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New FIN 48 Mandate for Pass-Throughs, Non-Profits and Private Entities

Are You Ready for FASB's Reserve and Disclosure Demands?

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
Randy Robason, National Partner-In-Charge, Tax Accounting and Risk Advisory Services, **Grant Thornton**, Dallas
Rick Olson, Principal, Corporate Tax, **LarsonAllen**, Minneapolis

Tuesday, January 19, 2010

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1 pm Eastern
12 pm Central
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New FIN 48 Mandate Webinar

Jan. 19, 2010

Review Of Key FIN 48 Concepts

Randy Robason, Grant Thornton
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Accounting For Income Taxes; Why Worry?

- Accounting for income taxes is the most prevalent issue when categorizing all material weaknesses caused by U.S. GAAP and accounting failures reported in 2008[1]

- This percentage has come down in 2008 but is the largest category of U.S. GAAP and accounting failures in 2006, 2007 and 2008

[1] Source: Analytics, *404 Dashboard – year 4 Update*, December 2008

Which FAS Applies?

Old FAS 5: Income and non-income taxes

New FAS 5: Non-income taxes only

FAS 109: Income taxes only

FIN 48: An explanation of FAS 109

FAS 18: Interim reporting

FIN 48 Vs. ASC 740

- All references to FIN 48 within this presentation are intended to be synonymous with ASC 740 in the new codified accounting guidance from the FASB

FAS 5 Vs. FIN 48

- Prior to FIN 48 – “Liability” approach
  - FAS 5: Accounting for contingencies
  - Accrue liability when it is “probable” of occurring, and the amount can be reasonably estimated

- FIN 48: “Asset” approach
  - Tax position must meet minimum recognition threshold before recognition in the financial statements

FAS 109

FASB Statement No. 109 (SFAS 109) provides no specific guidance on how to address uncertainty in accounting for income taxes

- Diverse accounting practices resulted, including:
  - Inconsistent criteria being used to recognize, derecognize and measure benefits related to income taxes
  - FIN 48 was developed to establish criteria for consistent applicability of the FAS 109 rules

FIN 48 Overview

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48)

- Issued in July 2006
- Objective is to increase the relevance and comparability in financial reporting of income taxes
  - All tax positions accounted for under SFAS 109 will be evaluated for recognition, derecognition, and measurement. using consistent criteria
  - Enhanced financial statement disclosures are required

FIN 48 Overview (Cont.)

- Effective for fiscal years beginning after Dec. 15, 2006
  - The cumulative effect of its adoption is reported as an adjustment to the opening balance of retained earnings for that year
- For a calendar-year company:
  - FIN 48 was effective for 2007
  - The cumulative effect was reported as an adjustment to the opening balance of retained earnings as of Jan. 1, 2007

FIN 48 Overview (Cont.)

FSP FIN 48-2 deferred effective date for non-public entities to fiscal years beginning after Dec. 15, 2007

- Issued in February 2008
- Due to perceived lack of preparedness by the original due date
- Not available for a non-public enterprise that:
  - Is a consolidated entity of a public enterprise, or
  - Has already issued a full set of FIN 48-compliant U.S. GAAP annual financial statements

FIN 48 Overview (Cont.)

FSP FIN 48-3 further deferred effective date for certain non-public enterprises to fiscal years beginning after Dec. 15, 2008

- Issued Dec. 30, 2008

- Deferral due to desire to give FASB additional time to:
  - Develop guidance for pass-through entities and tax-exempt not-for-profit organizations
  - Determine whether the required disclosures were useful to users of private company financial statements

- Deferral not available for a non-public enterprise that:
  - Is a consolidated entity of a public enterprise; or
  - Has already issued a full set of FIN 48-compliant U.S. GAAP annual financial statements

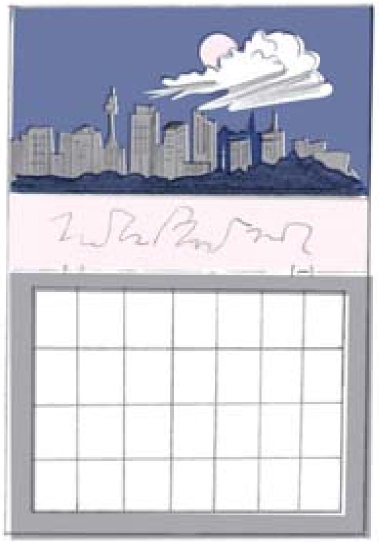
Accounting Standards Update No. 2009-6 (ASU 2009-6)

- Issued Sept. 3, 2009
- Purpose is to address the need for additional implementation guidance in the following areas:
  - Is the income tax paid by the entity attributable to the entity or its owners?
  - What constitutes a “tax position” for a pass-through entity or a tax-exempt not-for-profit entity?
  - How should accounting for uncertainty in income taxes be applied when a consolidated or combined group have both taxable and non-taxable entities?
- Additional decision to eliminate certain disclosure requirements in ASC 740-10-50-15

ASU 2009-6 Effective Date

- Effective for interim and annual periods **ending** after **Sept. 15, 2009** for entities already applying standards

- Effective for annual periods **beginning** after **Dec. 15, 2008** for entities that have deferred application



ASU 2009-6 Effective Date (Cont.)

- For a calendar-year private entity, this standard is effective for 2009 annual financial statements
- This standard applies to **every entity** that files financial statements in accordance with U.S. GAAP

FIN 48 Methodology Is New

- Inherently requires thorough analysis, conclusion and documentation of income tax positions, regardless of prior accounting method

- The impact of adoption with respect to public companies ranged from miniscule to huge, with some large companies adding billions of dollars in tax reserves while others added or subtracted as little as a few million dollars

Result Of Adopting FIN 48

It is **likely** that the amount of your recorded income tax assets and liabilities will be different as a result of adopting FIN 48, primarily due to the introduction of new concepts including:

- Recognition
- Measurement
- Penalties and interest

FIN 48 Overview: Summary

- FIN 48 applies to every entity issuing GAAP financial statements
- FIN 48 applies to all income tax positions
- FAS 5 will continue to apply to non-income tax contingencies
- A tax position is defined as a position taken in a previously filed tax return or a position expected to be taken in a future tax return
- A position can result in a permanent reduction of taxes, a deferral of taxes, or a change in the expected realizability of deferred tax assets
- FIN 48 also encompasses decisions not to file an income tax return, jurisdictional allocations and characterization of income

Identification Of Tax Positions

- Examples of tax positions may include:
  - Deductions taken or expected to be taken
  - Characterization of taxable income including exclusion, current and future
  - Conclusions to not file an income tax return
    - Federal
    - State
    - International
  - Conclusions that an entity or transaction is tax-free, in whole or part
  - Conclusions about entity status (e.g. partnership, qualified plan, NFP, S corporation …)

- A thorough inventory of all tax positions is required before analysis can begin

Unit Of Account

- The appropriate unit of account for determining what constitutes an individual tax position is a matter of judgment and should consider the following:
  - The manner in which the enterprise prepares and supports its income tax return, and
  - The approach the enterprise anticipate the taxing authority will take during an examination

- Examples:
  - Research and experimentation credit
    - In total
    - By project
    - By component of project

Initial Recognition Threshold

- Applied at a "**unit of account**" level
- Once the unit of account level is determined, the tax position must then undergo a separate recognition step before any tax benefits can be measured
- Requires a conclusion that all or part of the tax position is more likely than not sustainable
  - Based solely on the technical merits

Initial Recognition Threshold (Cont.)

- Detection risk is not a factor
  - Presumption that the tax position will be examined and evaluated by the relevant taxing authority, with full knowledge of all relevant information
- Derived from weight of relevant tax law authorities at the reporting date
  - Extends beyond literal terms of the governing statute to include relevant judicial doctrines
    - "[A]lthough…the capital loss fell within the literal terms of the statute, the transaction lacked economic substance and therefore must be disregarded for tax purposes"

      Coltec Industries Inc. v. United States, Fed. Circ., No. 05-5111,7/12/06
- Without the offset or aggregation with other positions
- Assumed resolution in the court of last resort

Measurement

- A **separate measurement step** is taken to determine the amount of tax benefit to be recorded for financial statement purposes
  - But only if the more-likely-than-not recognition threshold is met
  - The recorded tax benefit will equal the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority

Measurement (Cont.)

- Based on management's estimate of the **largest amount** of tax benefit that is **> 50% likely** of being realized upon ultimate settlement with a taxing authority
  - Based on information available at the reporting date, including:
    - Management's experience in similar matters
    - Management's plans for settlement, e.g., appeals or litigation
    - Quality of evidence and documentation
    - Expert advise

Recognition And Measurement Summary

1. Recognition

Determination that the tax position is "more likely than not" to be sustained upon audit

"MLTN recognition threshold"

No: Then no initial recognition

Yes: The position is deemed "valid"

2. Measurement

Determination of the amount of benefit to be recognized in the financial statements

Recognition And Measurement Summary (Cont.)

Recognition	Measurement
1. The position will be examined (i.e., no detection risk)	1. Same
2. The examiner will have full knowledge of all relevant information	2. Same
3. Evaluation based solely on the technical merits	3. Same
4. No consideration offset or aggregation of positions	4. Same
5. Conclusion should assume resolution in the court of last resort (e.g., U.S. Supreme Court)	**5. Conclusion depends on enterprise's plan for settlement**

Illustration Of Largest Amount That is > 50% Likely Of Being Realized

Possible Estimated Outcome	Individual Probability Of Occurring	Cumulative Probability Of Occurring
$100	25%	25%
$75	30%	**55%**
$60	35%	90%
$30	10%	100%
$10	-	-

>50%

$75 tax benefit is recognized
$25 is the "unrecognized tax benefit"

Interest And Penalties

- Interest and penalties, where applicable, must be accrued.

- Where are these interest and penalties recorded?
  - Tax expense
  - Interest expense
  - SG&A

Unique Issue Considerations: State And Local Tax Positions

This tax is your tax. This tax is my tax. Whose tax is it?

- With over 3,700 taxing jurisdictions and multiple entity types, it has become challenging to determine whether the tax is an entity-level or partner-level tax
  - If tax paid by the entity is attributable to the entity, it should be an income tax for Topic 740
  - If tax paid by the entity is attributable to the owners, it should be recorded as a transaction with owners
  - Determination is made based on the jurisdiction’s laws and regulations

Unique Issue Considerations: State, Local Tax Positions (Cont.)

This tax is your tax. This tax is my tax. Whose tax is it?

Example 1: A partnership with two partners has nexus in Jurisdiction J. Jurisdiction J assesses income tax on the partnership and allows the partners to file a tax return, utilizing their pro rata share of the partnership's income tax payment as a payment of the partners' liability

Unique Issue Considerations: State And Local Tax Positions (Cont.)

This tax is your tax. This tax is my tax. Whose tax is it?

Example 2: With the same facts as example 1, assume that Jurisdiction J does not provide for owners to file tax returns and use the payments on behalf of the partners' tax liability.

Example 3: An S-Corporation files a tax return in a jurisdiction that holds the S-Corporation and its owners jointly and severally liable for payment of taxes. Additionally, the laws indicate that the payments made by the entity are made on behalf of its owners.

Unique Issue Considerations: State And Local Tax Positions (Cont.)

Aren't individual state tax positions immaterial?

Individually, positions may often appear immaterial to the financial statements as a whole. However, these positions in aggregation with other tax uncertainties may result in misstatements that can range from amounts listed and communicated to management all the way to material errors

Unique Issue Considerations: State And Local Tax Positions (Cont.)

I don’t file a return in that state so I don’t have any tax positions there, right? (a.k.a. Nexus? What nexus?)

- A company may have historic or current activities in a state in which a decision was made not to file a tax return. Not filing a return **is** a position. When no return is filed, the statute of limitations doesn’t start. The company can be liable for accumulated tax, interest and penalties for any and all years in which the company has done business in that state
- A company may be able to seek relief through amnesty or voluntary disclosure programs

Unique Issue Considerations: State And Local Tax Positions (Cont.)

Other state and local tax positions

- Differences in statutes of limitations
- Related-party transactions/other addback provisions
- Additional filings or amended filings due to IRS exam/RAR
- Allocation vs. apportionment: Proper application of apportionment provisions
  - Sourcing of income
  - Moveable property
  - Throwback rules
  - Sourcing of intangible assets
  - Occasional, bulk and entity sales
  - Weighting of factors
- Attribute carryback and carryover

Unique Issue Considerations: International Tax Positions

- A replay … **Nexus? What nexus?**
- Allocation of income between jurisdictions
  - Uncertain tax position or tax planning strategy
- What kind of tax **is** this?
  - The variety of types of tax and tax bases can make it difficult to determine whether the tax is an income tax and subject to Topic 740

Unique Issue Considerations: Transfer Pricing Tax Positions

Transfer pricing is necessary to insure that the basic underpinning of the provision is on solid ground.

- Is income in the appropriate jurisdiction?
  - What is the appropriate jurisdiction?
- Income adjustments can get large very quickly
  - U.S. penalties can be **40% of the underpayment,** while other jurisdictions can vary significantly
- **Double-taxation** can often arise without treaty relief
- States have transfer pricing, too!
- Documentation and testing of inter-company transactions

Unique Issue Considerations: Compensation And Benefits Tax Positions

- Accounting for stock compensation (Topic 718-740)
- Tax positions can include:
  - Assumptions used to compute fair value
  - Stock plans: Are they performance-based?
  - Treatment and identification of restricted stock
  - Measurement for plans that vest based on performance, not time
- Reasonable compensation
- IRC 280(g) change-of-control payments
- IRC 409A and its impact on IRC 162(m) non-qualified income

New FIN 48 Mandate Webinar

Jan. 19, 2010

ASU 2009-06 Review

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NOTICEABLY
DIFFERENT

Accounting Standards Update - ASU 2009-06

- Implementation guidance and disclosure amendments issued September 2009

- Effective date
  - Entities already applying the standard
    - ◊ Reporting periods ending after Sept. 15, 2009
  - Entities previously deferring the standard
    - ◊ Years beginning after Dec. 15, 2008

Accounting Standards Update - ASU 2009-06

- Implementation guidance
  - Expanded entity scope of ASC 740-10 for ***uncertain tax positions*** to specify tax-exempt & pass-through
    - ◊ Added ASC 740-10-15-2AA
  - Definition of a "***tax position"***
    - ◊ Amended glossary definition (ASC 740-10-20)
    - ◊ Added examples 32-34 (para. 223-225, ASC 740-10-55)
  - Income taxes attributable to entity vs. owner
    - ◊ Added examples 35-37 (para. 226-228, ASC 740-10-55)
  - Financial statements of a group of related entities
    - ◊ Added Example 38 (ASC 740-10-55-229)

Accounting Standards Update - ASU 2009-06

- Disclosure amendment eliminates two ***unrecognized tax benefit*** disclosures for non-public entities:
  - ***Tabular reconciliation***
    - ◊ ASC 740-10-50-15(a) superseded
    - ◊ ASC 740-10-50-15A(a) added
  - Effective rate impacts
    - ◊ ASC 740-10-50-15(b) superseded
    - ◊ ASC 740-10-50-15A(b) added

Who: The Entity

- ***Entity*** vs. ***Owner***, pass-through entities
  - ***"Attribution of income taxes to the entity or its owners"***
    - ◊ New examples added pursuant to ASU 2009-06
      - Added examples 35-37 (para. 226-228; ASC 740-10-55)
  - ***"Attribution is based on the laws and regulations of the taxing authority rather than on obligations imposed by agreements between an entity and its owners."***
  - Entity payments of taxes attributable to owners are treated as distributions by the entity to the owners

Who: The Entity (Cont.)

- ***Entity*** vs. ***owner***, pass-through entity examples
  - Owner tax - partnership
    - ◊ Partners file individual tax returns in Jurisdiction J, and
    - ◊ Utilize entity payments as credits (Example 35)
  - Entity tax - partnership
    - ◊ No provision for partners to file returns in Jurisdiction J, and
    - ◊ Payments are not made on behalf of the partners (Ex. 36}
  - Owner tax - S corporation
    - ◊ Entity and owners are jointly and severally liable for tax
    - ◊ Entity payments are made on behalf of owners (Example 37)

Who: The Entity (Cont.)

- Financial statements of a group of related entities
  - New example added pursuant to ASU 2009-06
    - ◊ Added ASC 740-10-55-229, Example 38
  - Partnership, Entity A, owns 100% of a taxable entity, Entity B
  - Entity A files consolidated financial statements
  - Entity B has unrecognized tax positions and a related liability for unrecognized tax benefits

Who: The Entity (Cont.)

- Financial statements of a group of related entities, Example 38 (Cont.)
  - "Because entities within a consolidated or combined group should consider the tax positions of all entities within the group regardless of the tax status of the reporting entity."
  - "Entity A should include in its financial statements the assets, liabilities, income, and expenses of both Entity A and Entity B, including those relating to the implementation of this Subtopic to Entity B."
  - "This is required even though Entity A is a pass-through entity."

What: Identify - Step 1

- ***Tax position*** - State nexus (ability to tax)
  - New example added pursuant to ASU 2009-06
    - ◊ "Definition of a tax position," Ex 32; ASC 740-10-55-223
  - "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."

New FIN 48 Mandate Webinar

Jan. 19, 2010

Are You Ahead Of The Game Or Behind The Eight-Ball?

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Learning Objectives For FIN 48

- **FASB Interpretation No. 48 (FIN 48)**, *Accounting for Uncertainty in Income Taxes*, an interpretation of FAS 109, *Accounting for Income Taxes* [ASC 740-10]
  - Understand the:
    - ◊ General widespread applicability to all entities
    - ◊ Entity approach to effective implementation
      - Steps in application to the entity
      - Utilization of practice aids & your involvement in the process
      - Applicable disclosures
    - ◊ Practical considerations and shortcuts
    - ◊ Impact of FASB Codification [ASC 740-10]

Learning Objectives For FIN 48 (Cont.)

- FIN 48 objectives (Cont.)
  - Expand our comfort zone
    - ◊ "Ours is not to question why, ours is but to quantify"
      - Adapted from Alfred Lord Tennyson

Who: The Entity

- Applied to the ***entity***, scope
  - Income Tax Topic (ASC 740-10-15-2) applies to:
    - ◊ Domestic and foreign entities issuing GAAP statements
    - ◊ Includes not-for-profit entities with activities subject to income tax
  - "Overall" sub-topic (ASC 740-10-15-2AA); uncertain tax positions applies to all entities, including:
    - ◊ "Tax-exempt not-for-profit entities
    - ◊ Pass-through entities, and
    - ◊ Entities taxed similarly to pass-through entities
    - ◊ As added by ASU 2009-06

What: Five Steps (Plus One)

Step	Action	How?
1	Identify	Practice aids
2	Recognize	Tax services assistance
3	Measure	Tax services assistance
4	Disclosure	Slides 22-24
5	Follow-Up	Repeat next reporting period
6	Document	Practice aids

The Documentation Iceberg

What You Don't See Can Hurt You!

What: Identify - Step 1

- ***Tax position*** **(1) [ASC 740-10-20]**
  - Taken or expected to be taken in a tax return
  - Can result in a balance sheet impact as a:
    - ◊ Permanent reduction of taxes payable
    - ◊ Deferral of current taxes payable to future periods, or
    - ◊ Change in realizability of deferred tax assets

What: Identify - Step 1 (Cont.)

- ***Tax position*** encompasses: **[ASC 740-10-20]**
  - A decision not to file a tax return
    - ◊ State nexus, permanent establishment
  - An allocation or a shift of income between jurisdictions
    - ◊ State apportionment, transfer pricing (state or foreign)
  - The characterization of income or a decision to exclude reporting taxable income in a tax return
    - ◊ Characterization: Business vs. non-business
    - ◊ Exclusions: State subtractions

What: Identify - Step 1 (Cont.)

- ***Tax position*** encompasses: **[ASC 740-10-20]**
  - 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.”*
    - ◊ Added to ASC 740-10-20 (Glossary) by AU 2009-06

How: Practice Aids - Types

- **Issue identification** - Generally by entity; use checklists specifically developed for:
  - Tax-exempt
  - S corporation
  - Partnership/LLC
  - C corporation

How: Practice Aids – Types (Cont.)

- **Analysis and documentation** - By issue and overall
  - Issues
    - ◊ State nexus issue
    - ◊ "Industry focused" issues – Research credit/Sect. 199
  - Overall
    - ◊ Conclusionary memo on approach/result
- **Disclosure**
  - Entity: General tax footnote [ASC 740-10-50]
  - Issue: "***significant increases …***" (21d) [ASC 740-10-50-15d]
  - Other disclosures not by entity or issue

What: Identify By Entity - Step 1

- Tax-exempt organizations
  - Exemption issues
    - ◊ Initial exemption
      - Do you have a copy of the determination letter?
    - ◊ Ongoing exemption
      - Are all activities performed in furtherance of exempt status?
  - Other income taxes
    - ◊ Unrelated business income Tax (“UBIT”)
    - ◊ Includes state income tax
    - ◊ Does not include excise taxes

What: Identify By Entity - Step 1 (Cont.)

- Tax-exempt organizations (Cont.)
  - UBIT – Expense allocation
    - ◊ Is the allocation methodology for expenses:
      - Reasonable?
      - Consistent?
      - Documented?
  - New tax position examples
    - ◊ Qualification as a tax exempt entity
    - ◊ UBIT; activities & revenue/expense allocations
    - ◊ ASC 740-10-55-225; Example 34. Added pursuant to ASU 2009-06

What: Identify By Entity - Step 1 (Cont.)

- Pass-through entities - S Corporations
  - Initial qualification issues
    - ◊ Federal election is required
      - Do you have a copy of the acceptance notice?
    - ◊ S election not recognized by certain states:
      - No S election allowed (DC, MI, NH, TN, TX)
      - Separate state S election (AR, NJ, NY, OH)
  - Ongoing qualification issues
    - ◊ Involuntary termination considerations
      - Number and types of shareholders
    - ◊ Voluntary revocation of election
  - Other income taxes; former C corporations

What: Identify By Entity - Step 1 (Cont.)

- Pass-through entities - S corp., former C corp.
  - Built-in gain (“BIG” Tax; federal and some states)
    - ◊ Gains recognized during the recognition period
    - ◊ Generally 10-year recognition period
    - ◊ New tax position example; considerations similar to UBIT
      - Subject to tax: Revenue/basis allocation
      - ASC 740-10-55-224, Example 33. Added pursuant to ASU 2009-06
  - Taxes for open C corporation years
    - ◊ Statute of limitations
      - Federal, generally three years
      - State, generally four years; no expiration if a return not filed

What: Identify By Entity - Step 1 (Cont.)

- Pass-through entities - Partnerships/LLCs
  - Is it a partnership for federal income tax purposes?
  - State income tax considerations
    - ◊ Texas margin tax (determined to be an income tax by FASB)
    - ◊ Other states

What: Identify By Entity - Step 1 (Cont.)

- C corporations
  - Tax positions for all open years
    - ◊ Uncertain
    - ◊ Highly certain
  - Uncertain tax positions
    - ◊ Permanent differences
    - ◊ Temporary differences

What: Identify By Entity - Step 1 (Cont.)

- C corporations - Tax positions include:
  - State income tax nexus (permanent difference)
  - Tax accounting methods and elections (temporary difference)
    - ◊ Correct or erroneous?
      - Automatic change – file by return due date
      - Consent change – file by year-end
    - ◊ Timely filed/adopted?
    - ◊ Consistently applied/calculated?
  - Reduction in net operating loss due to Sect. 382 limits (change in realizability of deferred tax assets)

What: Identify By Entity - Step 1 (Cont.)

- C corporation “shortcuts” to recognition/MLTN
  - ***Administrative practices and precedents*** (7b) [ASC 740-10-25-7b]
    - ◊ General approach to nexus (A14 – six year look-back)
    - ◊ Voluntary disclosure agreements
    - ◊ State amnesty programs
  - ***Effectively settled*** (FSP FIN 48-1; new paragraphs 10A-10C) [ASC 740-10-25-10]
    - ◊ Recognize tax benefit prior to statute expiration

What: Identify By Entity - Step 1 (Cont.)

- C corporation "shortcuts" to recognition/MLTN
  - ***Highly certain tax positions*** (A19) [Example 5; ASC 740-10-55-99]
    - ◊ Clearly meets the recognition criterion. Tax positions believed to be based on clear and unambiguous tax law
    - ◊ Highly confident of full deduction; the expenses are <u>not</u> subject to:
      - Any statutory limitations on deductibility
      - Capitalization, or
      - Accrual limitations related to economic performance or other statutorily provided restrictions related to the timing of their payment

What: Disclosure - Step 4

- Initial
  - Disclose the ***cumulative-effect adjustment*** in the period of adoption (24)
- Annual disclosures (21) [ASC 740-10-50-15]
  - Aggregate; not by tax jurisdiction
- Comprehensive disclosure example (A33) [Example 30; ASC 740-10-55-217]

What: Disclosure - Step 4 (Cont.)

- All entities, non-public and public
  - Policy election for interest and penalties (19-20) [ASC 740-10-50-19]
  - Amount of interest and penalties (21c) [15c]
    - ◊ Operating statement
    - ◊ Balance sheet
  - Significant increases/decreases "***reasonably possible***" (21d) [15d]
  - ***Tax years subject to examination*** (21e) [15e]

What: Disclosure - Step 4 (Cont.)

- Applicable to public entities only
  - ***Tabular reconciliation*** (21a) [15a]
    - ◊ ***Unrecognized tax benefits*** (“UTB”)
  - Effective rate impact (21b) [15b]

How: Documentation - Step 6

- Need to ask (and answer) the hard questions (completeness vs. awareness)

- By showing your work, satisfies both standards:
  - SAS 103, *Audit Documentation*
    - ◊ Understandable by experienced auditor without connection to the audit
  - SAS 106, *Audit Evidence*
    - ◊ Sufficient (quantity) appropriate (quality) audit evidence
      - Reliability - knowledgeable source

Other Considerations - Taxing Authorities

- Tax accrual workpaper policy
  - IRS general rule – Policy is <u>not</u> to request, unless
    - ◊ Taxpayer is not compliant with info requests
    - ◊ Reportable transaction has not been reported
  - States are beginning to routinely request FIN 48 workpapers (CA, IL, MT)
- Attorney-client privilege should be considered
  - Additional concerns in light of *U.S. vs. Textron?*
    - ◊ Repeal of use of work product doctrine; “prepared in anticipation of litigation”

Other Considerations - Taxing Authorities (Cont.)

- New federal preparer penalties Sect. 6694
  - Old standard
    - ◊ "Reasonable possibility of success" (one-third), or
    - ◊ Disclose if a "non-frivolous position"
  - New standard
    - ◊ Substantial authority
    - ◊ Disclose (Form 8275) if a "reasonable basis" exists (20%)
  - Differences between FIN 48 and Sect. 6694
    - ◊ Private letter rulings can be used for Sect. 6694 (not FIN 48)
- Taxpayer is still subject to penalty under Sect. 6662 – "Substantial authority" rules

Other Considerations - Taxing Authorities (Cont.)

- Tax Opinions – Circular 230
  - “Covered opinion,” “reliance opinion”
    - ◊ Title 31 Code of Federal Regulations, Subtitle A, Part 10 ("Circular 230"), Reg. § 10.35(b)(2)(i)(C)(1) and (4)(i)
  - Written advice is to conclude at a confidence level of at least more likely than not (*i.e.*, a greater than 50 % likelihood) that one or more significant federal tax issues would be resolved in the taxpayer's favor

Conclusion: Action Plan For FIN 48

- The Six Ds
  - Decide to get started
  - Discuss - Company and assurance provider agree
  - Develop your own plan
  - Determine your approach for each step
  - Document along the way!
  - Don't expect another delay!

Conclusion: Practice Aids - List

- Draft of overall approach
  - Detail five-step workplan — PA #2
- Drafts of documentation
  - Document review checklist — PA #3
  - State nexus review summary — PA #4
  - Tax position memo — PA #5
  - FIN 48 memo — PA #6

Note: Practice aids are provided to meeting participants solely as illustrations for educational purposes

Practice Aids – Utilize Five-Step Workplan

1) **Identify**/list all tax positions
   a) Modify and complete the *Document Review Checklist* (PA #3)
   b) Complete the *State Nexus Review* (PA #4)
2) **Recognize** - Evaluate each UTP for MLTN
   a) Start a *Tax Position Memo* (PA #5) with the facts for each UTP and MLTN analysis
3) **Measure** each UTP that meets MLTN
   a) Complete analysis for each *Tax Position Memo (PA #5)*
   b) Determine interest expense
   c) Determine penalty expense

Practice Aids – Utilize Five-Step Workplan (Cont.)

4) **Disclose** - Determine reporting and prepare disclosures
   a) Complete each *Tax Position Memo (PA #5)*
   b) Complete the overall *FIN 48 Memo (PA #6)*
   c) Complete the appropriate disclosure (slides 22-24)
5) **Follow-up** - Each subsequent period
   i. Review recognition, derecognition and measurement
   ii. Review and revise Tax Department <u>process</u> documentation

Draft - PA #6.1 - Report Outline

Sample Corporation
Adoption and Application of FIN 48 [ASC 740-10]
Identification and Measurement of Uncertain Tax Positions
Year Ended December 31, 2009

1) Overview

a) The purpose of this memo is to provide documentation related to Sample Corporation's (the "Company's") adoption of Financial Accounting Standards Board ("FASB") Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), an interpretation of FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* ("FAS 109") [codified as Accounting Standards Codification ("ASC") 740-10] for its fiscal year ended December 31, 2009.

b) Scope

c) Tax Position

d) Unit of Account

e) Confidence Threshold for Recognition

f) Initial Recognition, Subsequent Recognition and Derecognition

g) Measurement

2) Review Procedures

We have reviewed the following primary documents solely for the purpose of identifying potential uncertain tax positions pursuant to FIN 48:

a) Financial Statements or Annual Report

  i) Audited financial statements for the years ended December 31, 200x-200y

b) Income Tax Returns

  i) Federal income tax returns, Form 1120, for tax years ended December 31, 200x -200y, including review of the book to tax differences reported in Schedule M-1 or Schedule M-3.

  ii) Form 3115, Application for Change in Accounting Method filed with the Company's federal income tax return for the year ended December 31, 200z and workpaper documentation related thereto.

  iii) State income tax returns for tax years ended December 31, 200x -200y and corresponding state income tax apportionment workpapers.

  iv) City income tax returns for tax years ended December 31, 200x -200y and corresponding city income tax apportionment workpapers.

c) Tax Workpapers

i) Income tax provision workpapers for tax years ended December 31, 200x - 200y, including corresponding reconciliations of the income tax provision to the income tax returns as filed.

ii) Draft income tax provision workpapers for the tax year ended December 31, 2009.

d) Other Information

i) The Trial Balance for the year ended December 31, 2008 and cumulative through September 30, 2009.

ii) ***State Income Tax Nexus Summary, PA #4***

e) A complete listing of items reviewed is contained in the ***Document Review List, PA #***3.

3) Taxing Authority Examination History

4) Statute of Limitations Considerations

5) Company Profile

6) Accounting Methods for Income Tax Purposes

a) Overall method - accrual/cash accounting

b) Tax year

c) Revenue Recognition

i) Financial Statement

ii) Income Tax

d) Deductions

i) Reserves

(1) Identified reserves

ii) Cost of sales

iii) Accrued Liabilities

(1) Identified reserves

(2) Other potential non-deductible accruals

(a) economic performance rules

(b) "recurring item exception" under Sec. 461(h)

(c) other income tax provisions which may limit or delay their deduction for income tax purposes

iv) Prepaid Expenses

(1) Accelerated deduction provided pursuant to the rules of Reg. 1.263(a)-4.

7) Elections for Income Tax Purposes

a) Fixed Assets

b) Inventory Capitalization

c) Accrued Liabilities

i) "recurring item exception" method of Sec. 461(h)

(1) applicable to all years

8) Identified Uncertain Tax Positions & Related Conclusions

a) Permanent Differences

i) State and local tax income tax - See the separate tax position memo, "***State Income Taxes – Nexus Exposure - PA #5***"

(1) Nexus

(a) State

(b) City and local

(2) Credits

ii) Sec. 199 Production Deduction

iii) Research Credit

iv) Meals & Entertainment Expense

v) Net Operating Loss

b) Temporary Differences

i) Depreciation:

(1) General fixed asset capitalization policy

(2) Computer hardware and software capitalization policy

(3) "Administrative practices and precedents of the taxing authority" when assessing tax positions for recognition.

ii) Accrued Liabilities

9) Highly Certain Tax Positions

10) Conclusions

a) Initial Impact of FIN 48 - January 1, 2009 Adoption

i) Recognition Criteria - MLTN

ii) Measurement of Recognized and Derecognized Positions

iii) Account Balances

(1) Adoption

(2) Subsequent reporting periods

(3) Balance Sheet Classification

iv) Disclosures

(1) Income Tax Footnote / Other

Practitioners should consider inserting their IRS Circular 230 notice here

Note: Practice Aids are provided to seminar participants as illustrations for educational purposes only

Sample Corporation
FIN 48 Uncertain Tax Positions
Index to FIN 48 Adoption Documentation Workpapers
Year Ended December 31, 2009

W/P	Worksheet Tab	Purpose	Ref
Index	**Index**	Index to FIN 48 Adoption Documentation Workpapers	

	General Documentation		
PA C	Tax History	Tax History	
PA C1	C Corp List	C Corporation Checklist	
PA C2	Doc Review	Document Review Checklist	
PA C3	SALT Docs	SALT Document Review Checklist	

	Supporting Workpapers		
PA C4	State Nexus	State and Local Income Tax Nexus Review	2009
		Tax History	

	Memos (separate files)		
PA C5	TPM	Tax Position Memo (created for each material uncertain tax position)	
PA C6	Memo	Memo - Comprehensive Memo	

Tax Year Inputs					
2004	**2005**	**2006**	**2007**	**2008**	**2009**

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<u>Draft - PA #2</u>

Sample Corporation
Detail FIN 48 Workplan Procedure

I. Identification of Tax Positions

1) Identify tax positions (Para 4)
   a) Identify applicable taxing (income tax) jurisdictions (Para 3 – all jurisdictions to which FAS 109 applies)
      i) FAS 5, "Accounting for Contingencies" continues to apply to non income tax positions
      ii) Determine the applicable statute of limitations for each applicable taxing jurisdiction
         (1) Consider the "effectively settled" criteria of Proposed FASB Staff Position (FSP) No. FIN 48-a
   b) Determine the appropriate "Unit of Account" (Para 5) - "facts and circumstances;" consider both the:
      i) Company's historical approach to preparation and support of the income tax return
      ii) Anticipated taxing jurisdiction approach to examination
   c) Develop a ***Document Review Checklist, PA #3 ("Checklist")*** incorporating applicable documents for applicable open years
      i) Develop new documents as applicable; an example would be the ***State Income Tax Nexus Summary, PA #4***
   d) Review applicable documents – see attached ***"Checklist"***
      i) Document existing tax accounting methods
      ii) Document tax elections made
2) Based on Review in #1, develop a comprehensive list of all tax positions
   a) Include a listing of all tax accounting methods and elections
3) Determine if the identified tax positions are Uncertain Tax Positions ("UTPs") (Para 4)
4) Document the "Highly Certain Tax Positions."
   a) Based on "clear and unambiguous" tax law (Para A19-A20)

II. Recognition of Uncertain Tax Positions

1) Determine if each UTP is "more likely than not" ("MLTN"), based on its technical merits, of being sustained upon examination.
   a) MLTN is defined as a likelihood of more than 50 percent.
   b) "Upon examination" includes the "resolution of the related appeals or litigation processes, if any." Para 6.
   c) It must be presumed that each position will be examined and that the taxing authority will have full knowledge of all relevant information (Para. 7 a.)

d) Each position must be evaluated on its own merits and cannot consider the "possibility of offset or aggregation with other positions" in examination (Para 7 c.)
e) Consider the:
   i) "sources of authorities in the tax law" (Para. 7 b),
   ii) applicable "administrative practices and precedents" (Para. 7 b), and
   iii) examination history with relevant taxing authorities with respect to examinations that are "effectively settled" pursuant to Proposed FASB Staff Position (FSP) No. FIN 48-a

2) For each UTP, develop a separate ***Tax Position Memo, PA #5***, documenting the:
   a) Tax Position,
   b) Unit of Account,
   c) Facts and
   d) MLTN analysis (see the example "State Income Tax Nexus

III. Measurement

1) For each UTP that is recognized (meets MLTN), determine the initial measurement as being:
   a) The "largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority having full knowledge of all the relevant information." (Para. 8),
   b) Taking into consideration "the amounts and probabilities of the outcomes that could be realized upon ultimate settlement" (Para. 8)
2) Provide for adjustment for each UTP that does not meet MLTN
3) Determine applicable Interest & Penalties (Para 15)
4) Consider the applicable accounting policy for interest & penalties (Para 19)
5) Add documentation on these measurement items for each UTP to the ***Tax Position Memo, PA #5,*** developed for that UTP under II. 2. above.
6) Summarize the results of the review with a ***FIN 48 Report, PA #6***

IV. Reporting & Disclosure

1) Balance sheet classification
   a) Determine the appropriate balance sheet classification (Paras 17-19) for each applicable UTP
   b) Complete the documentation for each UTP in the tax position memo developed for that UTP under II. 2. above
2) Disclosures:
   a) SAB 74 requires disclosure of the impact of new accounting pronouncements; required quarterly for publicly held companies after issuance of FIN 48 (July 13, 2006)
   b) Annual disclosures (develop for each UTP and then appropriately aggregate:
      i) Accounting policy on categorization of interest expense and penalties (Para. 20)
      ii) Tabular presentation (Para. 21a.)

iii) Impact on effective tax rate (Para. 21b.)
iv) Interest and penalties included in operating expense or income tax expense (Para. 21c)
v) Significant increases or decrease in the next 12 months (Para. 21d.)
vi) Tax years subject to examination by major jurisdictions (Para. 21e.)

V. Follow-up

1) Review and Revise Tax Dept. Control Documentation
   a) Revise control documentation to include procedures for identifying tax positions on an ongoing basis.
   b) Develop procedures for regular review of tax positions previously identified.
2) Review for Subsequent Recognition, Derecognition & Measurement
   a) Monitor the identified tax positions and formally review each position quarterly.
   b) Consider the three conditions of Para. 10:
      i) Changes in the tax position with respect to the MLTN threshold
      ii) Ultimately settlement of the tax position, as modified to include "effectively settled" by Proposed FASB Staff Position (FSP) No. FIN 48-a
      iii) Expiration of the statute of limitations
   c) Subsequent changes in judgment "should 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." (Para. 12)

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Draft - PA #5.1 - State TPM Outline

Sample Corporation
Adoption and Application of FIN 48 [ASC 740-10]
Tax Position Memo - State and Local Income Taxes:
Nexus Exposure & State Credits
Year Ended December 31, 2009

1) Tax Position

a) **State Income Taxes - Nexus**: Permanent difference for state and local income taxes

   i) The activities of the Company have not surpassed the protection provided by P.L. 86-272 prohibiting state and local governments from imposing a tax measured by net income of interstate business (the "State Nexus" tax position as it applies to each individual state taxing jurisdiction).

b) **Local Income Taxes - Nexus**: Permanent difference for city income taxes levied by various cities

   i) The activities of the Company have not surpassed the protection provided by P.L. 86-272 prohibiting state and local governments from imposing a tax measured by net income of interstate business (the "Local Income Tax Nexus" tax position as it applies to each individual local taxing jurisdiction).

c) **State Income Taxes - Credits**: Permanent difference for state Enterprise Zone credits

   i) The Company qualifies for Enterprise Zone credits claimed in California that are applied against state income tax liability (the "State Enterprise Zone Credit" tax position).

2) Unit of Account

a) The following accounts by state and city:

   i) Sales by destination

   ii) Fixed assets at cost

   iii) Inventory at cost

   iv) Payroll

   v) Rent expense

b) Other relevant information by state and city:

   i) Employee activities

   ii) Vouchers produced for California Enterprise Zone purposes

3) Facts

a) State Income Taxes

b) City and Local Taxes

c) Enterprise Zones

4) Analysis - Nexus Considerations

a) Sourcing of Sales - Seller of Tangible Personal Property vs. Service Provider

b) Sale or Lease of Tangible Personal Property

  i) Employee Activities

    (1) Sales Solicitation Activities

      (a) Public Law 86-272 (15 U.S.C. § 381 (a))

      (b) Other Employee Activities

    (2) Non-sales solicitation activities of employees

      (a) on-site services to customers

      (b) installation,

      (c) training and consulting support

  ii) Fixed Assets - Ownership and Rental

  iii) Inventory

  iv) Other Considerations

  v) Local Income Taxes

5) Tax Audit Examination History

6) Statute of Limitations Considerations

a) Potential for Refunds

7) Conclusions

a) Initial Impact of FIN 48 - January 1, 2009 Adoption

b) FIN 48 Conclusions at Adoption January 1, 2009

  i) Recognition Criteria - MLTN

  ii) Measurement of Recognized and Derecognized Positions

  iii) Account Balances and Balance Sheet Classification

    (1) Reporting Period of Adoption

    (2) Subsequent reporting periods

    (3) Balance Sheet Classification

iv) Disclosures

(1) Income Tax Footnote

(2) Other

Practitioners should consider inserting their IRS Circular 230 notice here

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Background – FASB ASU 2009-06
http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819501289&blobheader=application%2Fpdf

Background – FASB Interpretation No. 48
http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818746949&blobheader=application%2Fpdf