

ACCOUNTING FOR UNCERTAINTIES IN INCOME TAX (FIN 48)



700 Koehler Avenue Suite B
Ronkonkoma, NY 11779
(631) 595-2291
TomB@TBrownCPA.com

Thomas Brown CPA

Agenda:

- ❑ ***FIN 48 Background***
- ❑ ***Identifying tax positions***
- ❑ ***Measurement and Recognition***
- ❑ ***Interest and Penalties***
- ❑ ***Monitoring positions going forward***
- ❑ ***Internal Controls***
- ❑ ***FIN 48 and the IRS***
- ❑ ***FIN 48 and your Audit Firm***
- ❑ ***State Issues***
- ❑ ***Tax Executive Survey***
- ❑ ***FIN 48 Horror Stories***

Adoption of FIN 48

- ❑ FIN 48 is Financial Interpretation of Financial Accounting Standard No. 109 (FAS 109)
- ❑ Preceded by FAS 5, Account for Contingencies
- ❑ Issued by the FASB in July, 2006
- ❑ Effective for fiscal years beginning after Dec 15, 2006 public (2007 for calendar year companies)
- ❑ Effective years beginning after Dec 15, 2008 private (2009 for calendar year companies)

The Term Tax Position includes...

- A position in a return
 - Already Filed
 - To be filed
- A decision not to file a return.
- An allocation or shift of income between jurisdictions.
- The character of the income.
- A decision to exclude reporting taxable income in a return.
- A decision to classify a transaction, entity or other position in a return as tax exempt.

What is an Uncertain Tax Position?

- Uncertain tax positions are positions taken on the return (or/including by omission) that should be reserved to cover future impact
- Reasons for uncertainty include:
 - Lack of clarity or guidance by revenue authority
 - Judgment calls were made and an exact answer cannot be known
 - Information is not fully accessible/still becoming available

The More Likely Than Not Threshold

- ❑ A company can recognize an income tax benefit only if the position has a "more likely than not" (*i.e.*, more than 50 percent) chance of being sustained on the technical merits.
- ❑ In making this determination, the possibility that the company will not be audited, or the position will escape an auditor's notice, cannot be taken into account.

Unit of Account Definition

- ❑ Determines the level at which uncertainty is measured
- ❑ The appropriate unit of account is a matter of judgment based on the individual facts and circumstances of that position, evaluated in light of all available evidence:
 - Manner in which the enterprise prepares and supports its income tax return
 - Approach the enterprise anticipates the taxing authority will take during the examination

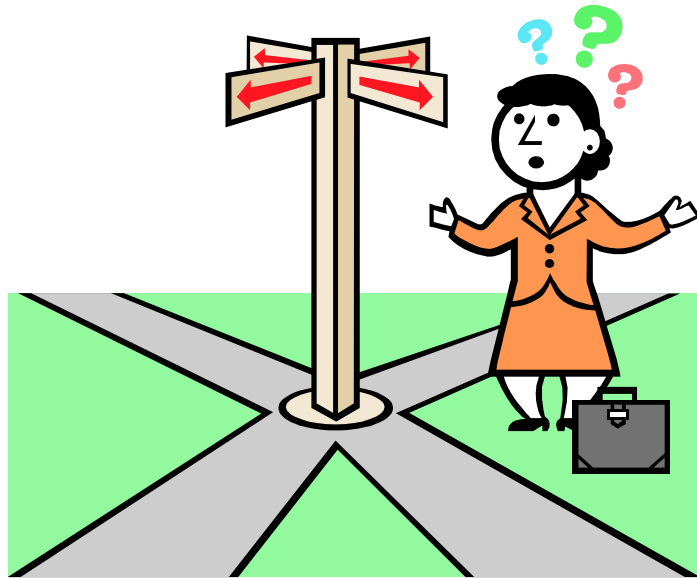
Unit of Account Examples

- T&E expense
 - Corporate T&E and operating T&E may be different units.
- Research and Development may be by project or group.
- Automobile expense may be different units of account depending on the employee groups.

Process to identify UTP's

- Line-by-line review of tax returns
- Review of detailed trial balances
- FAS 109 deferred tax roll forward
- Review of accounting policies
- Prior year financial statements
- Discussions with human resource, legal, treasury and accounting personnel
- Review of the results of any prior income tax audits

Is it a Highly Certain Position?



- ❑ Interest or Dividend?
- ❑ Is the outside consultant opinion MLTN?
- ❑ How old was the opinion?
- ❑ Has the law or facts changed.

Recognition and measurement

2 Steps

□ Step 1 ***Recognition***

- Assume audit
(Detection Risk not a factor)
- Authorities evaluate the technical merits of each tax position
- Private companies never audited.
- Practical sense positions between 40% and 70% MLTN need greatest analysis



Step 2 *Measurement*



- ❑ Cumulative Probability that exceeds 50%.
- ❑ Most subjective aspect of FIN 48.
- ❑ Impact on Effective Rate.
- ❑ Document process.
- ❑ Facts and Circumstances.

Step 2 *Measurement Cumulative* *Probability*

Est. Outcome	Individual %	Cumulative %
10000	20%	20%
5000	40%	60%
0	40%	100%

Step 2 *Measurement*

- Since 5000 is the amount suspected to be sustained, there is 5000 (gross) difference between the position taken and that amount that must be reserved against
- $5000 \times \text{the tax rate} = \text{underlying reserve for taxes payable}$
- Assuming a Fed-only position, we get: $5000 \times .35 =$

\$1750 in underlying taxes payable must be reserved

Interest and Penalties

- ❑ Interest will accrue on these UTP. It can be treated above or below the tax line for disclosure purposes.
- ❑ Keeping interest and penalties distinct and up-to-date will be an important part of the FIN 48 process

Monitoring positions going forward

- ❑ Unrecognized tax benefits should not be changed unless new information comes to light in that reporting period.
- ❑ Monitor changes in tax law and their impact on existing (and new) tax positions.
- ❑ Taxing authority has completed its examination procedures including all appeals and administrative reviews.
- ❑ Statute expirations.



Internal Controls

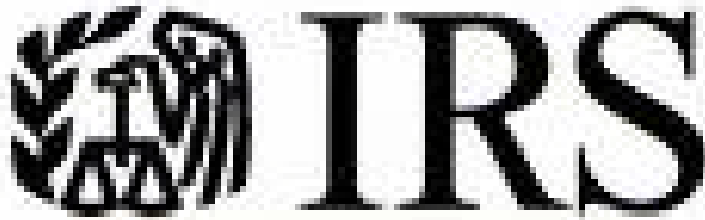
- ❑ Companies subject to Section 404 should already have documented the processes and procedures they use in accounting for income taxes.
- ❑ Companies should, at a minimum, develop and document the control processes and procedures that, will achieve the following control objectives:



Example of Internal Control Objectives:

- All material tax positions taken or expected to be taken in tax returns are identified.
 - The appropriate unit of account is determined for each material tax position.
 - New information --such as new tax laws, regulations, and court cases --that affects the recognition and measurement of the benefits of a tax position is identified in a timely manner and properly evaluated.
 - Only tax positions that meet the more-likely-than-not recognition threshold are recognized
 - All previously unrecognized tax positions that subsequently meet the more-likely-than-not recognition threshold are recognized in the first interim period in which the recognition threshold is met.
- All previously recognized tax positions that subsequently fail to meet the more likely-than-not recognition threshold are derecognized in the first interim period in which the recognition threshold is no longer met.

FIN 48 and the IRS



Department of the Treasury
Internal Revenue Service

- Access to FIN 48 workpapers
 - Tax Accrual Workpapers “TAW” IRS follows restraint Policy.
 - FIN 48 Disclosures reported in financial statements, and any other public documents, are not subject to the policy of restraint.

FIN 48 and the IRS

IRS Restraint Policy

- ❑ Field Examiner's Guide general standard for requests for audit or tax accrual workpapers is the unusual circumstances standard.
 - ❑ A specific issue has been identified by the examiner for which there exists a need for additional facts;
 - ❑ The examiner has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue; and
 - ❑ The examiner has sought a supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue and the examiner has performed a reconciliation of the taxpayer's Schedule M-1 or M-3 as it pertains to the identified issue.
- ❑ Listed transactions post 7/1/02, the Service will routinely request tax accrual workpapers that pertain only to the listed transaction for the year under examination

FIN 48 and the IRS

IRS Restraint Policy

- IRS loses major challenge to obtain TAW's
 - *United States v. Textron*, 507 F. Supp. 2d 138
 - *Regions Financial Corp. v. United States*, 2008 WL 2139008
 - Protected under the Work product Doctrine.
 - Prepared with anticipation of litigation
 - Does FIN 48 undermine this ruling?



Will the IRS reopen an examination because of disclosures made with FIN 48?

- ❑ IRS longstanding policy is that they do not reopen tax years that have been examined and closed.
- ❑ FIN 48 does require more information to be disclosed about uncertain tax positions. It is possible that re-openings will occur more frequently because of the potentially increased availability of information warranting reopening.

“LMSB Field Examiner’s Guide ”



IRS Closing Agreements

- Can a closing agreement contain a stipulation by the IRS that, although the statute of limitations has not legally expired, it is deemed to be expired and further examinations of the subject year(s) is consequently barred?
 - *No. Counsel has stated that we (IRS) have no authority to make such agreements.*

Effectively Settled IRS Audit

FSP FIN 48-1 (May 2007) (1 of 3)

- An enterprise shall recognize a tax position when it is effectively settled.
 1. *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.*

Effectively Settled IRS Audit

FSP FIN 48-1 (2 of 3)

2. *The enterprise does not intend to appeal or litigate any aspect of the tax position included in the completed examination.*

3. *It is remote that the taxing authority would examine or re-examine 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.*

Effectively Settled IRS Audit

(3 of 3)

- ❑ 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.
- ❑ When an IRS examination is closed there has been effective settlement of all uncertain tax positions for the examined year, whether such uncertainties are known to the IRS and examined or not, so long as the 3 conditions in the immediately preceding slides are present.

"IRS LMSB Field Examiners' Guide"

FIN 48 and your Audit Firm

- Can the audit firm help a client in applying FIN 48 without impairing independence?
 - Advising the client as to whether:
 - Those tax positions meet FIN 48's more-likely-than-not threshold
 - Calculating the related unrecognized tax benefits
 - Would not impair independence under the AICPA's independence rules provided the client can make an informed judgment on the auditors services.



IFRS/FAS 109 FIN 48

- ❑ FAS 109 and IAS 12 standards are conceptually very similar.
- ❑ FIN 48 uses a more likely standard
- ❑ IFRS reporting no specific guidance yet. Potential liabilities may have to be recognized, with no recognition threshold.
- ❑ Detection risk not known under IFRS.

State Issues



- Nexus – non filing of state returns.
 - Does FIN 48 liability expire?
- Administrative Practices relief:
 - Nexus non filing state won't go back to yr 1.
 - Penalties.
 - Must be widely understood practice.

Survey among Senior Tax Executives

- ❑ 33% of the tax executives felt that their company would take less aggressive tax positions.
- ❑ 92% of the respondents think that FIN 48 disclosures will provide a roadmap for the IRS
- ❑ 80% believe that FIN 48 will result in a significant expansion of IRS requests for tax accrual workpapers.



Survey among Senior Tax Executives

- 33% of the tax executives indicated that their company has added one or more full time tax professionals to comply with FIN 48.
- 83% of senior tax executives have claimed FIN 48 will significantly increase the level of documentation for accounts and transactions that historically have not been separately documented in reserve calculations.



Survey among Senior Tax Executives

- Over 90% of the executives believe that FIN 48 will greatly increase demands on the tax department (requests for schedules, answering questions, etc.) by their company's financial statement auditor.

75% of the respondents feel that the application of FIN 48 will result in significantly more swings in quarterly effective tax rates.



FIN 48 Horror Stories

- ❑ Tax Basis vs. Book Basis.
- ❑ Surprise office lease.
- ❑ Effective Rate.
- ❑ IRC Section 382 Study.



Thank You



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