FINANCIAL STATEMENTS AND INCOME TAX RETURNS MUST ADDRESS FIN 48, ...
Roman, Laura L;Thomas, Mary K;Taylor, Joe K;Miller, Joshua A
Petroleum Accounting and Financial Management Journal; Summer 2011; 30, 2; ProQuest
pg. 86

Financial Statements and Income Tax Returns must address FIN 48, Schedule UTP and International Business Disclosure Requirements

Laura L. Roman, CPA, CMAP
Mary K. Thomas, CPA, JD
Joe K. Taylor, CPA, JD
Joshua A. Miller, CPA
Weaver

Introduction

Amidst industry-specific accounting and reporting items, oil and gas companies must also comply with uncertain tax position (UTP) recognition and disclosure requirements in their financial statements and tax returns.

The Financial Accounting Standards Board (FASB) requires corporations disclose UTPs in financial statements. Starting with the 2010 tax year, the Internal Revenue Service (IRS) also requires that many corporate taxpayers identify such positions in their income tax returns.

Based on IRS provisions, many states require identifying UTPs in state income tax returns. International business practices present additional uncertain tax disclosure concerns.

Each oil and gas company must evaluate its specific circumstances and ensure that any UTPs are properly reported in financial statements and tax returns.

FIN 48/ASC 740-10

The FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes; an Interpretation of FASB Statement No. 109 (FIN 48) for public companies that's fiscal years began after Dec. 15, 2006. FIN 48 was designed to provide clearer direction for assessing and recognizing such positions, and a more uniform standard for evaluating tax-related information presented in financial statements.

The FASB's Accounting Standards Codification Topic 740-10 (ASC 740-10) encompasses FIN 48 requirements. It also applies FIN 48 requirements to nonpublic entities, including pass-through entities and tax-exempt not-for-profit entities.

المنارة للاستشارات

FIN 48 established a higher, but more uniform threshold that companies must meet for recognizing the benefits of a tax position on their financial statements. Meeting that threshold first requires assessing whether or not the tax position merits recognition, and then determining what portion of that claimed benefit should be recognized in the financial statements.

Tax provisions allow oil and gas companies to claim intangible drilling cost (IDC) deductions. Cost of depletion provides additional tax benefits. Research and development credits may apply to the designs and installations of new equipment, as well as improved production processes.

Through leases, royalty payments, partnerships and other contractual relationships, individual oil and gas companies share costs and profits with other entities, too.

Those and other scenarios contribute to tax positions that may or may not sustain a challenge by tax authorities. FIN 48 requires that the taxpayer determine whether or not any UTP would *likely* sustain an IRS challenge.

FIN 48 defines the following factors as evidence of such likelihood:

- Unambiguous tax law supporting that position

- An unqualified *should prevail* tax opinion provided by a qualified expert for which all conditions are objectively verifiable

- Similar positions in past tax returns that were obviously presented and either accepted, or not disallowed or challenged during an examination by taxing authorities

- Legal precedent for similar positions taken by other taxpayers that have been favorably resolved through litigation with taxing authorities.

Complying with UTP Rules

Compliance efforts for FIN 48/ASC 740-10 should focus on the following concerns:

- Identifying tax positions

- Determining the unit of account

المنارة للاستشارات

- Recognition
- Measurement
- Tax-planning strategies
- Changes in subsequent periods
- Interest and penalties
- Financial statement classification
- Disclosures.

A company needs to identify all tax positions taken in a tax return. It then needs to identify and maintain an inventory of all tax positions that present a significant degree of uncertainty, except for tax positions outside an applicable statute of limitations. Related documentation for each UTP should include the tax year and jurisdiction.

Each material tax position requires the proper unit of account, or level of desegregation. Proper documentation is needed for each selected unit of account and supporting rationale.

A company must then address recognition concerns, based on whether or not a position would likely be sustained upon examination. Issues to consider include the technical merits of the position, and whether recognition is based on the presumption that the appropriate taxing authority would have full knowledge of all relevant information.

Were relevant administrative practices identified and considered when making recognition? Was each tax position evaluated without consideration of the possibility of offset or aggregation with other positions?

Was any benefit recorded in the financial statements for a position that did not meet the recognition threshold? For any unrecognized position, a liability must be reported. Interest expense and any likely tax penalties must be calculated, too.

Such concerns must also be addressed when determining whether or not a UTP is recognized. Proper documentation must exist to support each recognized or unrecognized position. That documentation should also include calculation of interest and penalties.

Recognized tax positions require proper measurement. The benefit recognized for each position should be the largest amount of benefit greater than 50 percent of what is likely to be realized in a settlement with a taxing authority.

Probabilities of potential outcomes need to be identified and considered when making that measurement. Measurements need to reflect all available information at the reporting date, and the company must maintain sufficient documentation to support its conclusions for each tax position.

Any differences between tax positions taken in a tax return and amounts recognized in the financial statements may be reflected as a liability for income taxes payable or as a reduction of an income tax refund receivable. That difference may also be recognized as a reduction in a deferred tax asset or an increase in a deferred tax liability. All of those options may be applicable.

Tax-planning strategies may include future taxable income to support realizing a deferred tax asset. Such planning must involve the recognition and measurement tests of the UTP rules to determine the amount of future taxable income.

A tax position may have previously failed to meet the more-than-likely recognition threshold. A position previously met may not meet that threshold now. Changes in subsequent periods must be addressed so that the current financial reporting period accurately reflects proper recognition and treatment for any UTPs.

Interest and penalties associated with unrecognized tax benefits must be properly calculated and recognized. The methodology used to calculate such interest and penalties must be documented.

In its financial statements, a company must disclose – in footnotes – its policy for classification of interest and penalties. Various changes and reconciliations regarding unrecognized tax benefits must be disclosed. Those disclosures must include interest and penalties recognized. The company must also project any changes it foresees occurring within the following 12 months.

IRS Schedule UTP

The IRS first announced Schedule UTP in January 2010, with a stated goal of creating certainty sooner for taxpayers, reducing IRS examination time, and focusing on issue resolution, rather than document production. The final schedule was released in September 2010, for the 2010 tax year.

Schedule UTP applies to an entity or a related party that is:

- Required to file a Form 1120, U.S. Corporation Income Tax Return
- An insurance company required to file a Form 1120 L, U.S. Life Insurance Company Income Tax Return, or Form 1120 PC, U.S. Property and Casualty Insurance Company Income Tax Return
- A foreign corporation required to file Form 1120 F, U.S. Income Tax Return of a Foreign Corporation.

The IRS requires that a UTP must be disclosed in Schedule UTP if:

- The taxpayer has recorded a reserve in an audited financial statement at least 60 days prior to the filing of the tax return
- Has not recorded (at least 60 days prior to the filing of the tax return) a reserve due to plans to litigate
- Has not recorded a reserve (at least 60 days prior to the filing of the tax return) because the IRS has an administrative practice of not auditing such a position.

Schedule UTP requires that each recorded UTP description include:

- Code sections potentially implicated by the position
- The taxable year or years for that position
- A statement regarding whether the position involves an item of income, gain, loss, deduction, or credit against tax
- A statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both
- A statement whether the position involves a determination of the value of any property or right
- A statement whether the position involves a computation of basis.

In many respects, the IRS reporting requirements reflect FIN 48 provisions. An oil company, for example, may have incurred costs related to acquiring several potential businesses. One acquisition was completed during the year and the other acquisitions ultimately failed.

The company deducted the cost related to the failed acquisitions, and capitalized the cost related to the allocable to the completed acquisition. The company then established a reserve due to the possibility that the costs allocated to uncompleted acquisitions were excessive.

The oil company's concise description for Schedule UTP would need to summarize that activity, as well as comply with other schedule requirements.

For the 2010 tax year, Schedule UTP applies to entities that have at least $100 million in assets and at least one UTP. That assets reporting threshold changes to $50 million for the 2012 tax year, and to $10 million for the 2014 tax year and subsequent tax years.

The IRS initially wanted disclosure of the maximum tax adjustment for each UTP, but dropped that provision for the final schedule. The IRS also clarified its policy of restraint with respect to accrual work papers in Announcement 2010-76. Tax accrual work papers can be requested under audit; however, the taxpayer can redact information related to the amounts of any revisions, any working drafts, comments or revisions and the computation of the ranking of the position.

Corporations that meet that criteria and file forms 1120, 1120-L, or 1120 PC should look at Box D of the form Page 1, or the highest figure for the beginning or ending assets on Schedule L. Foreign corporations filing form 1120F should look to worldwide assets as if Schedule L were on a worldwide basis.

FIN 48 and State UTPs

State UTPs, are disclosed pursuant to FIN 48, following the same criteria as those identified for federal tax purposes. Identification of state UTPs, though, is a complex undertaking. There are 50 states and numerous local taxing authorities. Each authority has its own tax laws, systems and reporting methods. States also have different rates, tax types, apportionment methods and standards for determining the state tax base. Few states require a schedule UTP to be filed with their tax returns; however, state auditors will have access to the federal return and the audited financial statements

المنارة للاستشارات

when performing an audit. States also share information such that if UTPs are found by an auditor of one state, that information may be shared with audit divisions of other states.

State rulings on a particular issue are inconsistent, too. An expense fully deductible in one state may be disallowed in another, while a third state may modify or limit the deductible amount. Not all state rulings and court decisions are published. Some states have a number of unwritten rules that may trap an unwary taxpayer.

The statute of limitations for assessments and refunds vary among states as well. A state's tax assessment generally covers the current year and three prior years. Some states have longer statute periods, though, while others have shorter time spans. Many states adopt the Internal Revenue Code (IRC), but then modify or eliminate some code sections.

Understanding a state's position requires knowledge of the state's court decisions, rulings, administrative practices, tax policy and precedents.

Some potential issues can be readily identified. Most states do not allow state income taxes to be deducted, so these taxes are added back. Further, some "hot topics," such an intercompany charges and transfer pricing, will result in an audit and potentially a disallowance when detected.

Intercompany items receive attention in states that require members of a consolidated or combined group to file separate tax returns. Unitary groups create complex analytical situations to determine whether a combined filing is required and what constitutes a unitary group on a state by state basis. States scrutinize situations where one or two entities of a combined group having nexus with the state generate tax losses while the other members (without nexus and not required to file) have large taxable incomes.

A management fee will generally result in an audit because those fees have been sources of abuse in the past. At one time, management fees were a good planning tool to charge subsidiary companies for legal and professional, accounting, payroll processing, human resources and other services.

Management fees reduce taxable income of the subsidiary in separate reporting states. Abuses occurred when all of a subsidiary's profits were claimed as management fees.

المنارة للاستشارات

Management fees require proper documentation and confirmation that an intercompany contract identifies the services provided and the computation of the service charges.

Transfer prices also attract auditor scrutiny, due to abuse by multistate entities. Companies siphoned away income by charging a high price for inventory sold or transferred to an affiliated entity doing business in a state requiring separate income tax reporting. The greater the transfer price of the inventory, the lower the taxable income in the state.

Following the federal transfer price provisions, state auditors can review supporting documentation for an intercompany inventory price. The price must meet the arm's length standard, with the transfer price based on what an unrelated party would pay. Failure to prove the arm's length standard generally results in the state setting a new price.

Other readily identifiable intercompany transactions which may be potentially uncertain are royalty and interest. Documentation is crucial for all uncertain intercompany transactions.

Identifying UTPs requires reviewing corporate filings and registration documents, merger, acquisition and disposition work papers and documents, tax memoranda, the current and prior year tax returns along with the related work papers, prior federal and state audits and the Revenue Agent's Reports and state audit reports issued.

State tax attributes, such as credits and net operating losses, generally do not follow the federal rules regarding carryover and carry back. Many states only allow carry forward of NOLs to future years, and the carry forward period in some states is shorter than the federal time span. Similarly, state tax credits may be limited in their use under state reporting or may apply to only one reporting period.

The greatest concern when identifying state UTPs is nexus, which results when an entity's contacts with a state subject it to state tax jurisdiction and tax levies.

Each state has enacted statutes regarding nexus. The federal government enacted Public Law 86-272 in the late 1950s to protect entities from state income taxation, provided their only presences in states were sales people merely soliciting but not completing a sale of tangible personal property or goods.

Technological advances have altered the way entities conduct business. Those advances are altering the ways states determine nexus. New economic nexus standards are becoming popular with state governments because they allow states to tax income of an entity doing business via the internet. These standards contain threshold dollar amounts which, once surpassed, represent a substantial nexus.

That transformation to economic nexus creates complexity. An entity may not be subject to taxation in one state while being fully subject in another. Further complicating matters is the difference in thresholds set by different states for determining economic nexus. Additional confusion arises from the use of "substantial contact" or "substantial revenue" measures.

Two other nexus concerns are agency nexus and affiliate nexus. When an entity conducts business in a state through an independent agent, agency nexus may be created. Most states define agency nexus as instances when business is conducted through company employees, "agents or other representatives." This position may be refuted depending on the agent's activities and company contract.

Affiliate nexus may occur when the company has an affiliate that creates nexus with the state. Companies in a consolidated or combined group may be required to file and pay tax to a state even if only one affiliated company has nexus in that state.

Business versus non-business income also creates an issue among states. The controversy arises from the reading of the commerce clause of the U.S. Constitution. The clause contains two separate tests; one is a transactional test and the other a functional test.

The transactional test focuses on whether or not income is earned in the normal conduct of its trade or business. The functional test also encompasses income from tangible and intangible property, including any interest in, control over, or use in the property held directly, beneficially, by contract, or otherwise, that materially contributes to the production of business income, if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Some states apply both tests, while others may select just one test. Some states define non-business income by business type, such a rents, royalties, and interest, ignoring the transactional and functional tests altogether.

المنارة للاستشارات

All of that creates situations in which some states consider items to be allocable to a particular state, while other states define those items as business income and subject the amount to apportionment.

The facts and circumstances related to business activities and operations must be collected prior to initiation of procedure to identify potential UTPs. This process may yield different opinions and results. A CFO may have a different perspective regarding company activities than a Director of Sales or Operations Director. Therefore, conversations with different employees are necessary to obtain all the relevant facts and circumstances for the analysis.

Measurement

Once the UTPs are identified, the amount of the uncertainty must be measured. The UTPs identified for each company must be completed on a separate company basis to prevent intercompany transactions from being eliminated. The analysis must be performed on a year by year basis and in addition, must be conducted for each tax jurisdiction.

The quantification of the UTPs is the income tax exposure. Penalties and interest must be added to determine total exposure. Penalty and interest costs vary among states. Once calculated, the total exposure is compared to the materiality levels to determine disclosure responsibility.

After taking the state's modifications of federal taxable income into account, state taxable income is determined by analyzing the federal UTPs under state law. The state may adopt the federal code section under review, modify or not adopt that code section at all. The effects are taken into consideration to further modify the federal taxable income.

This state tax base is then subject to the state's apportionment rules including throwback and sourcing rules. These rules are applied on a state by state basis. Apportioned income is then subjected to the state's tax rate to derive the tax due. Penalties and interest are applied to yield total exposure. This process is repeated for each state to determine total exposure for the open years. Non-filing positions in excess of the statute of limitations, though, are subject to tax by a state for all years the taxpayer has created nexus and not filed returns and/or paid taxes.

Once state UTPs are identified and measured, they must be reviewed each year for changes in rulings, court decisions, laws and tax policy. Such changes may require that a UTP be removed from the list, while other

المنارة للاستشارات

positions are added. This is an ongoing process because state tax policy and systems evolve in response to the ever changing economic environment.

International Business Concerns require Attention

Oil and gas companies, as well as companies in other industries, with businesses that include international operations face particular challenges in complying with the various reporting provisions, including FIN 48/ASC 740-10, and Schedule UTP.

An oil company's right to drill in a foreign country may be governed by foreign concession or subject to a production sharing agreement. The production sharing agreement calls for a share of the oil produced to be sold on behalf of the foreign government which the proceeds remitted to the foreign government. The "share oil" is eligible for a foreign tax credit. The agreement, though, may be between two different divisions of the government, such as the ministry of oil and the ministry of finance or taxation.

Such agreements and contractual relationships could present possible UTPs. Companies need to give adequate consideration to whether the contract provides for an actual creditable tax under the regulations. In addition, consideration should be given to the documentation received from the appropriate government entity. Often times this documentation does not meet the standards outlined in the regulations. Other considerations with respect to foreign tax creditability include whether a tax is creditable tax for U.S. foreign tax credit purposes. In order to be creditable a foreign tax must be a tax on income and it must be paid or accrued. If a production sharing agreement provides for a royalty, it may not be a tax on net income. If any concerns exist regarding the creditability of the tax, the company should consider recording a UTP.

Another issue that is receiving more and more scrutiny is transfer pricing. Transfer pricing includes not only scenarios where a product is sold to an affiliate but also includes cost sharing arrangements and cross charging of general and administrative costs.

Transfer pricing considerations include:

- Whether adequate contemporaneous documentation exists

- Whether a transfer pricing study is current

- Significant changes in the organization that shifts risk from one country to another

- Compliance with new Internal Revenue Code (IRC) Section 482 regulations concerning services and intangible property.

The instructions to Schedule UTP require a special designation for any transfer pricing issues (including cost sharing issues). These items are designated with a T on the Schedule. Given the IRS has transparency on any UTP related to transfer pricing on Schedule UTP, such disclosure will most likely trigger additional IRS scrutiny.

In the international context, it is important to remember Schedule UTP only requires disclosures of tax positions which impact U.S. liability. Any UTP related to a foreign jurisdiction does not need to be disclosed unless it impacts the company's U.S. tax liability. Often a change in the foreign tax liability can potentially impact the company's U.S. foreign tax credit.

Positions taken with respect to the calculation of earnings and profits of a controlled foreign corporation (CFC) that do not impact the company's U.S. tax liability should not be disclosed.

There are numerous considerations that influence how relationships with foreign subsidiaries are treated for U.S. tax purposes. Regular presence of a foreign company's personnel or other activities that indicate that a foreign company is established in the United States could establish U.S. nexus.

Several other potential UTPs exist with respect to international issues. Form 8832 must be filed if an eligible entity wishes to be taxed differently than its default classification as a partnership, corporation or disregarded entity. Certain direct, indirect, and constructive owners of a CFC must file Form 5471 each year. Compliance with the IRC is also required for a CFC. Trade or business expenses must be properly addressed according to IRC provisions.

In order to accurately complete Schedule UTP consider the following:

- When ranking UTPs related to transfer pricing in column f (ranking of tax position) use letter T. For all other positions, use letter G.

- The IRS does not require disclosure of foreign transfer pricing UTP if the only U.S. UTP relates to "competent authority adjustments."

- A UTP related to cost-sharing agreements should be classified as a transfer pricing item.

Compliance requires Diligence

Oil and gas companies face complex financial statement and income tax reporting unique to their industry. They must also address reporting and disclosure complexities that confront so many other businesses and industries.

Remaining in compliance requires diligence. If necessary, consult tax professionals with expertise in addressing industry-specific tax concerns at the federal, state and international levels.