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FIN 48

Recognition

New York
May 3, 2010

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1 FIN 48: Recognition

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2 Agenda

- Planning
- Steps to Recognition
- Unit of Account
- Types of Positions
- Widely Understood Administrative Practices
- Levels of Evidence
- Best Practices

3 First Steps to Any Audit

- **#1**: **Know your client's business**
- Determine materiality of potential exposures
  - If the result will be zero in the measurement step, then the result is zero from the start

4 Internal Control & Audit Planning

- The next step in audit of tax provision must be an evaluation of internal controls
  - Do the procedures identify tax exposures
    - Are operations (sales, etc.) people exposing the company to tax without someone knowing?
  - Where exposures are identified, are they communicated
  - Are tax provisions being recorded in accordance with facts, SFAS 109, FIN 48?
- Where internal controls are deficient
  - Increase audit procedures (scope)
  - Propose changes (consulting opportunity)

5 The First Step: Recognition

- "Under an approach that separates recognition from measurement, a tax position is first evaluated for recognition based on its technical merits. Tax positions that meet a recognition criterion are then measured to determine an amount to recognize in the financial statements. The measurement would incorporate information about potential settlements with taxing authorities.."
  - » FIN 48 para. B27

6 Recognition Step Steps

The order of these may vary:

- Determine what “positions” exist (inventory of positions)
- Identify “unit of account” for analysis
- For each position, determine MLTN standard at unit of account level
- If not MLTN, do not recognize any “benefit”
- If MLTN, go to measurement step

7 Role of Judgment

» FIN 48 para. 5,

- Determining what the unit of account is
- Assessing likelihood of position
- Measuring probability of outcomes
- Determining when to derecognize

8 Presumption of Examination

- “the enterprise should presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information” FIN 48 Summary; ASC 740-10-25-7a
- “The Board noted that consideration of examination risk is not consistent with the characteristics of an asset or a liability” in Statement of Concepts 6. FIN 48 para. B21.

9 Unit of Account

» FIN 48 para. B13-14; ASC 740-10-25-13

- “a single defined unit of account would not be applicable to all situations”
- Two factors must be considered:
  - The manner in which enterprise “prepares and supports” its income tax returns, and
  - The approach the taxing authority is expected to take
- “Both factors would be expected to vary with the facts and circumstances of a tax position and of the enterprise taking that position.”

10 Unit of Account, cont.

- Some are obvious:
  - project by project for mid-size R&D credit
  - All pension expense (where there’s one plan)
- Some require judgment to separate
  - Accrued bonus vs. accrued vacation
  - 1245 vs. 1250 recapture
- Some don’t even show
  - Nexus issues where no return filed
  - Validity of entity elections

11 Unit of Account Is NOT Static

- For year 1, “management considers both the level at which it accumulates [R&D credit] information to support the tax return and the level at which it anticipates addressing the issue with taxing authorities” and management decides project by project is appropriate
  » FIN 48 para A6; ASC 740-10-55-88
- But for year 2, “Management anticipates the taxing authority will focus the examination on functional expenditures” for R&D credit
  » FIN 48 para A8; ASC 740-10-55-89

12 Highly Certain Tax Positions

- This is a MEASUREMENT item
  - » FIN 48 para A19-20.
- Minimal analysis required
- Examples:
  - Deductibility of salaries actually paid (ASC 740-10-55-100)
  - C corporation status as taxable
  - Amount of MACRS depreciation
- Documentation that it was actually looked at still needed
  - Printout of highly certain accounts with notations by each

13 Materiality

- YOU must know what the audit materiality thresholds are: for PAJE, for adjustment
- Materiality for analysis or aggregation is likely lower, maybe much lower
- Still, a LOT of things are not material enough to do more than list
- ASC 105-10-05-6: "The provisions of this codification need not be applied to immaterial items."

14 When to First Recognize

» ASC 740-10-25-8

- Must provide tax in first reporting period in which an item is currently taxable or deductible or in which a temporary difference exists with respect to items recognized in financial statements

15 Intentional vs. Unintentional Positions

- Intentional positions are easy to spot & analyze
  - Transactions undertaken to save taxes
  - Aggressive positions on returns
- Unintentional positions are hard to spot
  - Mistakes of fact or law
  - Missed facts
  - Failures of controls
- Audit program must include steps to detect unintentional positions, which can be huge

16 Enacted vs. Prospective Law

- SFAS 109 requires that provision be based on tax law AS IT IS PRESENTLY ENACTED. ASC 740-10-30-2
- Expected but not enacted laws don't exist for provision
- Clients may argue that "everyone knows" a law change will happen, and that this is widely understood administrative practice. Such statement is false for tax provision.

17 Widely Understood Administrative Practices

- "When the past administrative practices and precedents of the taxing authority in its dealings with the enterprise or similar enterprises are ***widely understood***, those practices and precedents shall be taken into account." FIN 48 para. 7.b.; ASC 740-10-25-7b
- "management believes the administrative practice is widely understood" FIN 48 para A13. (an example)
- "in those limited circumstances in which taxing authorities permit what might be deemed technical violations of the tax law" FIN 48 para. B37.
- See examples at ASC 740-10-55-90 thru 95

18 What Is Widely Understood?

- Similar to concensus
- "The agent never looks at this" is NOT an administrative practice
- Limits on statute of limitation MAY be administrative practices, and MAY be widely understood
  - But you better be able to demonstrate it!
  - THE STATUTE NEVER CLOSES ANYWHERE FOR MATERIAL FRAUD!

19 When Are Tax Opinions Needed?

- "…management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law." Fin 48, para. 34
- "the Board does not believe that a legal tax opinion must be obtained" but "can be external evidence supporting a management assertion … Other evidence … could be obtained; the level of evidence that is necessary and appropriate is a matter of judgment" FIN 48 para. B

20 Competence: Standards of Field Work

- If YOU don't have the expertise to evaluate a particular part of an audit, you must engage someone who does
- Examples
  - Pensions
  - Valuations
  - Foreign matters
  - Tax issues beyond your firm's knowledge & experience

21 Dealing with Foreign Issues

- Do you really know whether your client is exposed to tax in Venezuela?
  - Corporate tax may apply to a flow-through entity, so this matters for an S Corporation
- Can you determine what the tax effects in Germany are going to be?
  - Many countries treat LLCs as corporations
  - Foreign checked entity taxes can be material
- Where do you even start???

22 Some Key Positions & Actions

- Nexus & subjectivity
  - Review client facts to determine nexus exposures
    - Personnel location
    - Property locations, even for minor items
    - What salesmen have with them
  - Talk to sales managers
- Transfer pricing
  - How much documentation is needed?
  - Who must do it? Do you need TP specialists in all cases?
- Corporate transactions
  - SOMEONE needs to do a memo on the tax effects. Need not be an opinion, just documentation as to why client takes position the tax is as represented
- Entity Status
  - Must get and retain copy of all entity election forms (2553, 8832, 4876-A, 8023,8869, 8893)
- Partner tax imposed on entity may be the entity's tax (ASC 740-10-55-227)

23 Who's Responsible

- EVERYONE involved in the financial statements

24 Hard Lessons From the Field

- Improper application of SFAS 109
- Lack of trained personnel on SFAS 109 matters
- Inadequate controls on calculations and reconciliations
- Inadequate policies and procedures to review complex or non-routine transactions
- Inadequate documentation to support recorded amounts
  - Foreign subsidiaries