

On June 13, 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. 48, an Interpretation of FASB No. 109 (FIN 48, the Interpretation). The Interpretation, codified in Accounting Standards Codification (ASC) Topic 740, *Income Taxes*¹, was effective for public entities' fiscal years beginning after Dec. 15, 2006.

After two deferrals, private companies, pass-through entities (PTE) and not-for-profit entities (NFP) must fully implement the Interpretation in annual financial reporting for years beginning after Dec. 15, 2008.

FIN 48 requires that each material "tax position" be evaluated to determine whether all, part, or none of its related tax benefit should be recognized for U.S. accounting purposes. Generally, a "tax position" is one that has been taken or is expected to be taken in a tax return, or by not filing a tax return. It is reflected in measuring current or deferred income-tax assets and liabilities. Such tax positions include the following:

- a deduction in determining taxable income
- an exclusion from, or reduction of, taxable income
- a tax credit in determining income-tax liability
- a decision not to file a tax return (nexus or permanent establishment)
- a shift of income between jurisdictions (transfer price)
- a decision to classify an entity, position or transaction as tax exempt
- a decision regarding the characterization of income (ordinary versus capital)

In principle, the validity of a tax position is a matter of tax law. But in some cases the law is subject to interpretation, and the sustainability of a position on examination is not assured.

Before FIN 48, there was inconsistency in the criteria used to quantify the economic benefits/burdens of tax positions. Under the Interpretation, all tax positions under ASC Topic 740 (formerly SFAS 109) will be evaluated for recognition, de-recognition and measurement under consistent criteria.²

The Uncertain World of Tax Positions

By Manuel E. Pravia, CPA

Application Requires Identifying Tax Positions

To apply the recognition and measurement concepts of the Interpretation, an entity must identify, review and document all tax positions for all jurisdictions for all tax years that are not closed by statute. Under FIN 48, an enterprise cannot recognize a tax benefit in its financial statements unless it concludes that it is "more likely than not" (MLTN) that the taxing authority will sustain the benefit of a tax position on audit based solely on the associated tax position's technical merits.

Therefore, with respect to the Interpretation, entities must assume that the position: 1) will be examined by a taxing authority that has full knowledge of all relevant information; and 2) will be resolved in the court of last resort.

The approach to identifying and documenting tax positions can differ depending on the entity's tax status, technical complexity and tax jurisdictions in question. The following is a broad outline of steps involved in the process:

Federal income-tax positions

- Review of federal income-tax returns for the open tax years
- Evaluate tax-accounting methods employed, including the existence of valid elections
- Perform thorough analysis of all book/tax differences
- Perform analysis of all income, deductions and balance-sheet line items

- Review of significant acquisition/dispositions to identify situations where benefits may be limited (e.g., § 382, capitalization of costs) or exposure may exist (pre-sale tax indemnification)

State and local income-tax positions

- Review of all state and local income tax returns for open tax years.
- Identify additions/subtractions to federal taxable income, including conformity with specific areas where states have decoupled from federal tax provisions (e.g., depreciation)
- Evaluate revenue sourcing and nexus issues
- Review calculation of apportionment factors

International tax positions

- Review of all international compliance (5471s and foreign tax returns) for open tax years
- Complete transfer pricing studies to support related-party transactions

¹Although the Accounting Standards Codification is now effective, the former nomenclature is used throughout the article for ease of reference.

²More information about the application of FIN 48 can be found in "FIN 48: Tax Uncertainties," *Florida CPA Today*, July/August 2008.



- Documentation of foreign taxes paid/withheld and eligibility for foreign-tax credit
- Tracking of controlled foreign corporations earnings and profits and potential for deemed dividend distributions under Subpart F
- Evaluation of tax positions taken in foreign jurisdictions, including conclusions regarding permanent establishment and treaty benefits

Like all Generally Accepted Accounting Principles (GAAP), FIN 48 applies to material tax positions. However, a position that currently is not material may be material in a future period.

Classifying Tax Positions is Next Step

Once identified and documented, an entity's tax positions should be evaluated to determine whether uncertainty exists, to distinguish between those that are:

- "highly certain" – tax positions where clear, unambiguous tax law applies to the item
- "uncertain" – tax positions that do not meet the MLTN recognition threshold
- "not highly certain" – tax positions that have some uncertainty but have at least a MLTN chance of being sustained and, therefore, can be recognized

By their nature, tax positions that are highly certain of being sustained will require no accounting adjustment from their treatment in the tax return, as such positions will, by definition, meet the criteria for full recognition of tax benefits under FIN 48. The principal approach,

with respect to highly certain tax positions, is to document that those tax positions were evaluated; that the evaluation process was sufficient to determine whether uncertainty existed; and why particular categories of tax positions do not contain uncertainty.

If the position is so uncertain that the recognition threshold is not met, then no benefit can be recognized, even when the enterprise believes some amount of benefit ultimately will be realized.

If the MLTN recognition threshold is met, the tax benefit is measured at the largest amount of the tax benefit that, in the enterprise's judgment, is more than 50 percent likely to be realized. The analysis should be based on the amount the taxpayer ultimately would accept in a negotiated settlement with the taxing authority.

Management Must Determine Applicability to PTEs and NFPs

Historically, PTEs and NFPs were unconcerned about accounting for income taxes as, by their nature, income taxes would apply under very limited circumstances. In discussions leading up to the issuance of Accounting Standards Update (ASU) No. 2009-06, the FASB made it clear that all entities are subject to the recognition and measurement standards of the Interpretation, even if their only tax position is their tax status.

A PTE's management must determine whether the entity qualifies as a PTE in the jurisdictions where it files tax returns or would otherwise be subject to income taxes. For example, if an S corporation election was not promptly made, or an event terminated the status (e.g., uneven distribution creating a second class of stock, admission of an ineligible shareholder), then the entity would be subject to corporate income taxes. By the same token, if a state requires a separate election (like New York does), the absence of the election would subject the entity to income tax.

PTEs must determine whether the tax laws in a particular jurisdiction apply to the entity or its owners. If the income taxes are attributable to the entity in that jurisdiction, those amounts due are subject to the recognition, measurement and disclosure provisions of FIN 48. If, on the other hand, the jurisdiction attributes the taxes to the owners (even if administratively remitted by the entity), amounts due to/from the taxing jurisdictions are classified as transactions with owners and FIN 48 does not apply.

Similar to PTEs, NFPs must review their status and activities to document their continued classification as tax exempt. Even if the NFP status is MLTN to be sustained, there may be instances where the entity may be subject to income tax.

An NFP should consider whether an activity gives rise to unrelated business income (UBI). An NFP would need to document which revenue is from UBI activities, and (since the tax is on a net UBI) what expenses are properly allocable. All of these are tax positions an NFP may have, and appropriate inquiries are necessary to obtain assurance they have not given rise to an unrecognized tax liability.

FIN 48 Requires Ongoing Monitoring

FIN 48 is more than a one-time exercise. It is a continuous effort to document and evaluate old and new tax positions for each interim and annual GAAP financial statement issued after the effective date. Also, conclusions about recognition and measurement may change because of developments in tax controversy or new legislation. All entities must devote additional time and effort, in the tax-provision cycle, to properly support the financial-statement assertions of completeness and accuracy regarding the tax assets and liabilities on the statement of financial condition.

Even PTEs and NFPs need to consider potential tax issues before issuing their GAAP statements. In particular, a liability recorded under the Interpretation may result in significantly reduced unrestricted net assets – a situation that may give rise to a going-concern issue. **FACT**

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