

Best Practices for Handling FIN 48

The adoption of FIN 48 will require a fresh look at tax exemption and exposure.

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Not-for-profit organizations can benefit from the experience of publicly traded companies in their adoption of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). Not-for-profits have some unique characteristics that may present a challenge from a FIN 48 perspective, however. For one, they need to comply with very specific tax rules that apply only to them, besides following all of the usual income tax requirements. Not-for-profit organizations are typically smaller than public companies, and thus often lack internal tax personnel. They are not subject to Sarbanes-Oxley, so they likely have not developed robust internal tax controls. Many have little or no audit history with taxing authorities upon which to draw. Finally, not-for-profit organizations keenly focus on their missions and so, given the general mind set that they are exempt from income tax, may not recognize when they unknowingly take an "uncertain" tax position.

On 2/1/08, The Financial Standards Accounting Board (FASB) announced that certain enterprises may delay their effective date of FIN 48 until their fiscal year beginning after 12/15/07. This deferral, however, will not apply to not-for-profit organizations that have public debt.

It is only human to approach something new, such as FIN 48, with the frame of mind of doing the absolute minimum. One best practice is to view FIN 48 as an opportunity to catalog the organization's entire inventory of tax positions in order to monitor and reduce the identified exposure. This provides a great opportunity for the organization's executives and board members to get a clear picture of the organization's tax exposure.

For example, a not-for-profit organization's tax exposure may include UBIT from various types of activities in which it engages. An unrelated business activity for one organization may or may not be for another—it really depends on the specific facts.

Along with the UBIT, there may be income tax exposure from activities within other states or foreign jurisdictions. A tax-exempt organization's most serious tax exposure, however, may be risks to its tax exemption. For example, an organization that is tax-exempt under Section 501(c)(3) must be organized and operated primarily for specified exempt purposes, cannot have any private inurement (i.e., it cannot allow its charitable assets to be used for the personal gain of insiders), and cannot undertake any political activity or any more than an insubstantial amount of lobbying. Sometimes an organization, whether inadvertently or not, may have violated one of these requirements. There may be an activity or transaction—a substantial business activity to raise money, some type of communication for or against a particular candidate for office, or unreasonably high compensation for one or more senior executives—that may put the organization's exempt status at risk, resulting in uncertainty for tax purposes.

The most important lesson that can be learned from the experiences of public companies is to start the FIN 48 process sooner rather than later. Doing so will make the organization and its board aware of uncertain tax positions while there is time to address them, as well as to carefully consider how they need to be reflected in the organization's financial statements under FIN 48.

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The process of cataloging tax positions

The key focus in adopting FIN 48 should be on the process used to identify uncertain tax positions. Specifically, has the organization analyzed the appropriate documents to ensure that it has identified all material uncertain tax positions? As a best practice, this process should include the following:

- A line-by-line review of tax filings in all significant jurisdictions for all tax years in which the statute of limitations remains open.
- A review of all activities of the organization, including those performed by volunteers and board members.
- A review of financial statements and trial balances for all legal entities for all open years.
- A review of the board of directors' meeting minutes for all open years.
- A review of the application for tax-exemption and any related correspondence to and from the IRS.
- Discussions with human resource, legal, and financial and accounting personnel.
- A review of the results of prior income tax audits, if any.

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 less documentation, other than a brief description as to why the tax law applies clearly to the particular facts. Uncertain positions are those other than highly certain positions and require additional analysis. Borderline immaterial positions are those positions that should be monitored going forward in case they become material in the future.

During this process, it is critical to avoid labeling positions as “highly certain” if they are not. An organization should thoughtfully consider potential limitations, exclusions, or special rules that may apply to the tax position.

For example, it may appear to be a “highly certain” tax position that a not-for-profit organization is exempt from income tax on rental income. However, on further examination, there are a variety of factors and specific tax rules and exceptions that have a potential impact on this conclusion with regard to rental income, as illustrated by the following questions:

- (1.) Is the rental income only from real property or is any of it from personal property?
- (2.) Is the rental income considered part of the organization's exempt function, program income?
- (3.) Is there acquisition debt on the property being rented?
- (4.) Is the rental income from a flow-through entity, such as a partnership or an S corporation?
- (5.) What type of services is the organization providing along with the rental of space?

- (6.) Is the “rental” income from a parking garage or parking lot?
- (7.) Is the organization an educational organization?
- (8.) Is the rental income from renting to affiliates?
- (9.) Is the rental based on the tenant's gross income or net profits?
- (10.) Is the rental income from use of less than 15% of the real property?

Generally, rental income received by not-for-profit organizations is not considered unrelated business income, but there are many exceptions and specific rules to consider and document. An organization's specific facts become extremely important in the analysis of each activity it undertakes, application of the tax rules to those activities, and whether the tax position is “highly certain.”

Recognition and measurement

The two key steps in the FIN 48 analysis of any uncertain tax position are recognition and measurement. The first step is recognition, in which each tax position is evaluated to determine whether it meets the “more likely than not” (MLTN) standard—that is, whether there is a greater than 50% chance that the position will be sustained on examination by the taxing authorities. A key requirement of FIN 48 is that an organization must assume that it will be audited, and that the taxing authority will evaluate the technical merits of each tax position. Even if an organization has never undergone a tax audit, it must analyze its tax positions as if it will be audited.

As a practical matter, most of the effort in a FIN 48 analysis should be focused on those positions close to the MLTN threshold—e.g., those with a 40% to 70% chance of being upheld. If a position has only a 25% to 35% chance, regardless of where the position ends up in that range, it will be below the MLTN threshold and thus 100% of the position's tax benefit will be unrecognized, which means that a tax liability may be recorded for financial statement purposes. On the other end of the spectrum, positions with a better than 70% chance of being upheld may require less documentation, as those positions will clearly meet the MLTN standard.

In evaluating whether a position meets the MLTN standard, care must be taken in relying on previous tax memoranda, work performed by an external consultant, or past perceptions. To begin with, the advice must be rendered at the appropriate unit of account level, which is a new concept under FIN 48. For example, perhaps the organization's total unrelated business income activities usually net to nearly zero taxable income, because some activities generate income and others generate losses. The concept of “unit of account level” will become important should the activity generating income be determined a “certain” tax position and the activity generating the loss be determined “uncertain.”

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If the tax benefit of the loss activity cannot be recognized for financial statement purposes, the organization may need to record a tax liability for the profitable activity. The potential for such an unpleasant surprise underlines the public company lesson to “start the FIN 48 process sooner rather than later.”

A tax opinion letter may also need to be updated to reflect recent technical developments and facts.

Certain tax analyses performed by outside consultants may not include a tax opinion at the MLTN level of confidence. If an organization hired a consultant to assist with a study on intercompany cost allocations, for example, the study will rarely provide a MLTN conclusion. Thus, an organization will likely need to prepare further technical analysis to determine if it meets the MLTN standard.

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. This is perhaps the most subjective aspect of FIN 48. Positions relating to taxable vs. exempt function or nontaxable income, state income tax nexus, and tax-exemption itself tend to be all-or-nothing positions. This is in contrast to the vast majority of tax positions of public companies, in which context the outcome of meeting the MLTN standard may well be less than 100%. The quality of overall books, 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 as well as the recognition process.

Monitoring positions going forward

A key aspect of FIN 48 is that amounts reserved for unrecognized tax benefits, and the recording of tax liabilities, should not be changed unless new information comes to light in that reporting period. A change in the interpretation of the tax law, for example, is considered new information and thus will have to be monitored to determine its impact on the amount of any unrecognized tax benefit, or recording of a tax liability. The requirement to monitor changes in tax law and their impact on existing (and new) tax positions will be especially difficult for tax-exempt organizations, which seldom have in-house tax personnel. These organizations may need to rely more heavily on their outside tax advisors to monitor technical developments.

Disclosures

Various footnote disclosures are required in connection with the adoption of and ongoing compliance with FIN 48. The two disclosures most likely to be troublesome to tax-exempt organizations are the “tabular reconciliation” and the “twelve month” disclosures. The tabular reconciliation is an annual reconciliation of all activity in unrecognized tax benefits by category (e.g., tax reserves added in the current year, prior year reserves adjusted, payments to taxing authorities, reserves reversed due to lapsing of the underlying statute of limitations, etc.).

For larger organizations, the disclosure of amounts by category will not be problematic, as they will have a large number of unrecognized tax benefits in each category and are generally subject to many taxing jurisdictions. For organizations that do not have as many unrecognized tax benefits and may be subject to only a few taxing authorities, the required disclosures may reveal more information to the tax authorities than they would prefer.

The “twelve month” disclosure is required when a significant adjustment to the unrecognized tax benefit is expected within 12 months of the report date (year end). For example, if 50% of an organization’s unrecognized tax benefit relates to a federal UBIT issue in its 2004 calendar return, that position will expire upon the lapsing of the statute of limitations for the 2004 tax year (11/15/08, assuming that the organization’s return was filed on the six-month extension due date). That means that a disclosure would likely be required in the 2007 annual report indicating that 50% of the organization’s unrecognized tax benefit will likely change within 12 months due to the lapsing of the underlying statute of limitations. It also will likely require a description of the nature of the underlying issue. These disclosures will no doubt be of interest to the taxing authorities. It is important to note that the Service’s revised Form 990 for tax year 2008 requires organizations to disclose the text of their financial statement footnotes relating to FIN 48. What a quandary a not-for-profit could find itself in if it cannot find it MLTN that its tax-exempt position could be sustained! It would have to record complete tax liabilities, plus penalties and interest, for all income earned in all open tax years.

Conclusion

In summary, the adoption of FIN 48 by a not-for-profit organization will require a fresh look at its tax exemption and tax exposure (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 organization for any potential tax audit or other scrutiny and will empower management to manage tax risk. •