

### **“A snake lurking in the grass”**

The newly issued Accounting Standards Update 2009-06 allows no more deferrals for private companies to apply FIN 48.

“For the vast majority of entities, it will apply to calendar year 2009 financial statements,” explained Randy Robason, national partner-in-charge of Grant Thornton’s tax accounting and risk advisory services. “Every entity that issues GAAP financial statements will have to consider the rules under FIN 48.”

FIN 48, Accounting for Uncertainty in Income Taxes, became effective for public companies for fiscal years beginning after Dec. 15, 2006. Under the rule, an uncertain tax position may not be recognized unless it is “more likely than not” that it will be sustained if it were challenged and considered by the highest court in the particular jurisdiction.

“FAS 109 (now included, along with FIN 48, in ASC740) was an attempt to put some structure around accounting for income taxes, but we found out as a result of Sarbanes-Oxley that it led people to create a last collie jar for accounting because there was so much discretion as to what people could book and there wasn’t any consistency,” said Robason. “Accounting for income taxes became the leading cause of material weakness, significant deficiencies and financial restatements for four years running. FASB looked at the situation and said we need to put more structure around accounting for income tax, and they created FIN 48.”

“The Securities and Exchange Commission was initially behind FIN 48,” explained Jay Hanson, national director of accounting for McGladrey & Pullen. “They did not like cookie jar reserves, where a company would put something on the books

when times were good, and take a bit out to improve earnings when things weren't so good.”

“For example, a company tells its shareholders it anticipates 25 cents per share earnings, but realizes it will be short this quarter and takes it out of its reserve for taxes,” he explained. “There were never any rules on how to calculate the reserve. The whole idea was to establish standard so everyone calculated for possible income tax examination in the same way.”

FIN 48 requires the company to take an inventory of its tax positions and decide which are likely to be sustained and which are not, said Hanson. “On any individual tax position, the concepts are not difficult to apply, but when you layer different positions together, and statutes of limitation expire at different times, it becomes very complex.”

### **SOME RELIEF**

ASU 2009-06 exempt private companies from some of the burdensome disclosure requirements of FIN 48, noted Bob Durak, a technical advisor at the American Institute of CPAs. “It exempts them from the tabular reconciliation of the total amounts of recognized tax benefits at the beginning and end of a period. FIN 48 requires the disclosure of the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. ASU 2009-06 exempts private companies from that requirement as well.”

Another key element of the ASU is that it provides implementation guides for pass-through entities, according to Durak. “This is important because the Private Company Financial Reporting Committee and other private company constituents asked for this,” he said. “Some pass-through entities may pay taxes for their owners. Basically

this provides guidance on what to do when an entity pays income taxes that are attributable to the owner.”

“The ASU also clarifies that fact that tax status itself is a tax position subject to FIN 48,” Durak said. “If I am an S corporation, that is a position subject to FIN 48 because there might be some uncertainty in that,” he said.

“Let’s assume the corporation used to be a C corporation that converted to an S corporation,” explained Robason. “Most tax people would say that’s simple, you just have to see if there was built-in gain at the time of conversion, and if so the S corporation has a liability to pay it, and you’re done.”

But not so fast, he cautioned: “How did you know you were an S corporation? Where is the application for the S corporation and was it approved? How many shareholders did you have and did you ever go over the maximum? Did you ever transfer stock to a disqualified shareholder?”

“Then you look at distributions,” he said. “Were any of them other than pro rata, and if so did you have a second class of stock? You have to decide and document whether you really were an S corporation and then you can look at the built-in gain issue. But you’re not done yet, because once you finish with the federal rules, you have to consider the states. If the entity operates in 30 states and five foreign jurisdictions, is there any chance you should have filed and didn’t? Or if you didn’t file, was the strategy a good one that if challenged by the state would hold up?”

### **BRACING FOR IFRS**

Robason said that this was particularly important in an economic downturn with many local governments trying to raise revenue. “There are now over 3,700 taxing jurisdictions

in the U.S., and you have to consider how they look at the type of entity. And FIN 48 applies to partnerships, not-for-profits, REITs and hedge funds as well.”

If this wasn’t confusing enough, there are more rules to come under International Financial Reporting Standards, he warned.

“Most of us believe that the question regarding IFRS is ‘when,’ not ‘if,” he said. “Rather than a two-step it has a one-step approach the probability from zero to 100 that you will be entitled to the exemption you took. It simply moves directly to a measurement, so the answers will be different.”

Private companies should immediately consult their tax advisors and outside auditors to coordinate the FIN 48 analysis, Durak advised. “This may involve setting up and maintaining an inventory of tax benefits, both recognized and not recognized,” he said. “An important step will be to identify the company’s outstanding tax positions for all open tax years. Company accountants should confirm the policies and procedures relating to positions on the return. You want to have adequate documentation supporting your tax positions so that you can justify any positions that you take on the return that might be different from what you took on the financial statements.”

“Most private companies are focused on making money, so FIN 48 will not be in their core skill set,” said Robason. “It’s a snake lurking in the grass. The best thing to do is to not let the snake bite us but to deal with any issues now, while there’s still time to implement the solution.”