

FIN 48 – The Bad & The Ugly – There Ain't No Good

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FIN 48 - Accounting for Uncertainty in Income Taxes

- Originally effective for fiscal years beginning after December 15, 2006
- FIN 48-2 defers the effective date for nonpublic enterprises until fiscal years beginning after December 15, 2007

Basic Requirements

- Upon applying FIN 48, companies must determine and assess all material positions taken in any income tax return as of the date they adopt FIN 48, including all significant uncertain positions, in all open tax years
- Must also assess tax planning strategies and the effect on deferred tax assets for carryforwards

Basic Requirements (cont)

- Addresses the recognition and measurement of income tax positions using a “more-likely-than-not” (MLTN) threshold
- A benefit related to an uncertain tax position (UTP) may be recognized in the financial statements if it is MLTN that the position will be sustained based on its technical merits
- Must be more than a 50% likelihood that the position would be sustained if challenged and considered by the highest court in the relevant jurisdiction

Applicability

- Applies to taxable as well as tax exempt organizations (cooperatives) because tax exemption is a tax position
- Applies to all positions taken on income tax returns, including the Texas State margins tax. Does not apply to sales, use, property, excise, gross receipts or value-added taxes

Unit of Account

- The determination of what constitutes an individual tax position (unit of account) may directly affect the assessment and is a matter of professional judgment. Should consider:
 - The level at which the entity accumulates information to support the tax return
 - The level at which it expects tax authorities to address the issues during examination

Unit of Account (cont)

- Example: Depreciation – Total deduction, account level, individual asset or project
- Example: Exclusion of certain revenues from 85% Test – Total excluded revenue, type of revenue (access, USF), account level

Materiality

- The provisions of FIN 48 need not be applied to immaterial items
- Consider quantitative and qualitative attributes
- Materiality should not determine unit of account
- Example of potential immaterial item – meals and entertainment deduction

Probability

- The tax benefit of a UTP is the largest amount of benefit that is more than 50% likely to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information
- Refer to the table for an example of measuring the “cumulative probability of occurring”

Two-step

- Two-step process
 - Step 1 is recognition by applying the MLTN threshold to the tax position. If less than 50%, record FIN 48 liability. If more than 50% perform Step 2
 - Step 2 is measurement. Even though it is MLTN that position will be sustained, should apply possible estimated outcome test if the company would be willing to negotiate a settlement upon examination

Reassess

- As of each balance sheet date, unresolved UTPs must be reassessed, and management should determine whether
 - The factors underlying the sustainable assumption have changed
 - The amount of the recognized tax benefit is still appropriate

Reassess (cont)

- A different assessment of the same information is not permitted. A different assessment must be supported by new developments

Reassess (cont)

- New developments
 - Case law
 - Changes in tax law
 - New rulings or regulations
 - Settlement through negotiation or litigation
 - Interaction with taxing authority
 - Expiration of statute of limitations

Recognition & Derecognition

- Judgments may change based on new information
- Unrecognized tax benefits should be recognized in the period in which the likelihood reaches the MLTN threshold
- Recognized benefits should be derecognized when the likelihood of a position falls below the MLTN threshold
- Using a valuation allowance is not permitted as a substitute for derecognition

Recognition & Derecognition (cont)

- Differences between tax positions taken in tax returns and recognized in the financial statements will generally result in:
 - An increase in income taxes payable or a reduction of an income tax refund receivable
 - A reduction in a deferred tax asset or increase in a deferred tax liability
 - Both of above

Recognition & Derecognition (cont)

- Recognition of FIN 48 liabilities for UTPs for which the uncertainty is strictly a timing issue do not affect overall expense but do reclassify the expense from deferred to current. The deferred tax liability for these UTPs is removed

Other

- An income tax liability should not be classified as deferred unless it results from a taxable temporary difference
- Interest and penalties should be accrued on UTP liabilities in the period that they would first accrue under tax law. Reverse in year statute expires or settled
- Classification – Liabilities for UTPs, including, interest and penalties, must be classified separately from other tax liabilities and classified based on expected timing of payment

Initial Application

- Initial application – The cumulative effect of applying FIN 48 to all open years shall be reported as an adjustment of the opening balance of retained earnings
- Companies must disclose the cumulative effect of the change on retained earnings in the statement of financial position. This disclosure is required only in the year of adoption

Disclosures

■ Disclosures

- In tabular form, a reconciliation of the total amount of unrecognized tax benefits at the beginning of the period to those at the end of the period
- The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate
- Total amount of interest and penalties (1) recognized in the income statement, and (2) recognized in the balance sheet

Disclosures (cont)

- 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
 - Nature of the uncertainty
 - Nature of the event that could occur that would cause the change

Disclosures (cont)

- An estimate of the range of possible change or a statement that it cannot be estimated
- Description of open tax years by major jurisdiction

FSP No. FIN 48-1

- Amends FIN 48 to provide guidance on whether a tax position is effectively settled
- Replaces the term *ultimately settled* with *effectively settled* for recognition and *settled* for measurement
- In tax years under examination, a tax position does not need to be specifically reviewed by the taxing authority to be considered effectively settled

FSP 48-1 (cont)

- If in the companies judgment, the year will not be reopened and there are no appeals, could conclude that all positions in that year are effectively settled
- Effective settlement of a position through examination does not result in effective settlement for similar or identical positions in other years

Planning

- Always consider FIN 48 when preparing tax returns, calculating taxability under 85% test, etc.
- IRS Circular 230 imposes a “more likely than not” threshold on tax practitioners as well

Implementation

- Formulate a policy/internal control document
- Create organization chart indicating legal and tax form of each entity and applicable tax jurisdictions
- Determine unit of account and create uncertain tax position inventory for all open years
- Perform Step 1 - Recognition

Implementation

- If MLTN, perform Step 2 – Measurement
- Calculate penalty and interest
- Determine proper financial statement classification for any liabilities recorded
- Formulate disclosures

Implementation – Identifying Tax Positions

- Sources for creating uncertain tax position inventory:
 - Tax filings and related tax return disclosures (esp Sch M-1 & M-3)
 - Reconciliations of book and taxable income
 - List of material federal, state and local tax elections

Sources for Creating UTP Inventory (cont)

- Reports of questionable transactions previously disclosed to taxing authorities (Form 8886)
- Tax examination documents including settlement or closing statements
- Notices of assessment or proposed assessment from taxing authorities

Sources for Creating Tax Position Inventory (cont)

- Schedule of state apportionment factors
- Description of significant related party transactions
- Tax opinions or correspondence from tax advisors
- Information on jurisdictions in which the enterprise conducts business but is not currently filing a tax return

Sources for Creating UTP Inventory (cont)

- Tax due diligence reports for acquired entities
- Information with respect to potential UTPs reflected in partnership K-1s
- Tax planning strategies that are used to support the recognition of deferred tax assets
- Topics discussed at industry or tax professional conferences or publications

Documentation

- FIN 48 does not provide guidance on the quantity or type of documentation that must be maintained
- Internal controls should be in place to insure compliance with FIN 48
- These controls should be documented
- Auditor cannot be a part of internal controls but tax advisor can provide info for client review

Control Objectives

- All material tax positions taken or expected to be taken are identified
- The appropriate unit of account is determined for each material tax position
- Only tax positions that meet the MLTN recognition threshold are recognized

Control Objectives (cont)

- All tax positions that meet the MLTN threshold are recognized
- The amount of benefit recognized for each tax position is the largest amount that is greater than 50% likely to be realized
- All UTBs that subsequently meet the MLTN threshold are measured and recognized in the first period that the threshold is met

Control Objectives (cont)

- All previously recognized tax positions that subsequently fail to meet the MLTN threshold are derecognized in the first period that the threshold is no longer met
- New information, such as tax laws, regulations, and court cases, are identified and evaluated in a timely manner

Control Objectives (cont)

- The recognition and measurement of benefits reflect all information available at the reporting date but do not take into account facts, circumstances and developments occurring after the reporting date but before issuance of the financial statements

Control Objectives (cont)

- Interest and penalties are properly measured and recorded for all UTPs
- UTPs and associated interest and penalties are properly presented, classified, and disclosed in the financial statements

Dealing with Taxing Authorities

- Tax reconciliation w/ps (TRW) – Used to compile data for placement on tax return – TBs, consolidation w/ps, reconciliation of book to tax income
- Audit w/ps (AW) – Those given to, or created by an independent auditor as part of a GAAS audit

Dealing with Taxing Authorities (cont)

- Tax accrual w/ps (TAW) – Subset of audit w/ps used for the sole purpose of determining a tax reserve for UTP, including FIN 48 w/ps
- TRW are routinely sought at the beginning of an IRS audit and are not considered privileged

Dealing with Taxing Authorities (cont)

- AW and TAW – US vs Arthur Young & Co gave IRS the power to seek these w/ps as part of a routine audit but they have voluntarily declined to do so
- Policy of restraint – AW & TAW sought only in “unusual circumstances”
- IRS does routinely request audited financial statements

The End



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