FIN 48: Accounting and Auditing Implications: Certified Public Accountant
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FIN 48: Accounting and Auditing Implications

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In June 2006, the FASB released FASB Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 amends Statement of Financial Accounting Standards (SFAS) 109 and specifies the accounting and reporting requirements for the uncertainty in tax positions an entity may take. The accounting and reporting requirements of FIN 48 involve a two-step process that may result in a larger income tax liability, a smaller deferred tax asset, or a smaller income tax refund. The requirements are difficult to understand and might have a significant impact on audited financial statements for large and small organizations.

The FASB provides the following reason for issuing FIN 48: "The diversity in practice (regarding uncertain tax positions) has resulted in noncomparability in reporting income tax assets and liabilities." FIN 48 was created primarily as a mechanism to provide greater transparency for uncertain tax positions in order to reform financial reporting of tax issues (S.E. Seigel, "There's a FIN in the Water," *Vital Speeches of the Day*. Metropolitan Club. New York, January 19, 2007.). As a result, FIN 48 has the potential to significantly impact financial statement reporting and disclosures, as well as financial statement audits.

The following summary of the recognition and measurement changes required by FIN 48 also includes practical examples of common tax positions that may result in uncertainty in income tax accounting, as well as common audit-related issues.

FIN 48 Requirements

FIN 48 requires any entity subject to income tax to apply a two-step analysis to uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006, for all public entities. The FASB decided to defer the effective date of FIN 48 for all nonpublic entities, including not-for-profits, to fiscal years beginning after December 15, 2007.

The first step in FIN 48 is to apply a recognition threshold to determine whether an uncertain tax position should be recognized within an entity's financial statements. If the threshold is met, an entity must then apply the second step, which is a measurement process to determine the amount of the uncertain tax position to be reported in company financial statements.

Recognition of uncertain tax positions. A tax position is a position taken by an entity in a prior or future tax return that is used when determining current income taxes, deferred income tax assets, or deferred income tax liabilities for annual and interim accounting periods. A tax position may cause a reduction in taxes payable, a transfer of current taxes payable to future years, or a change in how deferred tax assets are realized. Examples of tax positions noted in FIN 48 include classifying a transaction, entity, or other position as tax exempt; allocating or shifting income between jurisdictions; excluding taxable income from the tax return; and not filing a required tax return.

An entity should initially recognize the impact of an uncertain tax position in the financial statements if it is "more likely than not" (a likelihood of more than 50%) that a tax position taken by an entity will be sustained if examined using the technical merits of the position taken. The FIN 48 recognition threshold is based on the following assumptions: 1) The position taken by the entity will be examined by the appropriate taxing authority with full knowledge of all relevant facts; 2) the tax position will be evaluated without considering the impact of other tax positions; and 3) all authorities of tax law sources are used when considering the technical merits of the position, including widely understood past practices and precedents of the taxing authority related to the entity or similar entities.

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Measurement of uncertain tax positions. If a tax position meets the recognition threshold, the second component of FIN 48 requires the position be measured for reporting in the financial statements. Recognition should consider all of the facts and circumstances associated with the uncertainty, under the assumption that the taxing authority will have this full knowledge. FIN 48 requires measurement of a tax position at the largest amount of tax benefit that is more likely than not (greater than 50%). The measurement process should consider the amounts and outcome probabilities that could be realized upon final settlement, plus all information available to the entity. Determining the amount of an expected outcome is not always clear-cut and might require a detailed consideration of various potential measurement outcomes.

FIN 48 and FASB Staff Position FIN 48-1 include additional requirements for other accounting issues related to uncertain tax positions, as well as guidance on the communication and disclosure of uncertain tax positions. FIN 48 contains specific guidance in adopting the new accounting standards on uncertain tax positions and for application of other accounting and reporting issues; FASB Staff Position FIN 48-1 should be consulted for issues related to the definition of settlements.

Accounting Implications

While numerous tax issues could trigger the application of FIN 48, such as tax-sheltered investments, other less obvious situations may also create uncertainty in tax positions. Issues that are perhaps not so apparent include nexus in multistate operations, unrelated business income tax (UBIT) for not-for-profit organizations, and the built-in gains tax for subchapter S corporations. All three issues have recognition implications under FIN 48.

Recognition implications. First, nexus, as it applies in multistate operations, may have FIN 48 implications. Nexus refers to the relationship between a state and a corporation that must exist for a state to impose a tax on the income of a corporation. Typically, the presence of payroll, sales, and property in a state is sufficient to establish nexus. Because regulatory requirements vary between states, companies that operate in a multistate environment routinely perform a nexus study when they commence operations in a new state.

For example, assume ABC Company performs a nexus study in the initial year it installs a sales agent in state Y and determines that sufficient nexus for state income tax purposes does not exist. Several years later, ABC Company decides to rent office space and to acquire personal property in state Y. A new nexus study might reveal that ABC Company should now be subject to income tax in state Y. Companies preparing GAAP–based financial statements will need to continually evaluate nexus issues to be in compliance with FIN 48. Continuous evaluation of nexus issues may be particularly relevant in instances where a company's initial nexus study determined that nexus does not exist.

A second tax issue with FIN 48 implications is UBIT for not-for-profit organizations. In general, unrelated business income is income derived from activities not related to the exempt purpose of a tax-exempt organization. Taxing the unrelated business income is intended to neutralize an exempt entity's tax advantage.

At least two UBIT situations can result in FIN 48 implications for a not-for-profit organization: 1) unrelated debt-financed income net of related expenses (e.g., rental of property financed with debt), and 2) unrelated income derived from trade or business operations that are carried on *regularly*. As an example, assume a not-for-profit organization owns a parking lot that is used by employees during the week and rents out the parking lot to the general public one or two weekends a year. This situation generally is excluded from taxation because the business operation (e.g., the weekend parking to the general public) is not carried out on a regular basis. If the organization decides to improve its cash flow by renting out the parking lot to the general public every weekend, however, this regular operation would generate unrelated income. FIN 48 implications arise for a not-for-profit organization when the usage falls somewhere between the extremes illustrated above and the entity takes the position that the income is not UBIT.

Not-for-profit organizations that have or could have UBIT must evaluate their tax positions more carefully in light of FIN 48. The more aggressive an organization is in excluding potential UBIT, the more likely that UBIT might indicate an uncertain tax position.

The last example of tax issues with possible FIN 48 implications relates to built-in gains tax for subchapter S corporations. Subchapter S corporations that have positive earnings and profits at the time of the S election may be subject to a built-in gains tax (IRC section 1374). Thus, when a C corporation makes the S election and has positive earnings and profits, the corporation is required to appraise the value of all property on the date of the election. The built-in gain is measured as the excess of the appraised value over the corporation's tax basis on the date of the sale, and the built-in gain calculated at this point sets an upper limit on future taxable income.

To illustrate the potential effects of built-in gains tax for subchapter S corporations, assume that tax basis and fair value information are provided for two corporations, A and B. Corporation A has assets with a fair market value (FMV) of $2,600,000 and a tax basis of $2,300,000. A has a built-in gain of $300,000 (FMV of $2,600,000 – tax basis of $2,300,000). The FMV and tax basis of the assets of Corporation B are both $2,300,000. B does not have a built-in gain because there is no excess of FMV over tax basis (FMV of $2,300,000 = tax basis of $2,300,000).

The tax imposed for built-in gains is a corporate-level tax recognized when the S corporation disposes of an asset within 10 years after the S election takes effect. The tax is intended to mitigate a corporation's ability to avoid double taxation on C corporation income by making an S election.

Uncertainty can arise if an aggressive appraisal is made at the time of election to reduce the amount of built-in gains. In general, the lower the appraised value, the smaller the potential built-in gain, which results in less income exposed to the built-in gains tax. In such a situation, the corporation has, at least temporarily, avoided some double taxation. If the appraisal takes a very aggressive stand, however, the unrecognized built-in gains resulting from the appraisal might have FIN 48 implications. As a result, FIN 48 requires a careful assessment concerning the appropriate valuation of assets at the time of an S election, as well as possible disclosure of a tax uncertainty.

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Measurement implications. The following discussion reviews some of the measurement issues that may be involved for the three examples presented above. First, the nexus issue may result in FIN 48 measurement implications. For example, a corporation that determines that a nexus issue applies should measure the potential state income tax due for FIN 48 purposes. There are at least two complications: First, because a tax return has not been filed within a possible nexus state, the statute of limitations may be open for all affected years. It may also be difficult to determine when sufficient nexus occurred. Therefore, the first issue is to determine the date that nexus began; if this happened more than one year ago, then probabilities must be assigned to each year. Second, most tax authorities are open to some negotiation as part of a final settlement. A thorough review of case law and other relevant information will help in the determination of the expected outcomes. If there is an array of expected outcomes, each outcome must be assigned a probability.

When applying the FIN 48 measurement analysis to a not-for-profit organization with potential UBIT, an entity will need to perform a careful analysis of all suspect activities. The goal is to determine an amount that would represent a full settlement with the taxing authority, and the development of amounts and attendant probabilities will be largely guided by case law. After a determination is made that UBIT is more likely than not, then the applicable years, the calculation of the UBIT, the probabilities, and the negotiated settlement amounts are all applicable in determining a final measurement of the FIN 48 amounts to be recognized. The use of tax case law should be helpful in establishing probabilities and possible settlement amounts.

The last measurement issue discussed in the previous section relates to built-in gains for subchapter S corporations. Subchapter S corporations have a potential 10-year window within which the built-in gains tax can apply. Because sales of appreciated property could occur anytime within this window, a determination of any settlement amount should include all sales of appreciated property, an array of alternative valuations, and assigned probabilities. Clearly, the measurement analysis for FIN 48 purposes becomes more complicated as both the volume of transactions and the alternatives for valuation amounts increase. A careful review of case law and IRS and Treasury pronouncements should help set the required probabilities. The valuation of historical assets may be difficult, entailing the use of extensive "estimates after the fact."

Audit Practice Implications

FIN 48 requires auditors to consider issues with regard to identifying and evaluating possible tax uncertainties, audit documentation, and materiality that follow generally accepted auditing standards (GAAS), while providing quality service to companies with possible FIN 48 issues. Each of these three considerations is discussed in greater detail below.

FIN 48 results in several important audit documentation issues. Auditors must be able to identify the major tax issues faced by their clients with possible FIN 48 implications. Although the identification process is inherent in any good tax accounting practice, communication channels between tax and audit experts must be a formal part of the financial statement audit. In some firms, audit and tax experts do not communicate effectively enough with one another about issues with both tax and audit implications. Good communication is an instrumental first step toward successful consideration of FIN 48 issues.

Auditors can implement various procedures to identify possible FIN 48 issues. A thorough examination of prior years' tax returns is essential for identifying potential FIN 48 issues. Two complementary approaches should be considered: a line-by-line approach and a major tax issue approach. The line-by-line approach involves a systematic review of each individual line item on a tax return. The advantage is that the reviewer is able to identify line items with amounts reported on the return, as well as line items left blank. In other words, omissions should be as much of a concern as any uncertain amounts already reported on the return. The line-by-line approach, creates the opportunity for practitioners to discover both omitted and reported items. The second approach, a major tax issue approach, provides an expedient method for identifying key tax issues that may result in uncertain tax positions. Tax experts will be able to quickly identify the limited number of major tax issues that might require FIN 48 reporting. Accountants should also always review the Schedule M-1 (for corporations with less than $10 million in assets) or Schedule M-3 (for corporations with $10 million or more in assets) to identify particular tax issues that result in book-tax differences.

While previous years' tax returns are relevant for identifying historical tax-related issues, one should also be concerned about tax issues with FIN 48 implications that arise in the current year. These contemporaneous tax issues may be identified in at least two different ways. First, auditors should review the current year tax file to identify any correspondence with the client about current tax-related issues. This assumes that tax-related communications between auditor and client have been adequately documented. In addition, audit engagement personnel should also have discussions with the higher-level tax professionals directly involved with the client. These discussions should include inquiries about any communications regarding FIN 48 in general, as well as specific issues with FIN 48 implications.

Accountants must be able to evaluate the identified major tax issues that might have FIN 48 implications. For each engagement, adequate time must be allocated to the overall time budget so both tax and audit personnel are able to evaluate all uncertain tax positions that might result in FIN 48 reporting. In addition, upper-level audit and tax personnel should be actively involved. Finally, accountants should reevaluate which personnel are currently performing the SFAS 109 calculations during an audit engagement. While auditors of public companies are prohibited from creating SFAS 109 calculations, accounting firms with nonpublic clients may still be involved with SFAS 109 calculations. Audit firms involved in these calculations must determine the appropriate type (tax, audit) and level (staff, senior, manager) of personnel participating in SFAS 109 calculations, especially given the increased complexity of implementing FIN 48.

Furthermore, firms should consider making the procedures for identifying and evaluating FIN 48 issues standardized so that the processes are applied consistently by all personnel. In recent years, auditing

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standards have stressed the importance of documentation within the audit process. As a result, auditors need to consider the development of technology, such as electronic checklists, that provide a consistent approach for identifying FIN 48 issues. The use of checklists also promotes adequate audit documentation of uncertain tax positions in audit working papers. As part of the creation and use of standardized procedures specific to FIN 48, auditors should also allocate an appropriate level of resources toward education and training for both the identification and evaluation of FIN 48 issues. As with any audit technology, it is only as good as the individual using it.

Finally, many FIN 48 reporting issues will be mitigated by materiality for at least two reasons. First, actual FIN 48 issues identified will often be small and therefore not quantitatively material. That said, an auditor may determine that the mere existence of a FIN 48 concern is qualitatively material, requiring FIN 48 reporting. For example, an uncertain tax position that results from tax evasion rather than from tax avoidance may be considered qualitatively material, even if the dollar amount is small. Second, some FIN 48 issues result only in reclassification on the balance sheet. For example, a reclassification entry may be required between accounts within a classification (e.g., between current taxes payable and current deferred taxes) or between classifications (e.g., between current taxes payable and long-term deferred taxes) within the liability section of a balance sheet. Although some financial statement users, especially those interested in liquidity and debt ratios, may consider reclassifications within the balance sheet to be material, the materiality level for reclassification is generally higher than for adjustments to financial statements.

Conclusion

FIN 48 requires that companies recognize, measure, and report uncertain tax positions using a two-step analysis to recognize and measure the amount of a position.

Accountants and auditors should be concerned about some not-so-obvious tax issues that will have FIN 48 implications. These issues include nexus in multistate operations, UBIT for not-for-profit organizations, and the built-in-gains tax for subchapter S corporations. These three tax items create recognition and measurement issues for companies, and lead to documentation and procedural issues for auditors. ❑

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