New rules put pressure on private companies

The free ride is over. Privately held companies now face the same burden borne by public companies last year: Implementing FIN 48.

In July 2006, the Financial Accounting Standards Board, or FASB, issued a financial interpretation called FIN 48 (Accounting for Uncertainty in Income Taxes), effective for fiscal years beginning after Dec. 15, 2006. FASB granted a reprieve on Feb. 1, 2008, by deferring the effective date of FIN 48 for most private companies to periods beginning after Dec. 15, 2007. The deferral has expired and private companies must implement FIN 48.

Under FIN 48, a company may book an income tax benefit on its financial statements only if it is “more likely than not” (MLTN) that the benefit will be sustained if it is examined by a fully informed taxing authority. FIN 48 must be applied by every company that prepares financial statements in accordance with U.S. generally accepted accounting principles.

FIN 48 requires a company to apply a multi-step analytical process to every one of its income tax “positions.”

●Identify the company’s individual income tax positions. The term “position” includes, not only the claiming of a deduction or credit on a tax return, but all other decisions that affect reported income tax liabilities. FIN 48 applies to all income taxes, including federal, foreign, state and local income taxes.

●Determine, for each income tax position, whether it is MLTN that the position will be sustained, based on the “technical merits” of the position, if it is examined by the appropriate taxing authority. If a company determines that a tax position does not satisfy the MLTN standard, it may not book any benefit from the position. In making the MLTN determination, companies must assume that the taxing authorities will have all relevant information. Companies may not take into account the possibility that the position will be undetected.

●Measure the financial statement benefit to be recognized for each income tax position that satisfies the MLTN standard. For each such position, the amount recognized is “the largest amount that is greater than 50 percent likely of being realized upon settlement with a taxing authority that has full knowledge of all relevant information.” The measurement process will require companies to predict the taxing authority’s risk assessment and willingness to compromise.

The standards imposed by FIN 48 require companies to make numerous judgments. Since the standards are relatively new and unfamiliar, companies are treading carefully as they put new processes in place.

Although MLTN determinations must be based on the “technical merits” of tax positions, FIN 48 does not require a company to make a legal determination about whether the courts would sustain each tax position if it were challenged by the taxing authority. Only positions that exceed a materiality threshold and entail some degree of uncertainty must be examined.

Auditors should require only that companies have a reasoned basis for determining the largest amount of tax benefit from a return position that is more likely than not to be realized after audit. There are many ways of making such a determination.

A company’s outside auditor will ask the company for documentation supporting the company’s FIN 48 determinations. There are no clear rules as to what constitutes adequate documentation, and companies are understandably concerned that their auditors may require a massive record to support the tax estimate. Hopefully, that concern will turn out to be unfounded — auditors should not require companies to document the FIN 48 process beyond what is necessary to explain the company’s decisions.

A company should not need written analyses supporting its “highly certain” tax positions. But a company should have a system for inventorying its highly certain positions and identifying, for each position, a resource for supporting the judgment that there is no material uncertainty.

In the first year that a company adopts FIN 48, the company must (1) apply FIN 48 to all prior-period tax positions taken in years that are not closed by the statute of limitations, and (2) report the cumulative effect of applying FIN 48 to those positions as an adjustment to the opening balance of retained earnings. Due to the deferred effective date for most private companies, a calendar year company will not need to apply FIN 48 on its annual financial statement until early 2009.

For many companies, the sheer volume of work required by the transition to FIN 48 is daunting. However, companies that devote appropriate time and resources to the transition now should find the process manageable.

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