature of any event that could change the estimate of uncertainty, and a quantitative estimate of the range of reasonably possible changes. If the enterprise later changes its judgment about the technical merit of any tax position, the financials must be changed to reflect the same.²¹

While FIN 48 does not by its terms prohibit a taxpayer from taking a return position that it believes the tax authority is unlikely to sustain, it nevertheless discourages such positions as a practical matter. The enterprise taking a tax position that is not likely to be upheld now: (i) incurs additional accounting expense because of the analysis required, (ii) cannot claim the benefit of the position for GAAP purposes, (iii) may face embarrassment or negative publicity associated with the required disclosures of aggressive positions on its financial statements, and (iv) increases its exposure to liability or sanctions for errors in its FIN 48 analysis.

For the seller of a business enterprise, these rigorous requirements mean that when the seller warrants that its financials are GAAP compliant, it is making several implied warranties regarding the target's uncertain tax positions. Some of these are:

- that the target has identified its outstanding tax positions for all open years, and has re-assessed its open positions in every quarter;
- that it has correctly applied the FIN 48 measuring criteria using the "more likely than not" standard and accurately estimated the tax asset/liability associated with each such position, for all open years;

- that it has correctly calculated the sum of all tax assets/liabilities across all tax positions and properly disclosed the total; and
- that the target has assessed and fully disclosed any reasonably possible changes to the same, and accurately quantified the same.

Despite the algorithmic, mathematical quality of the estimating procedure mandated by FIN 48, no one doubts that quantifying the financial exposure arising from uncertain tax positions is an armchair speculation. Even the key component—determining whether a particular position is “more likely than not” to be sustained—is a question on which any two reasonable accountants are more likely than not to disagree.

A feasible scenario in any business sale is that the buyer’s own accountants would earnestly disagree with the FIN 48 assessment that was made by the seller’s accountants. In such case, the target’s management, for all practical purposes, would be required under FIN 48 to recognize a loss, decreasing immediately the net worth of the company just purchased. The buyer in such case would perceive, justifiably, that the seller had breached its warranty that target financials were GAAP-compliant. Liability can hence arise for the seller under its financial warranty, notwithstanding that there has been no assessment—or even an examination—by the relevant tax authority.

The seller’s liability could be alleged on any of a number of grounds: that the target failed to consider all open years; that the target determined that a tax position was more likely than not to be sustained when, in fact, it had only (say) a 45% chance of being sustained; or that the target failed to address its *not* having filed a return in a jurisdiction where it might arguably have been required. Similarly, liability could arise because the target, although it correctly determined that a position was unlikely to be sustained, miscalculated the financial impact of such failure. Or, even if the financial impact was correctly quantified, liability could exist because the target failed to disclose that the position had a reasonable possibility of changing within the next year, or because it failed correctly to determine the financial impact of such change.

The standard of care required by the seller in making all these delicate assessments is unknown. There is no guidance, and no experience to date on

point. Certainly, FIN 48 *itself* does not limit the obligation to a “good faith” or “commercially reasonable” standard.²² No doubt, the standard of care will evolve and become clear over time. A cottage industry is starting to bloom as many accountants are beginning to specialize in the analysis and quantification of tax uncertainties. As this professional niche develops, standards for the calculation of unrealized tax liabilities will begin to solidify, and expectations will develop for the level of accuracy required. The seller’s warranty of a particular standard will become “market,” and the failure of a seller to achieve that standard will become a recognized breach of GAAP. In the meanwhile, until the standard of care is clearer, it seems that sellers take an extraordinary risk in making an unqualified financial warranty that target financials are GAAP-compliant.

The Buyer’s Risk Is Ignorance

The increase in risk engendered by FIN 48 is not limited to sellers. FIN 48 applies to the buyer as well as the seller, and the buyer has its own separate obligation to comply. Because FIN 48 requires analysis of tax positions in all open years, a key concern of the buyer should be having sufficient information concerning the target’s past-year positions, so that the buyer can fully comply with FIN 48 following acquisition of the target.

Two different risks, then, arise to a buyer under FIN 48. First, the risk that the financial statements provided by the seller will fail properly to account for uncertain tax positions, and that as a result the company would be worth less than its price. Second, the very different risk that the buyer’s own compliance with FIN 48 will be hampered, or made expensive and difficult, because it lacks sufficient information about the target’s earlier tax positions.

What Needs To Be Done

The seller’s counsel can reduce the seller’s FIN 48 risk only by explicitly defining, and limiting, the scope of its liability and indemnity obligation to the buyer. A carve-out from the usual financial warranty can relieve a seller from responsibility for erroneous estimates of uncertain tax positions made in good faith. Language for the carve-out might be as follows: “Seller represents and warrants that the audited financial statements have been prepared in accordance with GAAP, except that no representation

is made concerning accounting for unrecognized tax liabilities pursuant to FASB Interpretation No. 48.”

The buyer’s risk that the target’s financials understate the strength of its tax positions is an extension of the more general risk of undisclosed liabilities, and as such, this risk can be allocated through clauses in the agreement. However, given that a well-advised seller will now refuse to provide an unqualified financial warranty, the buyer may have to be content with the qualified representation such as suggested above. The buyer’s exposure can nevertheless be addressed with a separate representation and warranty, not conditioned on GAAP, that “the audited financial statements fairly present the financial condition and results of operations of the company.” This point can be resolved only through negotiation, as price adjustments or other concessions are made in exchange for one party, or the other, assuming the risk that the seller (though acting in good faith) may have significantly overestimated the target’s tax positions.

The buyer’s counsel will want to see the tax accrual work papers prepared by the target’s independent accountants for the open pre-closing periods.²³ Access to these documents has two important functions: First, it will help the buyer’s advisors to identify questionable positions, and to understand the target’s analysis of them; in turn, this will illuminate whether or not the seller’s FIN 48 analysis was well-considered, or deficient. Second, it will provide the buyer’s advisors with the information they will need to insure the target’s compliance with FIN 48 going forward. Although some sellers may chafe against such an intimate disclosure, access to this information seems an appropriate *quid pro quo* for the seller’s carve-out from an absolute financial warranty.

A Self-Limiting Disease

It may well turn out that the increased risks created by FIN 48 will last only for a year or two. Our limited experience with FIN 48 to date suggests that it has already provoked a marked decrease in aggressive tax positions. Taxpayers increasingly will be reluctant to adopt tax positions that have to be recorded as liabilities on financial statements, even if they meet IRS requirements for avoiding penalties. If that trend becomes asymptotic—such that virtually all return positions have a more-likely-than-not chance of being sustained—then there will be no significant unrecognized tax liabilities to analyze or to disclose under

FIN 48. At that point, risk allocation clauses could revert to those of the halcyon, pre-FIN 48 days. In the meanwhile, the modification of traditional risk-allocation methods seems to be obligatory.

NOTES

1. FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109,” issued June 2006. FIN 48 just became effective for nonpublic entities, for periods beginning after Dec. 15, 2007; it has been effective for public companies for periods beginning after December 15, 2006.
2. See as examples: Gamino, J. “The (New) Other Side of the Planning Coin: Identification and Disclosure of Tax Uncertainty, 105 J.Tax’n. 227 (Oct., 2006); August, J.D., “Understanding FIN 48: Accounting for Uncertainty in Income Taxes, 9 Business Entities (May/June 2008).
3. See as examples: (a) “Neutral Stock Purchase” in Ginsberg & Levin, *Mergers, Acquisitions and Buyouts*, Jan. 2008, ¶ 2203; (b) “Model Stock Purchase Agreement with Commentary,” in American Bar Association Committee on Negotiated Acquisitions, *Negotiating Business Acquisitions, 12th Annual Institute, 2007*.
4. The ABA reported that in 99% of private deals, the seller included representations both that (i) its financials are prepared “in accordance with GAAP” and that (ii) the financials “fairly present” in all material respects the financial positions and results of operations of the Company. The latter representation is sometimes (but not always) itself qualified by “in accordance with GAAP.” “2007 Private Target Mergers and Acquisitions Deal Points Study,” in ABA, *Negotiating Business Acquisitions, 12th Annual Institute, 2007*. Chapter W-1, Slide 23.
5. The warranty that taxes have been paid generally takes one of two different forms: either (i) that all taxes shown on the filed return have been paid, or (ii) that all taxes have been paid, whether or not shown on the returns, and whether or not yet assessed.
6. As a result, FIN 48 effectively applies retroactively; entities adopting FIN 48 for 2008 must analyze tax positions taken in 2005, 2006 and 2007.
7. Securities Exchange Act of 1934, Section 32(a); Sarbanes-Oxley Act of 2002, Section 303(b).
8. Moreover, when the target is a private company, accessible remedies are likely to actually exist. In public company sales, the buyer’s remedies are usually quite limited.

9. P.L. No. 107-204, 116 Stat. 745, codified as Title 15, Section 7201 et seq.
10. Securities Exchange Act of 1934, Title 15 U.S.C. Section 77s(b), Section 78m(b)(2).
11. Senate Report on the Sarbanes-Oxley Act of 2002, No. 205 at p. 1 (2005).
12. More specifically, the PCAOB is established "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." Title 15, U.S.C., Sec. 7211(a).
13. FIN 48, at p. 2, cites as its *raison d'être*, the need for "increased relevancy and comparability in financial reporting of income taxes".
14. See August, J.D., footnote 2, *supra*. The general consensus is that Internal Revenue Service has the authority to request FIN 48 work papers, but that it is likely to do so only in audited cases involving listed transactions, and that the Service will not make random or exploratory requests for tax work papers. See Office of Chief Counsel Memorandum AM 2007-0012 (June 8, 2007); Announcement 2002-63, 2002-2 CB 72, (June 17, 2002). The Service *has* requested tax work papers in several contested cases. See for example: *United States v. Textron, Inc. and Subsidiaries*, 100 AFTR.2d 2007-5848, 507 F.Supp.2d 138 (D.R.I., 2007); *United States v. Roxworthy*, 98 AFTR 2d 2006-5964, 457 F.3d 590 (CA-6, 2006).
15. FIN 48, Paragraph 7(a).
16. FIN 48, Paragraphs 5-7. If the position *does* meet the more-likely-than-not threshold, its measurement must nevertheless consider the probabilities of different outcomes of a hypothetical audit, based on known facts and circumstances. FIN 48, Paragraph 8.
17. FIN 48, Appendix A.
18. Circular 230 prohibits a practitioner from advancing on a return any position that is "frivolous" even if disclosed, or (if undisclosed) that does not have a "realistic possibility of being sustained on the merits." Circ. 230, Section 10.34. Internal Revenue Code Section 6694 penalizes any tax practitioner who taxes a position (i) without a reasonable belief that the position would more likely than not be sustained on the merits or, (ii) if the practitioner has disclosed the position, if there was no reasonable basis for the position. Prior to the Small Business and Work Opportunity Tax Act of 2007, Code Section 6694 also applied the more liberal "realistic possibility" standard. In order for the taxpayer to avoid penalties for understatement, the position must be supported by "substantial authority." Treas. Reg., 1.6222-4(d).
19. A "tax position" includes not only any position taken on a tax return, but also any decision not to file a return, the allocation of income between jurisdictions, etc. FIN 48, Paragraph 4.
20. FIN 48, Paragraph 6.
21. FIN 48, Paragraph 13.
22. FIN 48 indicates only that the taxpayer must use its "best judgment." FIN 48 at Paragraph 12. Moreover, that such liability might arise for the target does not necessarily imply that the target would have a subrogation claim against its financial advisors. Because FIN 48 is essentially a requirement for full disclosure, it is likely that a target's liability for misrepresentation to its investors will be broader than the liability of its advisors to the target, which is limited by a standard of reasonable care.
23. At least for stock acquisitions; in asset purchases, though transferee liability is still a problem, concerns about erroneous financials under FIN 48 will be much more minimal. Note that it does not matter whether the transaction is taxable or not, nor does it matter if the target is a taxable entity; FIN 48 applies nevertheless.

