FIN 48 And Transfer Pricing Teleconference

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Brian Andreoli, DLA Piper/New York, brian.andreoli@dlapiper.com

Julie Joy, Deloitte Tax LLP/Charlotte, N.C., jjoy@deloitte.com

Jim Wisniewski, Ernst & Young/Chicago, jim.wisniewski@ey.com

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Key Aspects Of FIN 48

- Effective date
  - Fiscal years beginning after 12/15/2006
- Transition
  - Cumulative effect in opening retained earnings (1)
- Going forward
  - Analyze the period's activity
  - Update and review prior conclusions
- FASB's objective: Increase comparability in financial reporting of income taxes
- (1) Or other appropriate components of equity or net assets in the statement of financial position

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Key Aspects Of FIN 48 (Cont.)

- Applies to all tax positions within FAS 109
- Two-step model: Recognition, measurement
- Recognition: More-likely-than-not that the tax position will be sustained
  - Greater than 50%
  - Cannot consider risk of examination
  - Evaluation based solely on technical merits
  - Must meet recognition threshold before recognizing the benefit of a tax position for financial reporting purposes

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Key Aspects Of FIN 48 (Cont.)

- Measurement: Largest amount that has a greater than 50% chance of being realized upon ultimate settlement
  - Use of cumulative probability table
  - Experience and knowledge (not limited to technical merits)
- Tax positions that do not meet recognition threshold are generally recorded as liabilities for financial reporting purposes at the full amount
- A liability is recorded for the difference between the measured amount and the full benefit

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Key Aspects Of FIN 48 (cont.)

- An enterprise shall subsequently recognize a tax position at the reporting date if one of these conditions is met:
  - The more-likely-than-not threshold is met
  - The tax matter is ultimately settled (FSP FIN 48-1)
  - The statute of limitations expires
- An enterprise shall recognize a position if the MLTN recognition threshold is no longer met
- Subsequent changes are based on management's evaluation of "new" information and not a new evaluation of previously available information

Misconceptions About What Taxpayers Should Do

- Misconception: Already provided a reserve under FAS 5
  - An FAS 5 analysis <u>does not</u> and cannot substitute for a FIN 48 analysis
    - Need to review and appropriately revise
    - However, historical FAS 5 process and analysis can provide a good starting point when implementing FIN 48
- Misconception: There are hundreds of UTP to analyze
  - FIN 48 only applies to material, uncertain tax positions
  - While it might be said that there is uncertainty in any tax position, the focus of FIN 48 is on those positions where the full tax benefit may not be ultimately realized
  - Highly certain positions generally do not require extensive analysis

Misconceptions About What Taxpayers Should Do (Cont.)

- Misconception: FIN 48 results in an addition to reserves
  - Not true: The underlying principle was that there needed to be more consistent standards
    - Companies have experienced significantly different results upon adoption of FIN 48 across many different industries
      - No material change in reserves (appears to be the majority)
      - A material reduction in reserves
      - A material increase in reserves
- Misconception: FIN 48 allows an analysis of the likelihood of the IRS finding an issue
  - Not true: It is assumed under FIN 48 that the tax authority has found the issue

Natural Tendencies To Under-Reserve Or Over-Reserve

- Prior to FIN 48: The FASB noted inconsistencies in applying recognition standards
  - Prior positions may be over- or under-reserved
  - Prior analysis may have used FASB 5; that is no longer correct
- May be a misunderstanding as to the precedental value of a settled case
  - Generally, no rationale is publicly stated, e.g. GSK and Merck cases

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Natural Tendencies To Under-Reserve Or Over-Reserve (Cont.)

- May be a tendency to under-reserve because the “IRS audited us” previously and never raised an adjustment
- May not be taking into account newer cases (*Coltec*, *Castle*, *Harbor*) or not being aware of IRS coordinated issues, audit policies, etc.

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FIN 48 And Transfer Pricing

- Recognition standard
  - Use of arm's-length standard
- Measurement standard
  - US *and* foreign perspective
  - Documentation to support position
  - Factors to consider (e.g., tax audit experiences, company experience or industry experience)
  - Competent authority (intent and ability)

FIN 48 And Transfer Pricing (cont.)

Areas of consideration – Transfer pricing

- Many companies only prepare documentation for some intercompany transactions (cost/benefit concept): Assess the reasonableness of that approach
- Documentation may reflect a restructuring transaction (international or domestic): Assess whether the new structure has been implemented
- Documentation may conclude at a reasonable basis or lesser level: Assess the reasonableness of that approach
- There may be issues that the tax department doesn’t know about (e.g. SOX 404 internal controls): Assess procedures to identify intercompany transactions

FIN 48 And Transfer Pricing (cont.)

Areas of consideration – Transfer pricing

- Federal-structured or tax-advantaged transaction (e.g. international supply chain management strategy)
- Domestic-structured or tax-advantaged transactions (e.g. royalty companies, procurement companies, etc.)
- Cost-sharing or intellectual property migration (e.g. costs shared on basis of reasonably anticipated benefits, inclusion of stock-based compensation, calculation of buy-in payment)
- Transactions with risk of double taxation or significant tax rate disparity
- Inbound transactions

Difficulties With Units Of Account

- Company accounting policy matter
  - Likely to differ from company to company, depending on specific facts and circumstances
  - Narrow binary approach focused on recognition
  - Broader approach focused on measurement
- Based on:
  - How tax return is documented and supported
  - How the tax authority is expected to examine
- Transfer pricing complications
  - Aggregation/disaggregation
  - TNMM/CPM vs. transactional methods
  - Different approaches among different jurisdictions involving the same transaction(s)
  - Adjustments for the “other side” of the transaction (gross vs. net)

Implications For Cost-Sharing Agreements (CSAs)

- As with any UTP, CSAs must be analyzed
- There are multiple levels of analysis in order to achieve the MLTN standard
- The key elements are: Current or proposed regulations. Also:
  - A written agreement
  - Identifying the IP to be shared
  - Valuation
  - Testing the allocation of benefits

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Implications For Cost-Sharing Agreements (Cont.)

  - Valuation of the buy-in
  - Evaluation of the cost sharing payments
- Any APA
- Where in the cycle: (pre-audit, under audit, appeals)
- Competent authority availability
  - Treaty
  - Open years

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Implications For Intra-Company Services

- New U.S. regulations
  - Stock-based compensation
  - Stewardship and shareholder costs
  - Cost safe harbor
- Recipient benefits
- Documentation of service and benefit
- Markups when safe harbor not used/not available
  - Foreign tax authority reaction
  - IRS reaction to inbound services
- Competent authority availability when general assessment is made that affects multiple jurisdictions

Assessing, Obtaining Competent Authority Relief

- Availability between country pairs
- Effectiveness between country pairs
- Effectiveness in resolving the particular issue
- Concession vs. correlative adjustment
- Benefit determined separately from liability
  - Income statement
  - Balance sheet
  - Disclosures
- It’s possible to end up with unexpected results when compared to FAS 5

Broadly Applying The Administrative Practices Exception

- Is there any guidance from the taxing authority? Is it written or verbal?
  - Example: Self-developed software for the research credit
  - Combination filings
- Is it a coordinated issue?
  - Certain issues are coordinated, and the field team is not authorized to close the issue without approval
- Has the corporation received any actual proposals from the taxing authority?
  - Proposals are usually subject to sign-off after a taxpayer "proposal"
  - What has been actual experience in past (e.g. capitalization)

Recording Penalties Because An Unrecognized Benefit Is Recorded

- FIN 48 requires the corporation to recognize penalties on the reserved amount
- Need to inventory the types of penalties that may apply, including but not limited to: Underreporting, substantial understatements, transfer pricing separate penalties, etc.
- Need to analyze the likelihood of application

Should Reserves Be Released If Tax Exposure Is Effectively Settled?

- Effectively settled tax position (FSP FIN 48-1)
  - Taxing authority completed its examination procedures
  - Company does not intend to appeal or litigate
  - It is remote that taxing authority will reexamine position
  - Recognize full amount of tax benefit
  - Does not result in effective settlement of position in periods not examined
- Transfer pricing considerations
  - Competent authority (intent and ability)

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Charging Out Stock-Based Compensation: Implications

- Inter-company service regs 1.482-9T(j) provide the definition of “total service cost”
- TSC includes all costs in cash or in kind, including stock-based compensation
  - This is based on an analysis of the facts and circumstances of the items directly identified with, or reasonably allocated to, the services
- Reg. 1.482-9T(f)(2)(i) also indicates that a profit-level indicator … is the ratio of operating profit to total service costs, as defined in (j)
- Stock-based compensation is highly controversial (see Xilinx)

Do Cumulative Adjustment Amounts Really Correct Prior-Period Errors?

- Cumulative adjustment is to reflect difference between application of current method (i.e., FAS 5) and new method (i.e., FIN 48)
- Identification of new exposures from past years
- Identification of issues resolved in past years
- Correction of an error vs. cumulative adjustment
  - Was FAS 5 treatment correct in the first place?
- Issues with processes and controls