

# FIN 48: Best practices for private companies

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# Introduction

## Lessons learned

Public companies have been dealing with the recognition and measurement steps relating to uncertain positions since 2007, so private companies can learn a lot from their public company counterparts.

Privately held companies got a two-year respite from FIN 48, but the time has come to buckle down and implement it for their 2009 year-end (technically, their first year beginning after Dec. 15, 2008). FIN 48 was originally intended to apply to all companies, public and private, for years beginning after Dec. 15, 2006. The FASB twice chose to delay the application of FIN 48 to private companies, mainly because of the confusion surrounding its application to flow-through and not-for-profit entities. That guidance was issued early in 2009 in proposed form (FSP FIN 48-d) then in final form in September 2009 through Accounting Standards Update No. 2009-06.

Additionally, the FASB completed its codification project (Accounting Standards Codification or ASC), effective for periods ending after Sept. 15, 2009. Thus, all further references in this article to FIN 48 will be to the recognition and measurement approach to uncertain tax positions, or to the specific section within FASB ASC Topic 740 (Income Taxes).

Public companies have been dealing with the recognition and measurement steps relating to uncertain positions since 2007, so private companies can learn a lot from their public company counterparts.

Private companies have unique characteristics that may present challenges when adopting the recognition and measurement approach to uncertain positions. First, private companies are often smaller than public companies; thus, they often lack internal tax personnel. Second, they are not subject to Sarbanes-Oxley, so they may have less developed internal tax controls. Third, due their smaller size, many private companies have little or no audit history with taxing authorities from which to draw. Finally, some private companies can just as sophisticated as their public counterparts when it comes to implementing aggressive tax strategies.

Private companies have to contend with fewer independence rules with their outside auditors and thus it is far more common for the financial statement auditors also to provide tax compliance and planning services. Private companies and their outside auditors should brace themselves for potentially awkward discussions if significant tax issues are uncovered during the process of documenting tax positions, especially if the same audit firm prepared the prior year tax returns.

Many companies seem to have the wrong mindset about the implementation process. They view this process as a waste of time and energy. In our experience, this mindset typically emanates from financial executives that have allowed themselves to become detached from the tax process and from tax personnel that willingly accept that lack of oversight. A more enlightened approach is to view this as an opportunity to take a fresh look at all of a company's significant tax positions. This fresh look will give financial executives a clear picture of the company's tax exposures along with opportunities to monitor and reduce the identified exposures going forward.

Four of the important lessons that can be learned from the experiences of public companies are to:

- 1 start the process early,
- 2 be prepared for state and local income tax surprises,
- 3 educate key internal personnel about the process, and
- 4 carefully coordinate the tax issues relating to international affiliates.

International affiliates tend to operate with a high degree of autonomy, so the coordination process can be challenging and time consuming. Plus, many of the international issues can have an effect on the related U.S. tax positions (e.g., transfer pricing, allocation of management fees, subpart F income, foreign tax credits, etc.).

For private companies that are considering a sale or disposition, implementation of these new rules will prepare them for any tax due diligence that will be undertaken by a potential buyer. If a company's uncertain tax positions are well documented and properly reserved under these rules, it is less likely that a buyer will find objectionable tax positions during their due diligence process that become "deal breakers" or that require a purchase price adjustment.

# Process of cataloging tax positions

Before the implementation process begins, it is critical that an appropriate workplan be developed. This workplan should establish the scope and materiality levels that will be applied. Setting the proper materiality level is critical. If the materiality level is set too high, then the company could miss identifying uncertain tax positions that are material, in the aggregate, to the financial statements. If the materiality level is set too low, the company will waste time “chasing nickels.” The company should set a reasonable materiality level and have their auditing firm confirm that the chosen materiality level is appropriate. Note that auditing firms tend to apply higher materiality levels to private companies than they do to public companies of similar size.

A key focus in adopting the recognition and measurement approach should be on the process used to identify uncertain tax positions. Your outside auditors will want to be sure that the process undertaken was thorough enough to ensure that all potentially material uncertain tax positions were identified. As a best practice, this process should include the following:

- A line-by-line review of tax returns in all significant jurisdictions for all tax years in which the statute of limitations remains open – this review should include a review of each income and expense item, significant book/tax differences (M-1s/M-3s), elections, statements, attachments, etc.
- A review of detailed trial balances for all significant legal entities for all open tax years
- A review of the cumulative inventory of book/tax differences (e.g., deferred tax roll forward schedule)
- A review of accounting policies
- A review of prior year financial statements for all open tax years
- A review of all significant acquisitions and dispositions in open tax years (tax due diligence and purchase accounting workpapers)
- Discussions with human resources, legal, treasury, accounting and operating personnel
- A review of the results of any prior income tax audits
- A review of the organization chart and related transfer pricing studies documenting cross-border and cross-legal transactions
- A review of tax opinions and work performed by third-party consultants

As these documents are reviewed, each tax position identified should be catalogued (typically, on an Excel® spreadsheet) and put into one of three categories – highly certain, uncertain or borderline immaterial. Highly certain positions are those with virtually no tax risk. They generally need little documentation other than a brief description as to how the tax law clearly applies to the particular facts. Uncertain positions are those other than highly certain positions and require more thorough analysis. Borderline immaterial positions are those positions that are not currently material, but should be monitored going forward as they may become material in a later period.

During this process, it is critical to avoid labeling positions as “highly certain” if they are not. A company should thoughtfully consider potential limitations, exclusions or special rules that may apply to the tax position. For example, interest expense may seem to be a “highly certain” position, but upon further examination, there are a variety of tax rules that could have potential impact:

- a Interest relating to an acquisition or construction of a fixed asset that should be capitalized under Internal Revenue Code (IRC) Section 263A
- b Interest on high yield discount obligations that should be deferred or is non-deductible under IRC Section 163(i)
- c Interest to foreign related parties that should be limited under IRC Section 163(j)
- d Interest relating to certain stock or asset acquisitions that should be disallowed under IRC Section 279
- e Accrued interest to related parties that should be deferred under IRC Section 267
- f Interest relating to a corporate equity reduction transaction under IRC Section 172(b)(1)(E), which may limit the ability to carryback a portion of the net operating loss (NOL) it created
- g Certain equity-related interest that may be disallowed under IRC Section 163(l)
- h Interest on certain foreign hybrid instruments that may be disallowed in the local country
- i Interest that may be subject to disallowance under “thin capitalization” or similar rules that may apply in a foreign jurisdiction

Careful consideration should be given to acquisitions and dispositions. Care must be taken to coordinate any adjustments with the requirement of FASB ASC Topic 805 (Business Combinations), which includes the implementation of former FAS 141R for years beginning after Dec. 15, 2008. While the new business combination rules of Topic 805 generally are not retroactive in effect, privately held companies may need to re-evaluate their pre-acquisition income tax contingencies as part of their overall implementation of the recognition and measurement approach to uncertain tax positions. Failure to properly identify and record these exposures may lead to future income statement charges if those exposures come to light.

# Recognition and measurement

## More-likely-than-not threshold

Most of the effort in documenting uncertain positions should be focused on those positions that are close to the MLTN threshold (e.g., positions in the range of 40-70 percent chance of success).

The two steps in the analysis of any tax position are recognition and measurement. In the recognition step, each material tax position is evaluated to determine whether it is more-likely-than-not (MLTN) that the position will be sustained upon examination by the taxing authorities. Only tax positions that are MLTN sustainable can be recognized in the financial statements. A tax position not meeting the MLTN criterion is not recognized and requires a 100 percent reserve. A key requirement in assessing tax positions is that a company must assume that it will be audited and that the taxing authority will have full knowledge of all relevant facts (see Topic 740-10-25-7). Thus, even if a private company has never undergone a tax audit, it must analyze its tax positions as if it will be. In real life, even if a company is audited, the agent may not discover the position. If the agent discovers the position, the agent rarely uncovers all of the relevant facts. Thus, this approach will often result in a worse conclusion than might be achieved in an actual audit.

As a practical matter, most of the effort in documenting uncertain positions should be focused on those positions that are close to the MLTN threshold (e.g., positions in the range of 40-70 percent chance of success). If a position has only a 20-35 percent chance of success, regardless of where the position ends up in that range, it will be below the MLTN threshold and thus a 100 percent reserve will be required. On the other end of the spectrum, positions with a certainty of greater than 70 percent may require less documentation as those positions will clearly meet the MLTN criterion. Based on public company experience with these rules, the “cliff effect” that occurs with borderline positions can create illogical results. For example, there is only a 2 percent increase in comfort level between a tax position considered to have a 49 percent chance of success and another with a 51 percent chance of success. Under these rules, the 49 percent position requires a 100 percent tax reserve while the 51 percent position may require no reserve at all. In my opinion, applying such disparate results to an inherently subjective assessment is a serious flaw in the recognition and measurement approach. However, that is the approach that must be taken.

In evaluating whether a position meets the MLTN criterion, care must be taken in relying on previous tax opinion letters or work performed by an external consultant. To begin with, the advice must be rendered at the appropriate unit of account level, which is a new concept under Topic 740-10-25-13. A tax opinion letter may need to be updated to reflect recent technical developments and reviewed to ensure that it did not place undue reliance on facts or assumptions that turned out to be incorrect. Also, if an opinion letter relies on a valuation, the propriety of that valuation must be considered.

Certain tax projects performed by outside consultants may not include a tax opinion at the MLTN level. For example, third-party prepared transfer pricing, research and development credit, and cost segregation studies rarely provide MLTN conclusions. Thus, a company will likely need to prepare further technical analysis to determine if the MLTN recognition criterion is met.

The current tax return preparer standards under IRC Section 6694 subjects a preparer to penalty if an undisclosed tax position does not have “substantial authority,” considered a greater than 40 percent chance of success. Thus, the fact that a tax preparer is comfortable with a tax return position does not necessarily mean that the position will meet the MLTN recognition threshold. Companies may be surprised by the number of tax positions that fall into this 40–50 percent range (i.e., higher than substantial authority but lower than MLTN). Put another way, a company can still have uncertain tax positions even if they have hired a third party to prepare their tax returns.

Once it has been determined that an uncertain position meets the recognition criterion, it must be further evaluated to determine the amount of the benefit that can be recorded (referred to as the measurement step). Under Topic 740-10-30-7, this is the largest amount of tax benefit that is greater than 50 percent likely to be realized upon settlement with the taxing authority. This measurement step is very subjective. Positions relating to taxable vs. non-taxable income, tax-free vs. taxable reorganizations, capital vs. ordinary income treatment, state income tax nexus and state business vs. non-business income tend to be “all or nothing” positions. As a result, all or nothing positions meeting the recognition threshold will typically require no reserve (i.e., there are only two potential outcomes — win the entire position or lose the entire position and it is MLTN that the company will win the entire position). For the vast majority of tax positions, the range of potential outcomes could be quite broad. The quality of the overall books and records and specific documentation supporting a tax position can have a significant impact on its outcome and thus must be considered in the measurement process.

## Monitoring positions going forward

Once an amount has been reserved for an unrecognized tax benefit (UTB), it should not be changed unless new information comes to light in a subsequent reporting period. Unlike public companies, which must review their UTBs every quarter, most private companies will reassess their UTBs once a year (for their annual report). A change in tax law, regulations or case law is considered new information and thus will have to be monitored to determine its impact on the amount of any UTB.

The requirement to monitor changes in tax law and their impact on existing (and new) tax positions will be especially difficult for small- to medium-sized private companies, which tend to have few, if any, in-house tax personnel. These companies may need to rely more heavily on their outside tax consultants to monitor technical developments. Failure to reflect the impact of a change in tax law on an existing UTB in the period of the law change may lead to a restatement if the subsequent adjustment is significant.

# Disclosures

Various footnote disclosures are required in connection with the adoption and maintenance of the recognition and measurement approach to uncertain tax positions. The FASB listened to the concerns of private companies and removed the most contentious disclosure — the tabular reconciliation — for private companies.

For private companies, the FASB also eliminated the disclosure relating to the amount of the UTBs, that, if recognized, would affect the effective tax rate. A “twelve-month” disclosure is required for all companies whenever a significant adjustment to a UTB is expected within 12 months of the report date (e.g., year-end). For example, if 50 percent of a company’s entire UTB relates to a single federal issue in its 2006 calendar return, then that position will expire upon the lapsing of the statute of limitations for the 2006 tax year (Sept. 15, 2010, assuming the return was extended). That means that a disclosure would likely be required in the 2009 annual report indicating that 50 percent of the company’s UTB is likely to change within 12 months due to the lapsing of the underlying statute of limitations along with a description of the nature of the underlying issue.

Most public companies have been purposefully vague in making this disclosure, and the SEC has occasionally pushed back and required more detailed disclosures. Failure to properly make this disclosure is often cited as the most common error in applying the rules in this area. It remains to be seen how closely these disclosures will be enforced for private companies.

## Flow-through entities

Many privately held companies operate through a flow-through entity, which has its own unique tax characteristics. For example, every S corporation has a least one material tax position — that it properly elected and maintained its status as an S corporation.

One concern for S corporations can be the filing of composite state tax returns on behalf of shareholders. Failure to settle up these deemed distributions (i.e., make sure that each shareholder is treated equally) could be problematic under the S corporation rules (see Treasury Regulations Section 1.1361-1(1)(2)(ii)).

Some flow-through entities do business in a state or local country that taxes the entity as a standalone corporation. If the tax attributable to such jurisdictions is material, the underlying tax positions in that tax jurisdiction may need to be documented. If a partnership has a corporate partner, and that partnership interest is material to that corporation, then the partnership may be asked by the corporate investor to document the partnership's material tax positions.

## Summary

In summary, the adoption of the recognition and measurement approach to uncertain tax positions by a private company will allow a fresh look at its tax exposures (or in some cases, a first look). Once a thorough inventory of tax positions has been created, steps can be taken to minimize or reverse the exposures identified. Documenting and monitoring these positions, and identifying new positions in the future, will take effort, but the process will prepare the company for any potential tax audit and will enlighten management to the importance of managing tax risk.

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