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TOPIC 740 (FIN 48) ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

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MY BACKGROUND

- I have more than twelve years of experience in Taxation, specializing in State and Local Taxes
- Extensive Experience Regarding FIN 48 Analysis and Implementation



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Firm Overview

- Friedman LLP - Established in 1924
- Locations:
 - New York, NY
 - East Hanover, NJ
 - Uniondale, NY
- 39 Partners
- Over 275 personnel



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Agenda

- Overview
- What is FIN 48?
 - Effective Date
 - Application
 - Uncertain Tax Positions
- Possible Federal Issues
- Possible State Issues
 - Economic Nexus



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Overview

- FAS 109 contained no specific guidance on how to address uncertainty in accounting for income tax assets and liabilities
- Inconsistent recognition, derecognition and measurement of income tax benefits
- FASB addressed these concerns with *FASB Interpretation No. 48, Accounting for Uncertainties in Income Taxes* (“FIN 48”), now called Section 740-10-65 (FSP FIN 48-3)



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What is FIN 48

- FIN 48 applies guidelines in addressing uncertain tax positions to bring more relevance and comparability to the financial reporting of income taxes in accordance with FAS 109.
- It is effective for all U.S. GAAP financial reporting enterprises, including pass-through and not-for-profit entities, for tax years beginning after December 15, 2006.
- It is important to note that tax positions governed under FIN 48 are not limited to income tax positions taken on an income tax return.
- Must be applied to all open tax positions on initial adoption
- The cumulative effect of adopting FIN 48 is recognized as an adjustment to beginning retained earnings



FIN 48 Effective Date

Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises

- **Major Provisions:**
 - Defers the effective date of FIN 48, *Accounting for Uncertainty in Income Taxes*, for certain nonpublic enterprises including nonpublic not-for-profit organizations until the annual financial statements for **fiscal years beginning after December 15, 2008.**
 - Exceptions
 - Nonpublic consolidated entities of public enterprises that apply U.S. Generally Accepted Accounting Principles (GAAP).
 - Nonpublic enterprises that have applied the recognition, measurement, and disclosure provisions of Interpretation 48 in a full set of annual financial statements issued prior to the issuance of this FSP (December 30, 2008).



FIN 48 Application

- The heart of FIN 48 introduces a two-step process, **recognition** and **measurement**, that a company must apply to all tax positions they claim, based on the relevant facts and evidence.
- Step #1 - Recognition
- Criteria for financial statement recognition of a tax position:
 - More likely than not (more than 50%) the position will be sustained upon examination (including appeals or litigation required to settle the matter)
 - Based on the technical merits of the position
 - Presume examination by relevant taxing authorities that have full knowledge of all relevant information (i.e., no “audit lottery”)
 - Evaluate each position without offset or aggregation



FIN 48 Application

- Technical merits are based on:
 - Application of sources of tax law authority to facts and circumstances
 - Includes legislation and statutes, legislative intent, regulations, rulings and case law
 - May rely on widely understood administrative practices and precedents of taxing authority in dealing with similar businesses



FIN 48 Application

- Step #2 - Measurement
- Measurement = determining the largest amount of tax benefit greater than 50% likely to be realized upon settlement
 - Based on expected negotiated settlement with taxing authority that has access to all relevant facts
 - Based on management's best judgment given the facts, circumstances and information available at the time



Uncertain Tax Positions – FIN 48

Subsequent Recognition/Derecognition

- If More likely than not (MLTN) threshold not initially met, tax benefit recognized in first interim period that meets one of these conditions:
 - The MLTN threshold is met
 - The tax matter is resolved through settlement or litigation
 - The statute of limitations has expired
- A previously recognized tax position is derecognized when it is no longer more likely than not that the position will be sustained



Uncertain Tax Positions – FIN 48

Interest and Penalties

- **Interest** on underpayments should be recorded in the first interim period that interest would begin accruing by applying the statutory interest rate to the difference between tax position recognized in the financial statements and the amount claimed on the tax return.
- If a tax position does not meet the minimum threshold to avoid **penalties**, an expense must be recognized in the period the company expects to claim the position in the tax return.



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Uncertain Tax Positions – FIN 48

Classification of Liability

- Liabilities arising from the difference between the tax treatment and the financial statement measurement of the tax benefit is recorded based upon expected cash payment
 - Payable within one year or operating cycle - current tax payable
 - Payable in excess of one year - non-current tax payable
 - Deferred tax liabilities are only set-up to the extent arises from taxable temporary difference



Uncertain Tax Positions – FIN 48

Classification of Liability

- Interest and penalties may be classified as either income tax expense or interest expense based on accounting policy elected by management
- If interest is classified as income tax expense, the interest will need to be recorded net of the tax benefit, since the interest is tax deductible



Possible FIN 48 Issues – Federal

- Possible Federal Issues
 - Significant tax planning strategies previously executed during tax years with open statuses
 - Derivative exposure
 - Valuation of debt and securities - write down issues
 - Currency Rate issues
 - Interest Rate Hedges
 - Any tax examination activity during the previous in which the statute of limitations is still open



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FIN 48 – State & Local Tax Overview

Tax Positions

- FIN 48 only applies to income taxes and it applies to all tax positions accounted for in accordance with FAS 109, including:
 - Not filing a tax return
 - Characterizing or excluding income
 - Expense Addbacks
 - Allocating income between jurisdictions



FIN 48 – State & Local Tax Overview

State and Local Taxes Subject to FIN 48 Analysis

- Does not apply to non-income taxes such as
 - Franchise Taxes based on net worth
 - Gross Receipts Taxes
 - Sales/Use Taxes
 - Property Taxes
 - Unclaimed Property



FIN 48 – State & Local Tax Overview

State and Local Taxes Subject to FIN 48 Analysis

- Significant Concerns Regarding Nexus
- States are starting to institute “Economic Nexus Standards”



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FIN 48 – State & Local Tax Overview

State and Local Taxes Subject to FIN 48 Analysis

- General State Nexus Provisions
 - Taxpayers generally needs physical presence in a state to have a tax filing responsibility in the state
 - “Physical Presence” is payroll or property in a state



FIN 48 – State & Local Tax Overview

State and Local Taxes Subject to FIN 48 Analysis

- Economic Nexus
 - Basically a taxpayer has to derive income from taxpayers in a state, even though you have no physical presence in the state.
 - The most recent landmark cases are from West Virginia and Massachusetts



FIN 48 Issues- Economic Nexus West Virginia

- West Virginia Supreme Ct. of Appeals held that the state could impose income and franchise tax on a bank with no physical presence in the state
- Bank had credit card customers in state and therefore had substantial economic nexus with state



Capital One v. Commissioner Massachusetts Economic Nexus

- Mass. App Tax Bd (6/22/07)
- Upheld tax on out of state bank with no physical presence in jurisdiction
- Held no violation of Commerce Clause
- Held no physical presence required
- Board relied heavily on *MBNA*, *Lanco* decisions



Economic Nexus – Indiana

- *MBNA America Bank v. Indiana Dept of Revenue*
(Cause No. 49T10-0506-TA-53, October 2008)
- The Indiana Tax Court held that MBNA was liable for Indiana's financial institutions tax because while it did not have a physical presence in the state, it had an economic presence. MBNA had no employees or facilities in Indiana and only contacted credit card customers and potential customers there by phone or mail.



New York Economic Nexus Legislation

- New legislation provides for nexus under the bank franchise tax with respect to certain banking corporations having credit card customers in New York, applicable to taxable years beginning after 2007
- A banking entity is doing business in New York in a corporate or organized capacity if:
 - It has issued credit cards to 1,000 or more customers with New York mailing addresses;
 - It has merchant customer contracts with merchants, and the total number of locations covered by those contracts equals 1,000 or more locations in New York to which the banking corporation remitted payments for credit card transactions during the taxable year



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New York Economic Nexus Legislation

- A banking entity is doing business in New York in a corporate or organized capacity if (cont.):
 - It has receipts of \$1 million or more in the taxable year from its customers who have been issued credit cards by the banking corporation and have a New York mailing address;
 - It has receipts of \$1 million or more arising from merchant customer contracts with merchants relating to locations in New York; OR
 - the sum of the number of customers described in bullet 1 plus the number of locations covered by its contracts described in bullet 2 equals 1,000 or more, or the amount of its receipts described in bullets 3 and 4 equals \$1 million or more



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New York City Economic Nexus

- New York City has recently adopted similar economic nexus standards

Florida TAA 07C1-007 (Economic Nexus)

- In TAA 07C1-007 (10/17/07), the Florida DOR announces that “physical presence is not required to impose Florida’s corporate income tax.”
- Ruling based on recent state court decisions and U.S. Supreme Court denial of *certiorari* in *Lanco* and *MBNA* cases



Maine Tax Alert (Economic Nexus)

- Maine Department of Revenue issued tax alert in February of 2008 asserting an economic nexus standard for the Maine income tax
- Similar to Florida TAA



Economic Nexus – Connecticut

- Effective for the 2010 tax year –HB 6802
- Replaces a physical presence standard
- The New Standard:
 - “Any company that derives income from sources within this state, or that has a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, without regard to physical presence, and to the extent permitted by the Constitution of the United States, shall be liable for the tax imposed under chapter 208 of the general statutes.”



Economic Nexus – California

- For taxable years beginning on or after January 1, 2011 (R&T Section 23101)
 - Economic Standards:
 - Sales in CA of \$500K or 25% of total sales
 - Taxpayer's real and tangible personal property in CA exceeds lesser of \$50K or 25% of taxpayer's total of such property
 - The sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of pass-through entities.



Economic Nexus – Summary

- Per 2009 BNA Survey of State Tax Departments (April 24, 2009)
 - Approximately 35 states said they employed economic nexus standards
 - State's are being very aggressive
 - Be wary of new tax regimes
 - OH CAT, MI MBT, Texas Margins Tax



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Economic Nexus – Summary

- Banks with interstate customers may very well have economic nexus and therefore have a state income tax filing obligation
- Economic Nexus can still apply, even if you don't have a credit card business
- States are being VERY AGGRESSIVE, with regards to banks



FIN 48

Questions?

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