Case 09-9
Bricks & Mortar

Bricks & Mortar Co. (the "Company"), an SEC registrant, is a manufacturer of construction equipment. The Company has been in business for more than 50 years, operating profitably for the past 25. In addition, it has an applicable tax rate of 40 percent and no unused tax loss or credit carryforwards. The Company's fiscal year ends on December 31.

The Company adopted ASC 740-10, *Income Taxes: Overall* (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes),* as of January 1, 2007, and determined at that time that it was not necessary to recognize any income tax liabilities (or other adjustments) related to unrecognized tax benefits. The last date of payment of fiscal year 2007 tax is March 17, 2008, for purposes of accruing interest and penalties under the tax law.

The Company is preparing its financial statements for the year ended December 31, 2007. In determining the amount of its 2007 tax provision, the Company has prepared a draft of its 2007 tax return.

The Company's tax working papers indicate that its preliminary tax balances, on an "as-filed" basis (i.e., before ASC 740-10 (Interpretation 48) adjustments), are as follows:

Balance sheet accounts

Current tax liability	$2,000 [1]
Deferred tax liability	$ 800 [2]

Income statement accounts

Current tax expense	$2,000 [3]
Deferred tax expense	$ 200 [4]

[1] Agrees to tax-owed line item in draft tax return

[2] Relates to fixed asset temporary differences only (book basis of $100,000 and tax basis of $98,000)

[3] Agrees to tax provision rollforward

[4] Agrees to deferred tax provision working papers

Management has identified two deductions, taken in its draft 2007 tax return, for which the tax law is not clear as to whether those tax positions should reduce the Company's

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2007 tax liability. The Company is evaluating these tax positions under Interpretation 48 for financial reporting purposes. Management is highly confident that all other tax positions will be sustained by the taxing authority upon examination (recognition) and that 100 percent of the deductions claimed in the tax return should be reflected in the financial statements (measurement) because they are based on clear and unambiguous tax law.

Refer to Appendix A for information about situations in which interest and penalties could be assessed by the taxing authority. For Issues 1 and 2, assume that each of the tax positions has substantial authority for the purpose of determining whether penalties may be assessed.

Issue 1 Facts:

As a result of implementing a certain tax strategy, the Company has included a $100 deduction in its draft tax return, resulting in a $40 reduction to taxes payable. There is uncertainty over whether the tax strategy is sustainable under the tax law and therefore over whether the additional $100 is deductible for tax purposes.

Management asserts that there is a 40 percent chance that the tax position would be sustained if taken to the court of last resort. However, on the basis of its past experience in negotiating settlements with the taxing authority, management believes that if it were to negotiate a settlement with the taxing authority rather than take the dispute to the court of last resort, it would have an 80 percent cumulative probability of realizing at least $10 of benefit, (i.e., the Company believes it has a 10 percent chance of realizing $40 ($100 × 40%), a 40 percent chance of realizing $20 ($50 × 40%), a 30 percent chance of realizing $10 ($25 × 40%), and only a 20 percent chance of realizing no benefit).

The sustainability of this tax position does not affect the tax bases of the Company's assets or liabilities. This tax position meets the substantial authority threshold for determining whether penalties may be assessed.

Issue 1 Facts, One Year Later:

Assume the same facts as Issue 1 above, but it is one year later and the Company is preparing its financial statements for the year ended December 31, 2008. No facts or circumstances relating to this tax position have changed between December 31, 2007, and December 31, 2008, except for the passage of time.

Issue 2 Facts:

The Company has taken a tax deduction in its draft tax return in the amount of $100, resulting in a $40 reduction to taxes payable. Management has obtained a tax opinion from a law firm at a 65 percent level of confidence that the tax position is appropriately deductible under the tax law and concluded that the tax position meets the more-likely-than-not recognition threshold. Management asserts that it would negotiate a settlement

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with the taxing authority in the event of a dispute. In the event of a negotiated settlement with the taxing authority, management asserts there is a 35 percent probability that it would sustain the full $40 ($100 $\times$ 40% tax rate) tax benefit, a 35 percent probability that it would sustain $32 ($80 $\times$ 40% tax rate) of the tax benefit, and a 30 percent probability that it would sustain $24 ($60 $\times$ 40% tax rate) of the tax benefit.

This tax position does not affect the Company's tax bases of its assets or liabilities.

Required:

Issue 1:

- Determine the adjustments required to the Company's preliminary 2007 financial statements to comply with ASC 740-10 (Interpretation 48) by completing the table provided below, and justify your position.

- Over what periods should interest be accrued in 2008 for financial reporting purposes? Provide support for your conclusion

Issue 2:

- Determine the adjustments required to the Company's preliminary 2007 financial statements to comply with ASC 740-10 (Interpretation 48) by completing the table provided below, and justify your position.

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APPENDIX A

Interest

Interest generally accrues on underpayments of taxes from the last date for payment of tax. Payment of tax is generally due by the unextended due date for the tax return. In the Company's case, the last date for payment of tax is March 15 of the following year (or the next business day if March 15 falls on a Saturday, Sunday or holiday).

Penalties

The tax law for incurring penalties is complex. There may be different types of penalties to consider when evaluating a client's exposure under ASC 740-10 (Interpretation 48), and often the type of penalty will depend on facts and circumstances. In addition, different defenses may be available under the tax law for different types of penalties.

Assume that the tax positions described in this case do not relate to a transaction subject to the relatively new reportable transaction and tax shelter penalties, or to a transaction that had a significant purpose of tax avoidance or evasion; rather, the penalty described in this case is accuracy-related. This penalty applies, in part, to an underpayment of tax that is attributable to the substantial understatement of income tax. In jurisdictions in which the Company operates, there are various defenses to the substantial understatement penalty.

The first defense is the taxpayer has "substantial authority" for the treatment of the item on the tax return. Substantial authority for this purpose is defined as less than "more likely than not" but greater than a "reasonable basis." If the taxpayer does not have substantial authority, the taxpayer may avoid the penalty if there is reasonable basis for the tax treatment of the item and the taxpayer adequately discloses the item on its tax return or on a statement attached to the tax return. Another defense against this penalty is to prove reasonable cause and good faith in taking the position on the return.

If the taxpayer achieves one of these defenses, it generally will not be subject to the penalty.

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Issues 1 and 2: Determine the adjustments required to the Company's preliminary 2007 financial statements to comply with ASC 740-10 (Interpretation 48) by completing the following table.

	Tax balances on an "As-Filed" Basis (Prior to ASC 740-10 (Interpretation 48 adjustments)) (As of and for the Year Ended December 31, 2007)	**Adjustments Under ASC 740-10 (Interpretation 48)**		**Total**
		Issue 1	**Issue 2**	
B/S Accounts DR (CR)				
Current tax liability	$ (2,000)			
Liability for unrecognized tax benefits — noncurrent				
Accrued interest and penalties				
Deferred tax (liability) asset — fixed assets	$ (800)			
P/L Accounts DR (CR)				
Interest expense				
Penalties expense				
Current tax expense	$ 2,000			
Adjustment to tax provision for tax benefits not recognized under ASC 740-10 (Interpretation 48)				
Deferred tax expense	$ 200			

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