

ACCOUNTING FOR INCOME TAXES – UNCERTAIN TAX POSITIONS

December 2025

OVERVIEW

This Financial Reporting Insights is intended to be used as a resource in understanding and analyzing the accounting for uncertainty in income taxes recognized in an entity's financial statements. It describes the unit of account, recognition threshold and measurement attributes of a tax position taken or expected to be taken in a tax return. It also addresses how to account for changes in judgment, interest and penalties, and the related disclosure requirements for uncertain tax positions.

This publication does not address every aspect of accounting for income taxes and should therefore be read in conjunction with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, *Income Taxes*.

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1. Scope and Introduction

1.1 Scope

The guidance in this publication applies to all domestic and foreign entities that prepare financial statements in accordance with U.S. generally accepted accounting principles (GAAP), including not-for-profit (NFP) entities with activities that are subject to income taxes (e.g., those generating unrelated business income), as well as pass-through entities (e.g., partnerships and limited liability companies) and entities that are taxed in a manner similar to pass-through entities (e.g., real estate investment trusts and registered investment companies). In the U.S., partnerships and LLCs are generally not subject to entity-level income tax; rather, income (losses) “pass through” to the owners who record the tax expense (benefit) on their individual returns. However, entity taxes may be assessed in some cases (e.g., if an LLC makes an election to be taxed, or if a corporation or a partnership or LLC operate in a state, local or foreign jurisdiction that assesses entity level taxes on pass-through entities). Therefore, pass-through entities may have uncertain tax positions arising from their classification as a pass-through entity, the allocation of income (expenses) among its owners, and the timing or characterization of income.

1.2 Introduction



ASC 740-10-25-16

The amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability is created (or the amount of a net operating loss carryforward or amount refundable is reduced) for an unrecognized tax benefit because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized under the requirements of this Subtopic.

ASC 740-10-25-17

A tax position recognized in the financial statements may also affect the tax bases of assets or liabilities and thereby change or create temporary differences. A taxable and deductible temporary difference is a difference between the reported amount of an item in the financial statements and the tax basis of an item as determined by applying this Subtopic's recognition threshold and measurement provisions for tax positions. See paragraph 740-10-30-7 for measurement requirements.

The American Institute of Certified Public Accountants (AICPA) Statements on Standards for Tax Services defines a tax position as “(i) a position reflected on a tax return on which a member has specifically advised a taxpayer or (ii) a position about which a member has knowledge of all material facts and, on the basis of those facts has concluded whether such position is appropriate.” An uncertain tax position refers to a tax position taken by an entity that is subject to different interpretations of applicable tax law and may not meet the criteria for financial statement recognition. It is not controversial to recognize the benefit of a tax position in an entity's financial statements when there is certainty that the tax position will be sustained upon examination, based on its technical merits, by a taxing authority. An uncertain tax position arises when there is ambiguity or differences in interpretation about the tax treatment of a particular item or transaction. Such uncertainty may arise due to complex tax laws, differing interpretations of tax regulations or a lack of clear guidance from tax authorities. Uncertain tax positions may also arise because the threshold for recognizing tax positions in a tax return is lower than the threshold for recording tax positions within the financial statements prepared in accordance with U.S. GAAP. Tax positions may be reflected within a tax return if there is a reasonable basis for such positions, and tax return preparers may sign tax returns with positions that have a 40% likelihood of being sustained upon examination. Under U.S. GAAP, an entity cannot recognize a tax benefit in its financial statements

for a tax position taken in its tax return unless it is more-likely-than-not (i.e., more than 50% likely) that the position will be sustained upon examination solely on the basis of the technical merits of the position.

As defined in the ASC Master Glossary, a tax position refers to a filing position that an entity has taken or expects to take on its tax return. A tax position may result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years or a change in the expected realizability of deferred tax assets. Common tax positions include, but are not limited to:

- A determination of the taxability or deductibility of a transaction
- A decision not to file a tax return
- An allocation or a shift of income between jurisdictions
- The characterization of income or a decision to exclude reporting taxable income in a tax return
- A decision to classify a transaction, entity or other position in a tax return as tax exempt
- A decision to take a deduction on a tax return for a current expenditure rather than capitalize the amount and amortize over future periods
- An entity's status, including its status as a pass-through entity or a tax-exempt NFP entity

Uncertain tax positions not only impact income tax expense (benefit) but also may impact other line items within the financial statements. Differences between tax positions taken in a tax return and amounts recognized in the financial statements result in increases (decreases) in either current income taxes payable (refundable) or deferred tax liabilities (assets), or a combination of both.

ASC 740-10-25-6 and ASC 740-10-30-7, outline the required two-step model for recognizing and measuring tax positions. Step 1 relates to recognizing the tax position that is recognized in the financial statements, only if it is more-likely-than-not that the position will be sustained based on its technical merits. Step 2 relates to measuring the position, which is applied only after the recognition threshold has been met. In accordance with ASC 740, a tax position is measured at the largest amount of benefit that is more-likely-than-not to be realized upon settlement.

1.3 Examples of tax positions

The following illustrative examples from ASC 740 explain the concept of a tax position.



Example 1-1: Definition of a Tax Position (ASC 740-10-55-223 through 55-225)

Example 32: Definition of a Tax Position

Entity A has sales in Jurisdiction S but no physical presence. Management has reviewed the nexus rules for filing a return in Jurisdiction S and must determine whether filing a tax return in Jurisdiction S is required. In evaluating the tax position about whether to file a tax return, management should consider all relevant sources of tax law. The evaluation of nexus has to be made for all jurisdictions where Entity A might be subject to income taxes. Each of these evaluations is a separate tax position that is subject to the recognition, measurement, and disclosure requirements of this Subtopic.

Example 33: Definition of a Tax Position

Entity S converted to an S Corporation from a C Corporation effective January 1, 20X0. In 20X7, Entity S disposed of assets subject to built-in gains and reported a tax liability on its 20X7 tax returns. Tax positions to consider related to the built-in gains tax include, but are not limited to:

- a. Whether other assets were sold subject to the built-in gains tax

- b. Whether the income associated with the calculation of the taxable amount of the built-in gains is correct
- c. Whether the basis associated with the built-in gains calculation is correct.

It should be noted that whether or not Entity S is subject to the built-in gains tax also is a tax position subject to the provisions of this Subtopic.

Example 34: Definition of a Tax Position

Entity N, a tax-exempt not-for-profit entity, enters into transactions that may be subject to income tax on unrelated business income. Tax positions to consider include but are not limited to:

- a. Entity N's characterization of its activities as related or unrelated to its exempt purpose
- b. Entity N's allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income
- c. The allocation of Entity N's expenses between activities that relate to its exempt purpose and those that are allocated to unrelated business activities.

Even if Entity N were not subject to income taxes on unrelated business income, it still has a tax position of whether it qualifies as a tax-exempt not-for-profit entity.

2. Unit of Account

2.1 General



ASC 740-10-25-13

The appropriate unit of account for determining what constitutes an individual tax position, and whether the more likely than not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used shall consider the manner in which the entity prepares and supports its income tax return and the approach the entity anticipates the taxing authority will take during an examination. Because the individual facts and circumstances of a tax position and of an entity taking that position will determine the appropriate unit of account, a single defined unit of account would not be applicable to all situations.

The appropriate unit of account (i.e., level of disaggregation) for determining what constitutes an individual tax position is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. In determining the appropriate unit of account, an entity should consider the manner in which it prepares and supports its income tax return and the approach it anticipates the taxing authority will take during an examination. Selecting the unit of account may be more difficult when multiple activities or jurisdictions are involved. Tax positions may have multiple components (or elements); therefore, the level of aggregation (or disaggregation) could change the recognition and measurement of the tax position. Importantly, we believe the unit of account should be the same for both recognizing and measuring a tax position.

Once established, the unit of account for a tax position must be applied to all similar positions and remain consistent from period to period. All changes to the unit of account must be supported by changes in facts and circumstances and applied prospectively. Factors that may support a change in the unit of account include significant ownership changes (e.g., the sale of a subsidiary), recent correspondence or

interactions with tax authorities, changes in tax laws or regulations or changes in the regulatory environment within a jurisdiction. Further, if a change in the unit of account causes a material difference in the amount recorded, the entity is required to disclose the impact in the financial statements, detailing the nature of the change, its impact on the financial statements and the reasons for the change. If a change in the unit of account, however, results from something other than a change in facts and circumstances, it may indicate that such change is a correction of an error, rather than a change in estimate and should be accounted for in accordance with the guidance in ASC 250-10-45-22 through 45-24.

2.2 Examples of unit of account for a tax position

The following example from ASC 740 illustrates the application of the unit of account to the evaluation of the tax position.



Example 2-1: The Unit of Account for a Tax Position (ASC 740-10-55-81 through 55-89)

This Example illustrates the initial and subsequent determination by an entity of the unit of account for a tax position. Paragraph 740-10-25-13 requires an entity to determine an appropriate unit of account for an individual tax position. The following Cases illustrate:

- a. The determination of the unit of account (Case A)
- b. A change in the unit of account (Case B).

Cases A and B share all of the following assumptions.

An entity anticipates claiming a \$1 million research and experimentation credit on its tax return for the current fiscal year. The credit comprises equal spending on 4 separate projects (that is, \$250,000 of tax credit per project). The entity expects to have sufficient taxable income in the current year to fully utilize the \$1 million credit. Upon review of the supporting documentation, management believes it is more likely than not that the entity will ultimately sustain a benefit of approximately \$650,000. The anticipated benefit consists of approximately \$200,000 per project for the first 3 projects and \$50,000 for the fourth project.

Case A: Determining the Unit of Account—A Prerequisite to Recognition Assessment

This Case illustrates an entity's initial determination of the unit of account for a tax position.

In its evaluation of the appropriate amount to recognize, management first determines the appropriate unit of account for the tax position. Because of the magnitude of expenditures in each project, management concludes that the appropriate unit of account is each individual research project. In reaching this conclusion, management considers both the level at which it accumulates information to support the tax return and the level at which it anticipates addressing the issue with taxing authorities. In this Case, upon review of the four projects including the magnitude of expenditures, management determines that it accumulates information at the project level. Management also anticipates the taxing authority will address the issues during an examination at the level of individual projects.

In evaluating the projects for recognition, management determines that three projects meet the more-likely-than-not recognition threshold. However, due to the nature of the activities that constitute the fourth project, it is uncertain that the tax benefit related to this project will be allowed. Because the tax benefit related to that fourth project does not meet the more-likely-than-not recognition threshold, it should not be recognized in the financial statements, even though tax positions associated with that project will be included in the tax return. The entity would recognize a \$600,000 financial statement benefit related to the first 3 projects but would not recognize a financial statement benefit related to the fourth project.

Case B: Change in the Unit of Account

This Case illustrates a change in an entity's initial determination of the unit of account for a tax position.

In Year 2, the entity increases its spending on research and experimentation projects and anticipates claiming significantly larger research credits in its Year 2 tax return. In light of the significant increase in expenditures, management reconsiders the appropriateness of the unit of account and concludes that the project level is no longer the appropriate unit of account for research credits. This conclusion is based on the magnitude of spending and anticipated claimed credits and on previous experience and is consistent with the advice of external tax advisors. Management anticipates the taxing authority will focus the examination on functional expenditures when examining the Year 2 return and thus needs to evaluate whether it can change the unit of account in subsequent years' tax returns.

Determining the unit of account requires evaluation of the entity's facts and circumstances. In making that determination, management evaluates the manner in which it prepares and supports its income tax return and the manner in which it anticipates addressing issues with taxing authorities during an examination. The unit of account should be consistently applied to similar positions from period to period unless a change in facts and circumstances indicates that a different unit of account is more appropriate. Because of the significant change in the tax position in Year 2, management's conclusion that the taxing authority will likely examine tax credits in the Year 2 tax return at a more detailed level than the individual project is reasonable and appropriate. Accordingly, the entity should reevaluate the unit of account for the Year 2 financial statements based on the new facts and circumstances.



RSM COMMENTARY: Changes in the unit of account may require additional disclosures

As discussed in [Section 2.1](#), changes in the unit of account may result in material changes to the amount recorded for the tax position and therefore require additional disclosures in the financial statements.

3. Recognition Threshold

3.1 General

ASC 740-10-25-6 through 25-7 require entities to apply a recognition threshold before measuring the tax position. Entities may recognize a tax benefit only if the position has a more-likely-than-not chance of being sustained based on its technical merits if examined by the relevant taxing authorities. By recognizing a tax position, entities positively assert that they are entitled to the economic benefits of the tax position. To determine whether a tax position has met the more-likely-than-not recognition threshold, entities should consider the facts, circumstances and information available as of the reporting date and use their judgment when considering the level of evidence required to support their assessment.

The term "technical merits" includes all relevant sources of information, including tax laws and regulations, rulings, case law, widely known or accepted administrative practices, and any other available objective information (see [Section 3.2.1](#) for the hierarchy of evidence). Entities must consider the information as of the reporting date when evaluating the more-likely-than-not threshold. Entities must also assume that the relevant taxing authority has full knowledge of all such information and should not consider their history or likelihood of being audited or the likelihood of the taxing authority identifying the issue. Entities should consider each tax position separately without considering any potential offsetting of other tax positions. See [Section 5.6](#) for a discussion of subsequent events.

If a tax position does not meet the more-likely-than-not threshold, no tax benefit is recognized in the financial statements.

3.2 Types of evidence to support a tax position

3.2.1 Hierarchy of authoritative sources of tax law

Entities must consider the hierarchy of the authoritative sources of tax law when determining whether a tax position meets the more-likely-than-not recognition threshold. The following table summarizes the sources, nature and the hierarchy of types of evidence.

Source	Weight	Rationale	Example(s)
Tax Statutes (Legislation)	Highest	<ul style="list-style-type: none"> Enacted by the legislature Define the legal framework 	Internal Revenue Code (IRC) in the U.S. and Income Tax Act in Canada
Treasury Regulations	Very High	<ul style="list-style-type: none"> Official interpretations or implementation guidance issued by the Treasury department or equivalents 	Treasury Regulations
Tax Authority Rulings	High	<ul style="list-style-type: none"> Tax authority's interpretation and enforcement positions May be relied on unless demonstrated as contrary to a regulation or statute 	Internal Revenue Service (IRS) Revenue Rulings, Notices
Case Law (Judicial Decisions)	Moderate to High	<ul style="list-style-type: none"> Court decisions about interpretations of tax statutes, Treasury regulations and tax authority rulings set precedent Higher courts (e.g., Supreme Court) have more weight than lower courts Important source of evidence when statutes or regulations are unclear or silent 	U.S. federal court cases
Tax Treaties	Contextual	<ul style="list-style-type: none"> Treaties apply to cross-border taxation and may override domestic law in certain cases Not relevant for domestic positions only, but extremely authoritative for international tax matters 	List of tax treaties between U.S. and foreign jurisdictions (available on IRS website)

Entities should always consider the nature, relevance and weight of positive evidence together with the nature, relevance and weight of existing disconfirming evidence when assessing whether a position meets the more-likely-than-not recognition threshold. The disconfirming evidence may be from a higher authority or be more relevant and persuasive than the confirming evidence. Disconfirming evidence may not be ignored, and if it outweighs the confirming evidence, it will change the entity's conclusion.

3.2.2 Example of applying the hierarchy of evidence when evaluating a tax position



Example 3-1: Applying the hierarchy of evidence to determine whether the recognition threshold is met

The following example illustrates the process that an entity would follow when applying the hierarchy of evidence to determine whether a tax position meets the more-likely-than-not recognition threshold.

Entity A is a U.S.-domiciled entity that incurred significant moving expenses for an executive transferring to the United Kingdom to serve as the CEO of its new foreign subsidiary. The executive has significant experience running new businesses and does not have any other personal reasons for the transfer. Therefore, the entity has concluded that the executive is transferring to the United Kingdom for purely business reasons. Relocation expenses incurred by the executive consist of ordinary and necessary expenses such as transportation costs for the executive and his possessions. Entity A considers the following authoritative sources of tax law listed in the order of the hierarchy of evidence provided (i.e., from highest to least) in determining the merits of its tax position regarding whether the executive's relocation expenses are deductible on its U.S. federal tax return:

1. Statute: IRC §162 allows entities to deduct ordinary and necessary business expenses.
2. Regulation: Treasury Reg. §1.162-1 confirms that employee relocation expenses may be deductible if they meet the "ordinary and necessary" test.
3. Ruling: IRS Revenue Ruling 2000-9 further supports the deductibility of certain relocation costs.
4. Case Law: Commissioner v. Flowers limits the deductibility of expenses if the relocation is for personal reasons rather than business need.
5. Treaty: The U.S.-United Kingdom Tax Treaty may affect how income and deductions are treated cross-border in some cases.

Entity A notes that the statute is the highest level of support, which permits the entity to deduct the executive relocation expenses and provides the foundation for the entity's conclusions. The regulation and ruling further support Entity A's position because the costs meet the "ordinary and necessary" test. Entity A then considers the effect of the potentially disconfirming case law evidence and concludes that the case law evidence is not applicable to Entity A because the executive's relocation is for business rather than personal reasons. Finally, Entity A considers the tax treaty between the U.S. and United Kingdom and determines that there are no provisions that affect the deductibility of the relocation expenses. Accordingly, Entity A concludes that the executive relocation expenses meet the more-likely-than-not recognition criteria to be deductible on Entity A's U.S. tax return.



RSM COMMENTARY:

As discussed in [Section 1.2](#), entities must apply a two-step process related to the recognition and measurement of tax positions. This example illustrates the determination of whether the position is more-likely-than-not to be realized. Entity A is required to apply the measurement guidance discussed in [Section 4](#) to determine the amount to be reflected in the financial statements.

3.2.3 Highly certain tax positions

When a tax position is clearly supported by well-known tax law, regulations and administrative practice, a tax opinion is not required to support recognition in the financial statements. Notwithstanding the relative

certainty of a tax position, an entity should document its assessment and basis for conclusion, including references to relevant tax law, regulations and administrative practice, as applicable.

The following example illustrates the recognition and measurement criteria of ASC 740-10 for tax positions in cases where the tax law is clear.



Example 3-2: Highly certain tax positions (ASC 740-10-55-99 through 55-101)

This Example illustrates the recognition and measurement criteria of this Subtopic to tax positions where the tax law is unambiguous. The recognition and measurement criteria of this Subtopic applicable to tax positions begin in paragraph 740-10-25-5 for recognition and paragraph 740-10-30-7 for measurement.

An entity has taken a tax position that it believes is based on clear and unambiguous tax law for the payment of salaries and benefits to employees. The class of salaries being evaluated in this tax position is not subject to any limitations on deductibility (for example, executive salaries are not included), and none of the expenditures are required to be capitalized (for example, the expenditures do not pertain to the production of inventories); all amounts accrued at year-end were paid within the statutorily required time frame subsequent to the reporting date. Management concludes that the salaries are fully deductible.

All tax positions are subject to the requirements of this Subtopic. However, because the deduction is based on clear and unambiguous tax law, management has a high confidence level in the technical merits of this position. Accordingly, the tax position clearly meets the recognition criterion and should be evaluated for measurement. In determining the amount to measure, management is highly confident that the full amount of the deduction will be allowed and it is clear that it is greater than 50 percent likely that the full amount of the tax position will be ultimately realized. Accordingly, the entity would recognize the full amount of the tax position in the financial statements.

3.2.4 Use of tax opinions

Tax positions that are highly complex, or based on lesser-known laws and regulations, are more likely to require a formal tax opinion to enable the entity to adequately support recognition of the position in its financial statements. An entity should consider the technical merits of a tax position—including its nature, significance and complexity—when deciding whether a tax opinion is necessary. Additionally, the entity should consider whether it has the necessary expertise to evaluate all available evidence to reach an appropriate conclusion.

A tax opinion is a formal written statement issued by a qualified tax advisor or legal practitioner that presents their professional judgment on the technical merits of a specific tax position. A tax opinion is prepared after thorough analysis of the relevant facts and circumstances, applicable tax law and regulations, and any other legal or authoritative sources. Tax opinions are prepared assuming full disclosure to the taxing authority and do not consider audit risk or settlement likelihood. Complex tax positions may require tax opinions to reach an appropriate level of confidence, which is defined by the AICPA as the level of authority needed for either a taxpayer or a preparer to avoid the relevant penalty. The relevant levels of confidence for tax return positions as noted by the AICPA Statements on Standards for Tax Services¹ include:

- Will (90% or more, uncommon)
- Should (at least 70%)

¹ AICPA. Copyright 2017, Levels of Confidence for Tax Return Positions

- More-likely-than-not (more than 50%)
- Substantial authority (40%)
- Realistic possibility of success (at least 33%)
- Reasonable basis (20%)

An appropriate and well-documented tax opinion, at a confidence level of more-likely-than-not or higher, from a qualified tax advisor serves as evidence to support recognition of a tax position in the financial statements prepared in accordance with U.S. GAAP. However, tax opinions at a confidence level below more-likely-than-not may be used to support positions taken in tax returns. For example, if an entity takes a position with a reasonable basis and discloses the level of confidence related to such position in the tax return, the entity will not incur penalties if the position is denied by the tax authority.

Entities that receive a “will” or “should” level opinion should not assume that the higher level of confidence in applying the recognition threshold results in a higher measurable benefit because entities must measure the position in accordance with the measurement guidance discussed in [Section 4](#). Whether an entity obtains a tax opinion or not, it should prepare and retain appropriate documentation supporting its conclusions regarding the technical merits of the tax position, including references to the relevant tax law, regulations or other authoritative sources. The entity should also ensure that the documentation includes the information reviewed, together with its evaluation of the factors that are most likely to change.

3.2.5 Consideration of administrative practices and precedents

ASC 740-10-25-7(b) states that an entity should evaluate the tax position based on the technical merits of the position, including administrative practices and precedents, which are widely understood and consistently demonstrated by the relevant taxing authority. When asserting that a particular administrative practice or precedent is applicable to a particular tax position, an entity should presume that the taxing authority will examine the position using the same information that is available to the entity. Administrative practices and precedents do not require formal tax rulings or regulations; however, when relying on such practices or precedents, entities should ensure that they have sufficient evidence from past actions or statements of the taxing authorities that the related tax position would more-likely-than-not be sustained upon examination.

3.2.5.1 Asset capitalization administrative practices

Asset capitalization policies may affect the recognition and measurement of tax positions. An entity's capitalization policy indirectly affects its taxable income because items that are capitalized are charged to expense over their expected useful lives rather than expensed immediately. If the capitalization policy is unusual or the tax law doesn't specify permitted asset capitalization policies or thresholds, there may be uncertainty regarding the tax position.

For example, an entity may have a policy of capitalizing any assets valued over \$1,000, while the jurisdiction's tax law may be silent regarding the appropriateness of such threshold. In this situation, the entity should consider any existing widely understood administrative practices by the taxing authority when evaluating whether the tax position meets the more-likely-than-not recognition threshold.



Example 3-3: Administrative Practices – Asset Capitalization (ASC 740-10-55-90 through 55-92)

The guidance in paragraph 740-10-25-7(b) on evaluating a taxing authority's widely understood administrative practices and precedents shall be taken into account when assessing the more-likely-than-not recognition threshold established in paragraph 740-10-25-6. This Example illustrates such consideration.

An entity has established a capitalization threshold of \$2,000 for its tax return for routine property and equipment purchases. Assets purchased for less than \$2,000 are claimed as expenses on the tax return in the period they are purchased. The tax law does not prescribe a capitalization threshold for individual assets, and there is no materiality provision in the tax law. The entity has not been previously examined. Management believes that based on previous experience at a similar entity and current discussions with its external tax advisors, the taxing authority will not disallow tax positions based on that capitalization policy and the taxing authority's historical administrative practices and precedents.

Some might deem the entity's capitalization policy a technical violation of the tax law, since that law does not prescribe capitalization thresholds. However, in this situation the entity has concluded that the capitalization policy is consistent with the demonstrated administrative practices and precedents of the taxing authority and the practices of other entities that are regularly examined by the taxing authority. Based on its previous experience with other entities and consultation with its external tax advisors, management believes the administrative practice is widely understood. Accordingly, because management expects the taxing authority to allow this position when and if examined, the more likely than not recognition threshold has been met.

3.2.5.2 Nexus administrative practices

Nexus refers to the connection with a particular state or tax jurisdiction that gives that jurisdiction the legal right to impose taxes on the entity. Nexus rules vary by state and local jurisdiction. Typically, nexus may be triggered by property (e.g., an office, warehouse, or company-owned delivery truck); sales of products or services; or payroll for employees, third-party contractors or affiliates performing services that exist or occur within the state or locality.

Nexus may also be a source of uncertainty related to tax positions, since the tax laws and regulations may not have clear rules and regulations governing nexus. For example, an entity may believe, based on widely understood administrative practices, that it does not have nexus in a particular state and therefore does not file a tax return in that state. In this situation, the entity should consider any existing widely understood administrative practices by the taxing authority when evaluating whether the tax position meets the more-likely-than-not recognition threshold.



Example 3-4: Administrative Practices – Nexus (ASC 740-10-55-93 through 55-95)

The guidance in paragraph 740-10-25-7(b) on evaluating a taxing authority's widely understood administrative practices and precedents shall be taken into account when assessing the more likely than not recognition threshold established in paragraph 740-10-25-6. This Example illustrates such consideration.

An entity has been incorporated in Jurisdiction A for 50 years; it has filed a tax return in Jurisdiction A in each of those 50 years. The entity has been doing business in Jurisdiction B for approximately 20 years and has filed a tax return in Jurisdiction B for each of those 20 years. However, the entity is not certain of the exact date it began doing business, or the date it first had nexus, in Jurisdiction B.

The entity understands that if a tax return is not filed, the statute of limitations never begins to run; accordingly, failure to file a tax return effectively means there is no statute of limitations. The entity has become familiar with the administrative practices and precedents of Jurisdiction B and understands that Jurisdiction B will look back only six years in determining if there is a tax return due and a deficiency owed. Because of the administrative practices of the taxing authority and the facts and circumstances, the entity believes it is more likely than not that a tax return is not required to be filed in Jurisdiction B at an earlier date and that a liability for tax exposures for those periods is not required.

3.3 Uncertainties solely related to timing

In some cases, there is little to no uncertainty about whether the position can be supported. Instead, the uncertainty pertains to the timing of recognition and, therefore, the valuation of the position. A common example relates to deductions for property and equipment, where there is little uncertainty about a future depreciation deduction, though the timing of the deduction may be uncertain. This type of position generates temporary differences and therefore, over time, would not change the amount of taxes paid, only the timing of the payment. The timing of payment may create exposures for interest and penalties, which may impact the valuation of the uncertain tax position. We believe that uncertain tax positions that pertain solely to the timing of when an item of income or expense is reported on a tax return—rather than whether it is reported—automatically satisfy the more-likely-than-not recognition threshold. Once this threshold is met, the value of the uncertain position is considered during the measurement determination (See [Section 4](#)).

4. Measurement

ASC 740-10-30-7 requires that an entity measure all tax positions that meet the more-likely-than-not recognition threshold using a “cumulative probability approach.” As illustrated in ASC 740-10-55-102 through 55-107, this approach results in recognition of the largest amount of tax benefit that is greater than 50% likely to be realized upon settlement with a taxing authority that has full knowledge of all relevant information.

4.1 Applying the cumulative probability approach

Unless a tax position is clearly binary (i.e., only two possible outcomes)—which is rare—an entity should perform the following steps to apply the cumulative probability approach to measure the tax benefit amount to be recognized under ASC 740-10-30-7:

- Identify all possible outcomes of a tax position, including full, partial or no benefit.
- Assign a probability to each possible outcome, based on objective evidence such as past audit settlements, relevant case law, and management’s willingness to litigate or settle. Detection risk is not considered; rather, the analysis must assume that the taxing authority has full knowledge of the position.
- Starting with the most favorable outcome, add the probabilities in descending order of benefit until the cumulative probability exceeds 50%.
- Calculate cumulative probabilities starting from the largest tax benefit.
- The amount of tax benefit recognized in the financial statements is the largest amount for which the cumulative probability exceeds 50%.

The cumulative probability approach ensures that only the portion of the tax benefit that is more-likely-than-not to be realized is recognized in the financial statements. If the largest amount (or outcome) is more than 50% likely to occur, the position is considered to be “highly certain.” That means the amount should be recognized in the financial statements and the individual probabilities of the remaining possible outcomes should be disregarded.

When using the cumulative probability approach, an entity should consider factors such as the strength and characteristics of the relevant tax law, any applicable legal precedent, and the entity’s approach to litigation rather than negotiation. Historical outcomes with tax authorities, whether involving the entity itself or other parties, can provide useful data for these probability estimates. Past negotiations or settlements with the related tax authorities also contribute to these assessments. All potential outcomes, including both litigation and settlements, should be considered; however, entities must disregard detection risk and assume that the tax authority is fully aware of the uncertain tax position.

An entity should apply judgment and use all relevant information—such as amounts in tax returns, past experience, audit findings, agreements and expert advice—to establish reasonable probabilities and maintain documentation to support its assessment. The weight assigned to each type of information should correspond to its degree of objectivity and verifiability. For example, objectively determined information includes the deduction amount reported in an entity's filed tax return or a deduction for a similar tax position previously examined by, or resolved with, the taxing authority.

In certain cases, applying the cumulative probability approach may identify only a minimal amount of potential benefit related to an uncertain tax position. In these situations, the entity should reconsider both the suitability of its recognition conclusion as outlined in [Section 3](#) and the probabilities attributed to each possible outcome within the application of the cumulative probability approach.

4.1.1 Cumulative probability approach may not equal the most likely result

The cumulative probability approach does not yield the single most likely outcome. ASC 740 uses the cumulative probability approach rather than the single most likely approach, as it considers all possible settlement outcomes and their probabilities rather than merely the outcome with the highest individual probability, which is better aligned with the economic reality of tax uncertainties. Additionally, when two or more outcomes share the same individual probability, there is no logical reason to select one outcome over the other. The cumulative probability method resolves this issue by systematically selecting a single outcome.

4.1.2 Examples illustrating application of the cumulative probability approach

ASC 740 requires entities to perform a cumulative probability analysis when there are multiple outcomes but does not require entities to prepare a formal cumulative probability table, as illustrated in the examples below. While a cumulative-probability table is not mandatory, it helps management evaluate and document uncertainty in tax positions and demonstrates that recognized tax benefits align with ASC 740-10-30-7. The extent of analysis and documentation should be commensurate with the complexity and significance of the tax position. Therefore, in some cases, management may be able to determine the appropriate amount without constructing a formal table.

The following examples from ASC 740 illustrate the application of the cumulative probability approach, using a table, to measure the benefit amount of an uncertain tax position that meets the recognition requirements under ASC 740-10-25-6.

4.1.2.1 Measurement with information about the approach to settlement



Example 4-1: Measurement with Information About the Approach to Settlement (ASC 740-10-55-102 through 55-104)

This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on identified information about settlement.

In applying the recognition criterion of this Subtopic for tax positions, an entity has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. The entity has considered the amounts and probabilities of the possible estimated outcomes as follows.

Possible Estimated Outcome	Individual Probability of Occurring (%)	Cumulative Probability of Occurring (%)
\$100	5	5
80	25	30
60	25	55
50	20	75
40	10	85
20	10	95
-	5	100

Because \$60 is the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement, the entity would recognize a tax benefit of \$60 in the financial statements.

4.1.2.2 Measurement with more limited information

In some cases, entities may have more limited information than in the example above. The following example illustrates a cumulative probability approach when there are fewer potential outcomes, illustrating that the approach remains the same regardless of the number of potential outcomes.



Example 4-2: Measurement with More Limited Information About the Approach to Settlement (ASC 740-10-55-105 through 55-107)

As in the preceding Example, this Example also demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position determined to meet recognition requirements. While measurement in this Example is also based on identified information about settlement, the information is more limited than in the preceding Example.

In applying the recognition criterion of this Subtopic for tax positions, an entity has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. There is limited information about how a taxing authority will view the position. After considering all relevant information, management's confidence in the technical merits of the tax position exceeds the more-likely-than-not recognition threshold, but management also believes it is likely it would settle for less than the full amount of the entire position when examined. Management has considered the amounts and the probabilities of the possible estimated outcomes.

Possible Estimated Outcome	Individual Probability of Occurring (%)	Cumulative Probability of Occurring (%)
\$100	25	25
75	50	75
50	25	100

Because \$75 is the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement, the entity would recognize a tax benefit of \$75 in the financial statements.

4.2 Consideration of interactions with the taxing authorities

Entities should consider whether their interactions with the taxing authority provide evidence that increases (or reduces) the largest amount that is greater than 50% likely of being realized upon settlement (assuming the taxing authority has full knowledge of all relevant information). This is important because the measurement framework contemplates negotiation and the behavior or expected behavior of the taxing authority. While interactions with the taxing authority may yield further information regarding the measurement of a recognized tax position, such interactions are not to be considered automatically conclusive.



Example 4-3: Measurement of a Tax Position After Settlement of a Similar Position (ASC 740-10-55-108 through 55-109)

This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on settlement of a similar tax position with the taxing authority.

In applying the recognition criterion of this Subtopic for tax positions, an entity has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. In a recent settlement with the taxing authority, the entity has agreed to the treatment for that position for current and future years. There are no recently issued relevant sources of tax law that would affect the entity's assessment. The entity has not changed any assumptions or computations, and the current tax position is consistent with the position that was recently settled. In this case, the entity would have a very high confidence level about the amount that will be ultimately realized and little information about other possible outcomes. Management will not need to evaluate other possible outcomes because it can be confident of the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement without that evaluation.

4.3 Consideration of timing-related uncertainties

As discussed in [Section 3](#), if an uncertainty related to a tax position pertains solely to timing—such as the period when a deduction can be claimed, rather than its eligibility—the position meets the recognition threshold. This is because the item will eventually be sustained, regardless of the timing differences. In these instances, uncertainty related to timing is reflected in the measurement of the position, including any interest and penalties.

The following examples illustrate measurement of a tax position with timing related uncertainties and changes to timing related uncertainties.

4.3.1 Differences relating to timing of deductibility



Example 4-4: Differences Relating to Timing of Deductibility (ASC 740-10-55-110 through 55-112)

This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on the timing of the deduction.

In Year 1, an entity acquired a separately identifiable intangible asset for \$15 million that has an indefinite life for financial statement purposes and is, therefore, not subject to amortization. Based on some uncertainty in the tax code, the entity decides for tax purposes to deduct the entire cost of the asset in Year 1. While the entity is certain that the full amount of the intangible is ultimately deductible for tax purposes, the timing of deductibility is uncertain under the tax code. In applying the recognition criterion of

this Subtopic for tax positions, the entity has determined that the tax position qualifies for recognition and should be measured. The entity believes it is 25 percent likely it would be able to realize immediate deduction upon settlement, and it is certain it could sustain a 15-year amortization for tax purposes. Therefore, the largest Year 1 benefit that is greater than 50 percent likely of being realized upon settlement is the tax effect of \$1 million (the Year 1 deduction from straight-line amortization of the asset over 15 years).

At the end of Year 1, the entity should reflect a deferred tax liability for the tax effect of the temporary difference created by the difference between the financial statement basis of the asset (\$15 million) and the tax basis of the asset computed in accordance with the guidance in this Subtopic for tax positions (\$14 million, the cost of the asset reduced by \$1 million of amortization). The entity also should reflect a tax liability for the tax-effected difference between the as-filed tax position (\$15 million deduction) and the amount of the deduction that is considered more-likely-than-not of being sustained (\$1 million). The entity should evaluate the tax position for accrual of statutory penalties as well as interest expense on the difference between the amounts reported in the financial statements and the tax position taken in the tax return.



RSM COMMENTARY

The following journal entries illustrate the application of the fact pattern as of the end of Year 1, related to the acquired indefinite-lived intangible, assuming a tax rate of 30%.

Dr. Income tax receivable	\$4,500,000	
		Cr. Income tax benefit
		\$4,500,000

Note: To record the tax effect of the full cost of the separately identifiable intangible asset, which was deducted in Year 1 [As filed tax position (\$15,000,000) x Tax rate (30%) = \$4,500,000]

Dr. Income tax expense	\$300,000	
		Cr. Deferred tax liability
		\$300,000

Note: To record the deferred tax liability for the tax effect of the \$1 million which represents the Year 1 deduction from straight-line amortization of the asset over 15 years. [Straight line amortization (\$1,000,000) x Tax rate (30%) = \$300,000]

Dr. Income tax expense	\$4,200,000	
		Cr. Liability for unrecognized tax benefit
		\$4,200,000

Note: To record an unrecognized tax benefit for the tax-effected difference between the as-filed tax position (\$15 million deduction) and the amount of the deduction that is considered more-likely-than-not of being sustained (\$1 million). [Tax effected difference (\$14,000,000) x Tax rate (30%) = \$4,200,000]

4.3.2 Change in timing of deductibility



Example 4-5: Change in Timing of Deductibility (ASC 740-10-55-113 through 55-116)

This Example demonstrates an application of the measurement requirements of paragraph 740-10-30-7 for a tax position that meets the paragraph 740-10-25-6 requirements for recognition. Measurement in this Example is based on a change in timing of deductibility.

In 20X1 an entity took a tax position in which it amortizes the cost of an acquired asset on a straight-line basis over three years, while the amortization period for financial reporting purposes is seven years. After

one year, the entity has deducted one-third of the cost of the asset in its income tax return and one-seventh of the cost in the financial statements and, consequently, has a deferred tax liability for the difference between the financial reporting and tax bases of the asset.

In accordance with the requirements of this Subtopic, the entity evaluates the tax position as of the reporting date of the financial statements. In 20X2, the entity determines that it is still certain that the entire cost of the acquired asset is fully deductible, so the more-likely-than-not recognition threshold has been met according to paragraph 740-10-25-6. However, in 20X2, the entity now believes based on new information that the largest benefit that is greater than 50 percent likely of being realized upon settlement is straight-line amortization over 7 years.

In this Example, the entity would recognize a liability for unrecognized tax benefits based on the difference between the three- and seven-year amortization. In 20X2, no deferred tax liability should be recognized, as there is no longer a temporary difference between the financial statement carrying value of the asset and the tax basis of the asset based on this Subtopic's measurement requirements for tax positions. Additionally, the entity should evaluate the need to accrue interest and penalties, if applicable under the tax law.



RSM COMMENTARY:

Additional facts:

- The asset acquired in 20X1 was purchased for \$700,000.
- The entity had an effective tax rate of 30%.

Analysis:

The following journal entries illustrate the fact pattern as of December 31, 20X1, and 20X2.

Dr. Income tax expense	\$40,000	
		Cr. Deferred tax liability
		\$40,000

Note: To record the deferred tax liability as of December 31, 20X1. [Tax depreciation (\$233,000) – Book depreciation (\$100,000) = Taxable temporary differences (\$133,000)]. [Taxable temporary differences (\$133,000) x Tax rate (30%) = \$40,000]

Dr. Income tax expense	\$80,000	
		Cr. Deferred tax liability
		\$80,000

Note: To reverse the prior year deferred tax liability and record the unrecognized tax benefit as of December 31, 20X2. [Tax depreciation (\$466,000) – Book depreciation (\$200,000) = Unrecognized tax benefit (\$266,000)]. [Unrecognized tax benefit (\$266,000) x Tax rate (30%) = \$80,000].

4.4 Effect of changes in tax laws or rates on uncertain tax positions

Entities must use the enacted income tax rates in the applicable jurisdictions to record the unrecognized tax benefits from an uncertain tax position. Pursuant to ASC 740-10-25-47, the effect of a change in tax laws or rates should be recognized at the enactment date. This applies to both current and deferred taxes, including those related to uncertain tax positions. However, further consideration is necessary when an uncertain tax position relates to periods prior to the enactment date of new tax laws. If the uncertain tax position relates to a prior year's tax return (and would be settled at that prior year's rate), the liability continues to be measured at the original rate. However, if the uncertain position affects taxes in a

future period (e.g., an uncertain deduction that impacts a net operating loss carryforward or taxes payable in a subsequent year), the unrecognized tax benefit should be remeasured at the newly enacted rate. The effect of this remeasurement is recorded as a discrete adjustment to income tax expense from continuing operations in the period the law is enacted.

The following example illustrates the impact of a tax rate change on uncertain tax positions.



Example 4-5: Impact of a Tax Rate Change on Uncertain Tax Positions

Facts:

- Entity A recorded a tax position on its December 31, 20X3 (prior year), tax return that did not meet the more-likely-than-not recognition threshold for financial statements purposes.
- The impact of the tax position was measured using the cumulative probability approach and resulted in a gross unrecognized tax benefit of \$1,000,000.
- In 20X3, the corporate tax rate was 25%.
- In March 20X4, a new law was enacted that retroactively reduced the corporate tax rate from 25% to 20%, as of January 1, 20X3.

Analysis:

For the year ended December 31, 20X3, Entity A records the following journal entry to reflect the liability associated with the tax position taken on its 20X3 tax return that did not meet the financial statement recognition threshold under ASC 740-10-25-6. Pursuant to ASC 740-10-25-47, Entity A does not reflect the change in tax rates in its December 31, 20X3, financial statements because the new law was not enacted until March 20X4.

Dr. Income tax expense	\$250,000	
	Cr. Liability for unrecognized tax benefits	\$250,000

Note: To record the liability for unrecognized tax benefit as of December 31, 20X3. [Unrecognized tax benefit (\$1 million) x tax rate (25%) = \$250,000]

As of December 31, 20X4, Entity A reconsiders both the recognition and measurement criteria for this tax position and determines that the tax position still does not meet the more-likely-than-not recognition threshold for financial statement purposes. However, Entity A remeasures the associated liability due to the retroactive change in corporate tax rates and records the following journal entry.

Dr. Liability for unrecognized tax benefits	\$50,000	
	Cr. Income tax expense	\$50,000

Note: To remeasure the liability for unrecognized tax benefit due to the retroactive change in corporate tax rates as of December 31, 20X4. [Unrecognized tax benefit (\$1 million) x Change in corporate tax rate (5%) = \$50,000]

Entity A used the new corporate tax rate to remeasure the liability associated with the tax position taken on its tax return because the tax law that was enacted in March 20X4 retroactively reduced the corporate tax rate from 25% to 20%. If, instead, the new tax law prospectively changed the corporate tax rate and Entity A believed that the uncertain tax position would be settled at the previous tax rate, the unrecognized tax benefit would continue to be measured at the 25% tax rate.

5. Subsequent Recognition, Measurement and Derecognition



ASC 740-10-25-8

If the more likely than not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:

- a. The more likely than not recognition threshold is met by the reporting date.
- b. The tax position is effectively settled through examination, negotiation or litigation.
- c. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

Accordingly, a change in facts after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) shall be recognized in the period in which the change in facts occurs.

ASC 740-10-25-14

Subsequent recognition shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. A tax position need not be legally extinguished and its resolution need not be certain to subsequently recognize the position. Subsequent changes in judgment that lead to changes in recognition shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period. See Sections 740-10-35 and 740-10-40 for guidance on changes in judgment leading to derecognition of and measurement changes for a tax position.

ASC 740-10-25-15

A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs. Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

5.1 New information

At each reporting date, entities must consider whether new information requires a reassessment of the recognition and measurement of its uncertain tax positions. Such new information may result in the derecognition of a previously recognized tax position, recognition of a previously unrecognized tax position or remeasurement of an existing tax position. This new information can arise from changes in tax laws, recent developments in case law, updates to tax regulations, correspondence with tax authorities or other sources. Subsequent changes to uncertain tax positions are determined based on management's judgment using the facts, circumstances and information available as of the balance sheet date.

An entity may recognize tax position that previously did not meet the more-likely-than-not threshold only if new information changes the technical merits of the position. Evaluating new information assumes that the entity's previous evaluation of the technical merits of the position was fully informed and based on all relevant facts at the time and is not a reevaluation of existing information. If the entity determines that it was not fully informed or did not appropriately consider all relevant facts at a prior reporting period, and it determines that a change to either the recognition or measurement criteria is warranted, the entity should evaluate whether the change is a correction of an error, pursuant to ASC 250, *Accounting Changes and Error Corrections*.

Uncertain tax positions may also be derecognized upon expiration of the statute of limitations for such positions, which prevents a tax authority from challenging the entity's position (Section 5.3). Finally, uncertain tax positions may also be derecognized upon effective settlement (Section 5.2).

Alternatively, new information may not change the recognition threshold but rather only impact measurement of the tax position (i.e., the more-likely-than-not amount to be sustained upon examination). Section 5.5 discusses how new information may change the measurement of uncertain tax positions.

5.2 Effective settlement

Tax positions that have been examined by a taxing authority may be considered effectively settled pursuant to ASC 740-10-25-9 through 25-11, even if they do not meet the criteria for formal extinguishment. The criteria for effective settlement, of which all three need to be met, are included below.



ASC 740-10-25-9

A tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an entity shall make the assessment on a position-by-position basis, but an entity could conclude that all positions in a particular tax year are effectively settled.

ASC 740-10-25-10

As required by paragraph 740-10-25-8(b) an entity shall recognize the benefit of a tax position when it is effectively settled. An entity shall evaluate all of the following conditions when determining effective settlement:

- a. The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.
- b. The entity does not intend to appeal or litigate any aspect of the tax position included in the completed examination.
- c. It is remote that the taxing authority would examine or reexamine any aspect of the tax position. In making this assessment management shall consider the taxing authority's policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management shall presume the relevant taxing authority has full knowledge of all relevant information in making the assessment on whether the taxing authority would reopen a previously closed examination.

ASC 740-10-25-11

In the tax years under examination, a tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled through examination. Effective settlement of a position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined.

ASC 740-10-25-12

An entity may obtain information during the examination process that enables that entity to change its assessment of the technical merits of a tax position or of similar tax positions taken in other periods. However, the effectively settled conditions in paragraph 740-10-25-10 do not provide any basis for the entity to change its assessment of the technical merits of any tax position in other periods.

A tax position may be regarded as effectively settled if it was included in the period that was examined by the applicable taxing authority. When a tax position is specifically reviewed during an examination, the entity should evaluate the probability that the taxing authority might reconsider the tax position in the future. Additionally, a tax position may qualify as effectively settled even if the taxing authority did not directly assess the specific tax position during its review, provided it was part of the examined period. However, an entity should consider the scope of the examination, including the quantity and nature of positions left unexamined, when determining whether the possibility of future examination or reexamination is remote (ASC 740-10-25-10(c)).

See [Section 5.2.1](#) and [Section 5.2.2](#) for specific considerations regarding effective settlement, and see [Section 5.5.1](#) for a discussion about considering information obtained from tax authorities in an examination that may change the measurement of other tax positions.

5.2.1 Agreement with a taxing authority's findings upon completion of an examination

If a taxing authority examines a tax position and identifies issues, a formal resolution procedure begins. This process may involve more than one agency and several levels of administrative review. If the entity accepts the findings of the taxing authority, it confirms its agreement in accordance with the taxing authority's administrative procedures. In the U.S., an entity files Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*, to confirm its agreement with the IRS's proposed adjustments as a result of the examination. Filing this form also results in the entity waiving its right to receive a statutory notice of deficiency and allows the IRS to immediately assess and collect the tax deficiency.

For financial reporting purposes, once Form 870 is filed and the IRS closes the case, the tax positions covered by the form are typically considered to be effectively settled, unless there is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of material facts that may warrant reopening the case. This allows any previously unrecognized tax benefits related to those positions to be recognized in financial statements, as the risk of further IRS challenge is considered remote.

Many state taxing authorities have policies similar to those of the IRS; however, there are some jurisdictions, particularly foreign ones, where rules and regulations significantly differ. Evaluating whether a tax position is resolved in a particular state or foreign jurisdiction should be based on the relevant laws, administrative procedures and precedents of that jurisdiction. Management should review the taxing authority's policy regarding reopening closed examinations and assess the specific facts and circumstances of the tax position, assuming that the taxing authority has full knowledge of all relevant information.

In some cases, an entity may not agree with the results of the taxing authority's examination and may file an appeal. If the entity appeals the taxing authority's position, the second criterion for effective settlement (i.e., no intent to appeal or litigate) is not met, and the first criterion (completion of all required examination and appeals procedures) is also not met because the appeals process is considered part of the examination. Therefore, the tax position is not considered effectively settled until the appeals process is complete and the entity no longer intends to appeal or litigate any aspect of the tax position. This framework applies in both the U.S. and foreign jurisdictions, though the specific administrative processes may vary by country.

5.2.2 Considerations related to NOLs and tax credit carryforwards

Net operating losses (NOLs) and tax credit carryforwards may need further evaluation before concluding that the taxing authority completed its examination procedures as noted in ASC 740-10-25-10(a). Further evaluation is required for U.S. federal NOLs and carryforwards, because the IRS is entitled to review an NOL or tax credit position either in the period of origination or in subsequent periods when the position is utilized. Accordingly, an uncertain position related to an NOL or tax credit carryforward may be examined even if the statute of limitations for the year of generation expired, provided the tax position impacts a still

open tax year. Other taxing authorities may possess similar rights based on applicable tax law, regulations or judicial doctrine.

5.3 Expiration of statute of limitations

The term “statute of limitations” refers to the period during which a taxing authority may examine and challenge a tax position. Once the statute of limitations expires for a particular tax year or tax position, the taxing authority may no longer assess additional tax. Therefore, any previously unrecognized tax benefits should be recognized upon expiration of the statute of limitations. For U.S. federal tax purposes, the statute of limitations is generally three years from the date a tax return is filed, extended to six years from the date of filing if over 25% of gross income was omitted from a tax return. However, if an entity files a return that is not substantially complete, the measurement period for the statute of limitations for U.S. federal tax purposes does not begin until the missing information is provided and the return is complete.

Entities need to determine if their filed tax returns are substantially complete before assessing the expiration of the statute of limitations for U.S. federal purposes. They should determine whether all required forms, including international forms, have been filed with complete and accurate information. If the entity determines that its tax returns were substantially incomplete, the statute of limitations for the entire tax return could remain open indefinitely until it files the necessary information with the IRS, at which time the three-year statute of limitations would commence. The more-likely-than-not recognition threshold of ASC 740-10-25-6 would be applied in determining whether the statute of limitations has expired.

State, local and foreign jurisdictions may have different time periods for examination and challenge of tax positions.

5.4 Derecognition of previously recognized tax positions

ASC 740-10-40-2 requires entities to derecognize a tax position in the first period when the entity believes that it is no longer more-likely-than-not that the position would be sustained upon examination. Entities may not record an adjustment to the valuation allowance on existing deferred tax assets in lieu of derecognizing tax positions that no longer meet the recognition criteria. Such conclusions should be based solely on management's evaluation of the facts, circumstances and information available as of the reporting date and arise from new information, rather than from a reexamination or reinterpretation of information that was previously available in earlier periods.

Additionally, ASC 740-10-40-3 requires management to reassess those tax positions that were previously considered effectively settled when new information becomes available that changes its prior conclusion. Examples of such information include determining whether a taxing authority is likely to initiate or reopen an examination, or the taxing authority or entity deciding to appeal or litigate the position. In such circumstances, the criteria outlined in ASC 740-10-25-10 that previously supported considering the position to be effectively settled in the prior reporting period are no longer applicable. Accordingly, the entity should apply the recognition and measurement criteria to the previously derecognized position as of the reporting date.

ASC 740-10-40-4 requires entities to record the effects of derecognizing tax positions taken in prior annual periods (including any related interest and penalties) as a discrete item in the period in which the change occurs.

5.5 Changes in measurement of tax positions



ASC 740-10-35-2

Subsequent measurement of a tax position meeting the recognition requirements of paragraph 740-10-25-6 shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Paragraph 740-10-30-7 explains that the reporting date is the date of the entity's most recent statement of financial position. A tax position need not be legally extinguished and its resolution need not be certain to subsequently measure the position. Subsequent changes in judgment that lead to changes in measurement shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.

ASC 740-10-35-3

Paragraph 740-10-25-15 requires that a change in judgment that results in a change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs. Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

As discussed in [Section 5.1](#), new information may not impact the recognition criteria but may change the measurement conclusions. Such new information may change inputs and outputs from applying the cumulative probability approach and therefore result in an adjustment to the amount of unrecognized tax benefit recorded in the financial statements.

5.5.1 Information gathered during an examination

As discussed in ASC 740-10-25-12, one source of new information may arise during an examination that may change its assessment of the technical merits of similar positions in other periods. Such new information may change the recognition threshold, measurement of the position or both. For instance, an examination may give the entity new insights or clarifications from the taxing authority and support similar positions in future periods. Entities should be careful when evaluating evidence obtained from an examination to ensure that the evidence provides further clarity on the technical merits of similar positions and that the entity's conclusions reflect an assessment of current facts and circumstances, not merely the prior examination results. The results of an examination may not provide useful information on the technical merits of similar positions if the examination closed due to reasons unrelated to the technical merits of the positions. Entities should use judgment to determine the relevance of information, taking into account the substance of communications and discussions throughout the examination process. Additionally, consideration should be given to the materiality and significance of the tax return position to the entity's financial statements.

If new information changes the technical merits of a tax position such that the position meets the more-likely-than-not recognition threshold, an entity can recognize the related benefit even if the position did not previously meet the recognition threshold. Conversely, if a position previously met the recognition threshold, the benefit can be remeasured based on new information, regardless of its impact on the technical merits. When remeasuring a tax position, the entity should assess whether the largest amount with over a 50% likelihood of realization has changed, assuming full disclosure to the taxing authority.

5.6 Considering subsequent events

ASC 740-10-25-8 requires entities to recognize events which occur after the balance sheet date in the subsequent period even if the event provides additional evidence relating to conditions that existed prior to the balance sheet date. This differs from the recognition guidance within ASC 855, *Subsequent Events*,

which states that "...an entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements."

A key difference from ASC 855 is that the guidance in ASC 740 precludes entities from considering enacted tax laws or regulations or judicial decisions that occur after the balance sheet date when evaluating tax positions at the balance sheet date. However, ASC 740 does require entities to consider all information that was available prior to the balance sheet date. Entities must carefully distinguish between information that was available (i.e. a judicial decision that occurred prior to the balance sheet date but may not have been identified by management) from events that did not occur prior to the balance sheet date. For example, if a court decision was rendered after the balance sheet date, entities should not consider that decision when evaluating the recognition and measurement criteria of the tax position at the balance sheet date, even if such information could change the estimate. However, if the court decision was reached prior to the balance sheet date, the outcome must be considered as of the balance sheet date. Entities should disclose the potential impact of court decisions or subsequent legislation that occurred after the balance sheet date, if they are significant.

The following example from ASC 740 illustrates how subsequent events are treated under ASC 740, which is different from the approach under ASC 855.



Example 5-1: Information Becomes Available Before Issuance of Financial Statements (ASC 740-10-55-117 through 55-119)

Paragraphs 740-10-25-6 and 740-10-25-8 require that tax positions be recognized and measured based on information available at the reporting date. This Example demonstrates the effect of information becoming available after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).

Entity A has evaluated a tax position at its most recent reporting date and has concluded that the position meets the more-likely-than-not recognition threshold. In evaluating the tax position for recognition, Entity A considered all relevant sources of tax law, including a court case in which the taxing authority has fully disallowed a similar tax position with an unrelated entity (Entity B). The taxing authority and Entity B are aggressively litigating the matter. Although Entity A was aware of that court case at the recent reporting date, management determined that the more-likely-than-not recognition threshold had been met. After the reporting date, but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the taxing authority prevailed in its litigation with Entity B, and Entity A concludes that it is no longer more likely than not that it will sustain the position.

Paragraph 740-10-40-2 provides the guidance that an entity shall derecognize a previously recognized tax position in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination, and paragraphs 740-10-25-14; 740-10-35-2; and 740-10-40-2 establish that subsequent recognition, derecognition, and measurement shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Because the resolution of Entity B's litigation with the taxing authority is the information that caused Entity A to change its judgment about the sustainability of the position and that information was not available at the reporting date, the change in judgment would be recognized in the first quarter of the current fiscal year.

6. Interest and Penalties

6.1 General

Taxing authorities will typically charge interest on underpayments of income taxes. Penalties are assessed when the tax position fails to meet minimum statutory thresholds, such as lacking substantial authority or reasonable basis. Interest charges on positions taken in tax returns that do not meet the criteria for financial statement recognition are similar to loans from the taxing authorities and therefore should accrue interest. Penalties are intended to deter entities from taking aggressive or unsupported tax positions.

6.2 Recognition and measurement

ASC 740-10-30-29 and ASC 740-10-25-56 outline the guidelines for accruing interest on income tax payments. Interest should be calculated based on the difference between the tax position recognized in the financial statements and the amount claimed (or expected to be claimed) in the tax return. Entities that have incurred interest expense (income) should begin recognizing such interest expense (income) in the first period that it is required to do so under the law. For example, under U.S. federal tax law, entities are required to accrue interest beginning 3 ½ months following the year for which the position is being taken on a tax return. Entities with calendar year ends would begin recording interest on April 15 of the following year.

ASC 740-10-25-57 states that an entity should record the statutory penalty as an expense in the period that the entity claims or expects to claim a tax position that does not meet the minimum statutory thresholds. Therefore, an entity may recognize interest and penalties subsequent to the initial recognition of a tax position if management subsequently determines that the position no longer meets the minimum statutory threshold. ASC 740-10-40-5 states that previously recognized interest and penalties associated with tax positions that subsequently meet one of the conditions in ASC 740-10-25-8 (see [Section 5.1](#)) should be derecognized in the period that condition is met.

6.3 Classification of interest and penalties

ASC 740-10-45-25 allows an entity to elect an accounting policy regarding the classification of interest on underpaid income taxes in the financial statements, designating such amounts as either income taxes or interest expense. Additionally, penalties associated with tax positions that do not meet the minimum statutory threshold for penalty avoidance may be classified as either income taxes or as another expense, depending on the entity's chosen policy.

If an entity changes how it classifies interest and penalties, the entity should follow the guidance in ASC 250. Additionally, a preferability letter may be required for public business entities.

7. Presentation and Disclosure

7.1 Presentation

According to ASC 740-45-10A through 45-12, an unrecognized tax benefit should be presented in the financial statements as a reduction of a deferred tax asset related to an NOL carryforward, a similar tax loss or a tax credit carryforward. If such carryforwards are unavailable to offset these benefits, or if the entity is not required to and does not intend to use the deferred tax asset for this purpose, then the unrecognized tax benefit must be presented as a liability and should not be netted with deferred tax assets. The determination of whether a deferred tax asset is available relies on the unrecognized tax benefit and deferred tax asset existing at the reporting date, assuming the tax position is disallowed as of that date. For entities presenting a classified statement of financial position, unrecognized tax benefits shown as liabilities should be classified as current liabilities if settlement (or receipt) of cash is expected

within one year or the operating cycle, whichever is longer. Liabilities for unrecognized tax benefits should not be categorized as deferred tax liabilities unless they result from taxable temporary differences.

7.2 Disclosure

ASC 740 requires specific disclosures related to uncertain tax positions, including a tabular reconciliation of the amounts of unrecognized tax benefits at the beginning and end of the period. The FASB believes that this disclosure provides financial statement users with valuable information about a significant and sensitive estimate and changes in that estimate that are subject to significant measurement judgment. As noted in paragraphs B63 and B64 from the Basis for Conclusions in FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), the FASB considered whether such tabular reconciliation would provide a “roadmap” for taxing authorities. The FASB considered but rejected those arguments, primarily because requiring disclosures at the aggregate level does not reveal information about individual tax positions while still providing decision-useful information.

Accounting Standards Update (ASU) 2023-09, *Improvements to Income Tax Disclosures* removes the requirement for all entities to either disclose the nature and estimate of the range of reasonably possible changes in the unrecognized tax benefits balance over the next 12 months or state that such an estimate cannot be made. ASU 2023-09 is effective for public business entities for annual periods beginning after December 15, 2024, and one year later for all other entities.

7.2.1 Disclosures prior to adoption of ASU 2023-09



ASC 740-10-50-15

All entities shall disclose all of the following at the end of each annual reporting period presented:

- a. [Subparagraph superseded by Accounting Standards Update No. 2009-06].
- b. [Subparagraph superseded by Accounting Standards Update No. 2009-06].
- c. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position
- d. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
 1. The nature of the uncertainty
 2. The nature of the event that could occur in the next 12 months that would cause the change
 3. An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
- e. A description of tax years that remain subject to examination by major tax jurisdictions.

ASC 740-10-50-15A

Public entities shall disclose both of the following at the end of each annual reporting period presented:

- a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:
 1. The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
 2. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period

3. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
4. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.
- b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

See Example 30 (paragraph 740-10-55-217) for an illustration of disclosures about uncertainty in income taxes.

7.2.2 Disclosures after adoption of ASU 2023-09



ASC 740-10-50-15

An entity the following at the end of each annual reporting period presented:

- a. [Subparagraph superseded by Accounting Standards Update No. 2009-06].
- b. [Subparagraph superseded by Accounting Standards Update No. 2009-06].
- c. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position
- d. [Subparagraph superseded by Accounting Standards Update No. 2023-09].
- e. A description of tax years that remain subject to examination by major tax jurisdictions.

ASC 740-10-50-15A

Public business entities shall both of the following at the end of each annual reporting period presented:

- a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:
 1. The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
 2. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period
 3. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
 4. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.
- b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

See Example 30 (paragraph 740-10-55-217) for an illustration of disclosures about uncertainty in income taxes.

7.2.3 Example uncertain tax position disclosure (after adoption of ASU 2023-09)

The following example from ASC 740 illustrates a disclosure after the adoption of ASU 2023-09.

**Example 7-1: Disclosure Relating to Uncertainty in Income Taxes (ASC 740-10-55-217)**

This Example illustrates the guidance in paragraph 740-10-50-15 for disclosures about uncertainty in income taxes.

- The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 20X1. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X2 through 20X4 in the first quarter of 20X7 that is anticipated to be completed by the end of 20X8. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	20X7	20X6	20X5
	(in thousands)		
Balance at January 1	\$370,000	\$380,000	\$415,000
Additions based on tax positions related to the current year	10,000	5,000	10,000
Additions for tax positions of prior years	30,000	10,000	5,000
Reductions for tax positions of prior years	(60,000)	(20,000)	(30,000)
Settlements	(40,000)	(5,000)	(20,000)
Balance at December 31	\$310,000	\$370,000	\$380,000

- At December 31, 20X7, 20X6, and 20X5, there are \$60, \$55, and \$40 million of unrecognized tax benefits that if recognized would affect the annual effective tax rate.
- The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 20X7, 20X6, and 20X5, the Company recognized approximately \$10, \$11, and \$12 million in interest and penalties. The Company had approximately \$60 and \$50 million for the payment of interest and penalties accrued at December 31, 20X7, and 20X6, respectively.

Appendix A: Acronyms

Acronym	Definition
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
FASB	Financial Accounting Standards Board
IRS	Internal Revenue Service
U.S. GAAP	United States Generally Accepted Accounting Principles

Appendix B: Definitions

Term	Definition
Carryforwards	Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.
Deductible Temporary Difference	Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. See Temporary Difference .
Deferred Tax Asset	The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.
Deferred Tax Consequences	The future effects on income taxes as measured by the applicable enacted tax rate and provisions of the enacted tax law resulting from temporary

Term	Definition
	differences and carryforwards at the end of the current year.
Deferred Tax Liability	The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.
Income Taxes	Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.
Tax Consequences	The effects on income taxes—current or deferred—of an event.
Tax Position	<p>A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to:</p> <ol style="list-style-type: none"> A decision not to file a tax return. An allocation or a shift of income between jurisdictions. The characterization of income or a decision to exclude reporting taxable income in a tax return. A decision to classify a transaction, entity, or other position in a tax return as tax exempt. An entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.
Taxable Income	The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.
Taxable Temporary Difference	Temporary differences that result in taxable amounts in future years when the related asset is recovered, or the related liability is settled. See Temporary Difference .
Temporary Difference	A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years

Term	Definition
	<p>when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740- 10-25-24 through 740-10-25-25), but those temporary differences do meet both of the following conditions:</p> <ul style="list-style-type: none">a. Result from events that have been recognized in the financial statements.b. Will result in taxable or deductible amounts in future years based on provisions of the tax law. <p>Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.</p>
Unrecognized Tax Benefit	The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10.
Valuation Allowance	The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

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