
State Tax Risk, Opportunity, and Defense in a FIN 48 World

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Framing the Issue

“Unresolved and controversial issues permeate the state and local tax field”

– COST letter to FASB dated September 12, 2005 in response to exposure draft on “Accounting for Uncertain Tax Positions” released July 14, 2005.

Framing the Issue

“[T]he Exposure Draft should include examples of state and local tax issues. These examples should help taxpayers determine what type of documentation and support will be acceptable to reach the required standard.”

– COST letter to FASB dated September 12, 2005 in response to exposure draft on “Accounting for Uncertain Tax Positions” released July 14, 2005.

Framing the Issue

“If a particular state taxing authority never challenges the taxpayer, reserves would be held indefinitely.”

– Letter to FASB dated September 12, 2005 in response to exposure draft on “Accounting for Uncertain Tax Positions” released July 14, 2005.

Framing the Issue

“The tax laws of state and local governments...are...very grey, but the reason is often a lack of guidance...issues surrounding nexus and apportionment are particularly difficult.”

– Letter to FASB dated August 18, 2005 in response to exposure draft on “Accounting for Uncertain Tax Positions” released July 14, 2005.

Framing the Issue

“[T]here is a distinct possibility many state and local tax reserves will need to be recorded indefinitely...as a practical matter, such reserve will never be released unless the taxing authority directly challenges the taxpayer.”

– Letter to FASB dated August 18, 2005 in response to exposure draft on “Accounting for Uncertain Tax Positions” released July 14, 2005.

Background

Prior Rules – FAS 5

- Historically, all contingent liabilities (including contingent tax liabilities) were accounted for under FAS 5.

- FAS 5 requires companies to accrue a reserve for a loss contingency if:
 - It is “probable” that a liability has been incurred, and
 - The amount of the loss can be reasonably estimated.
 - For this purpose, FAS 5 defines “probable” as “likely to occur;”
 - Taxpayers generally avoided accruing a reserve if there was substantial authority for a tax position.

- If a loss is not “probable” or if the amount can not be reasonably estimated, FAS 5 generally does not require disclosure of the contingency in a company’s financial statements.

Background

Prior Rules – FAS 5 Example

- On its 2005 tax return, a company takes a deduction for interest expense, resulting in a \$100 million tax benefit.
 - If the company determines that it is not “probable” that a loss will occur upon audit with respect to the deduction:
 - No loss contingency reserve would be accrued, and
 - The financial statement benefit of the deduction would be fully recognized.

Background

Prior Rules – Changing Practices

- Despite the requirements of FAS 5, accounting firms began requiring higher levels of confidence for tax-motivated transactions.
 - Companies were required to obtain “more likely than not” or “should” level opinions to avoid accruing a loss contingency.
- This inconsistency led the FASB to issue FIN 48:
 - “[D]iverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.”

Background

- FIN 48 was issued in June 2006
- FIN 48 removes tax contingencies from the ambit of FAS 5, and adds new rules to FAS 109.
- FIN 48 applies a single standard for recognizing uncertain tax benefits – “more likely than not”.
- Requires determination of amounts likely to be realized upon ultimate settlement with a taxing authority.

Overview of FIN 48

Recognition

- A company shall recognize the financial statement effects of a tax position if it is more likely than not that the position will be sustained upon examination (including appeals and litigation).
 - This determination shall be based on the technical merits of the tax position, considering tax law authorities and relevant past experience with the taxing authority.
 - It shall be presumed that the tax position will be audited and that the taxing authority will have full knowledge of all relevant facts.

Overview of FIN 48

Recognition – Example

- A company claims a \$1 million research and experimentation credit on its current tax return. The credit is based on two separate projects (\$500,000 each).
 - Management determines that the first project satisfies the more-likely-than-not threshold. Therefore, the financial statement benefits of this portion of the credit are eligible to be recognized on the company's financial statements.
 - Due to the nature of the activities constituting the second project, the second project does not meet the more-likely-than-not threshold. Thus, the financial statement benefits of this portion of the credit shall not be recognized.

Overview of FIN 48

Measurement

- Once a tax benefit is determined to meet the more-likely-than-not standard, the benefit shall be measured as the largest amount that has a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority.

Overview of FIN 48

Measurement – Example

- Assume management determines that the probabilities of outcomes with respect to a \$500,000 benefit are as shown here.
- Because \$300,000 is the largest amount that is greater than 50% likely to be recognized, this amount would be recognized on the company's financial statements.

<u>Possible Outcome</u>	<u>Individual Probability</u>	<u>Cumulative Probability</u>
500,000	10%	10%
400,000	25%	35%
300,000	20%	55%
200,000	25%	80%
100,000	10%	90%
0	10%	100%

Overview of FIN 48

Classification

- Differences between amounts shown on a company's tax return and the amounts recognized on the company's financial statements generally results in the creation of a liability.
 - For example, if a company claimed a \$500,000 benefit on its tax return, but determined that only \$300,000 of the benefit can be recognized under FIN 48, the company would accrue a \$200,000 liability and a related charge to income.

Overview of FIN 48

Subsequent Recognition and Derecognition

- If a tax benefit does not initially meet the “more likely than not” threshold, the tax benefit shall be recognized in the first period in which:
 - The “more likely than not” threshold is satisfied;
 - The tax matter is ultimately settled; or
 - The relevant statute of limitations has expired.

- Tax benefits shall be derecognized in the first period in which it is no longer “more likely than not” that the tax position will be sustained on examination.

Overview of FIN 48

Interest and Penalties

- If tax law would require payment of interest on an underpayment of income tax, a company shall accrue interest expense on its financial statements under the applicable statutory rate.
- Similarly, if a position does not meet applicable standards to avoid tax penalties, a company shall accrue an expense on its financial statements for the applicable penalty amount.

Overview of FIN 48

Disclosures

- FIN 48 requires companies to make the following disclosures:
 - Tabular reconciliation of amounts of unrecognized tax benefits at the beginning and end of each period.
 - The total amount of interest and penalties recognized.
 - For positions for which it is reasonable possible that the total amount of unrecognized benefit will significantly increase or decrease within 12 months:
 - The nature of the uncertainty,
 - The nature of the event that may cause the change, and
 - An estimate of the range of the reasonably possible change.
 - A description of the tax years that remain subject to examination.

Overview of FIN 48

Effective date

- FIN 48 is effective for a company's first fiscal year beginning after December 15, 2006.
- The cumulative effect of applying FIN 48 shall be reported as an adjustment to beginning retained earnings.

Anticipated Impacts

Additional work

- Adopting FIN 48 will require continuing detailed analysis of all unsettled tax positions in all open tax years.
 - Recognition: The “more likely than not” standard will require a technical analysis of many more tax positions than the old FAS 5 standard (which was based on a much lower level of confidence).
 - Best Estimate: This requires an evaluation of the likelihood of a range of potential outcomes for each “more likely than not” position. Nothing like this was required under FAS 5, which ignored tax positions that satisfied its basic threshold.
 - Monitoring: FIN 48 requires continued monitoring of these decisions.

Anticipated Impacts

Fewer recognized tax benefits

- Fewer tax benefits will be recognized on a company's financial statements and more tax positions will result in a charge to income.
- This may have a chilling effect on a company's appetite for tax planning.

Anticipated Impacts

Discovery issues

- The additional documentation needed to support a company's financial statement analysis may be discoverable by the IRS and other taxing authorities in litigation.

Common State and Local Uncertain Tax Positions

- Classification
- Definitional Matters
- Nexus
- Taxable Income Modifications
- § 482
- Apportionment
- Unity
- Combination
- De-Combination
- Tax Credits

Emerging State and Local Uncertain Tax Positions

- Tax Shelters
- Tax Avoidance Transactions
- Reportable Transactions
- Similar to a Reportable Transaction
- Tax Motivated Transactions
- Business Purpose
- Economic Substance
- Elevating Form over Substance
- Step Transaction
- Sham Transaction
- Special Purpose Vehicles

Open Issues

Defining “units of account”

- Consensus must be built on how to define “units of account”

- FIN 48 applies to all income tax positions. However, related positions may be grouped into units of account.
 - For example, FIN 48 suggests that R&E credits can be evaluated per expenditure, per project, or in total.
 - To determine the proper unit of account, management must consider the magnitude of the benefit, previous experience with taxing authorities, and the importance of consistent accounting treatment.

Open Issues

Materiality

- Consensus must be built on how to determine materiality.
- FIN 48 states that these provisions need not be applied to immaterial items.

Open Issues

Disclosures

- FIN 48 provides the following example of a tabular disclosure of unrecognized tax benefits:

• Balance as of 1/1/2007	\$370,000
• Additions based on current year tax positions	10,000
• Additions for prior year tax positions	30,000
• Reductions for prior year tax positions	(60,000)
• Settlements	<u>(40,000)</u>
• Balance as of 12/31/2007	\$310,000

- Consensus must be built on how much additional information will be provided in footnote disclosures.
- Disclosures may provide the IRS and other taxing authorities with a “roadmap.”

Open Issues

- How is an enterprise to evaluate the “technical merits” of a specific uncertain tax position in the absence of “on point” authority or guidance from the specific jurisdiction?
- To what degree are federal income tax authorities and interpretations to be applied in assessing the “technical merits” in a state?

Open Issues

- To what extent can enterprises look to authority and interpretation in State A in assessing the “technical merits” in State B?
- Given the similarity in statutory provisions, would it be reasonable to treat the NYS uncertain tax position and NYC uncertain tax position as each representing a separate “unit of account”?

Questions and Answers
