

State Income Tax Uncertainty Under FIN 48

The Reserve Is Set Up, So Now What ?

The good news is that companies often have the opportunity to think strategically about what can be done to resolve uncertainty—and that resolution can become a powerful means of reducing a company's effective tax rate.

Charles F. Barnwell, Jr.

Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (often referred to as “FIN 48”)¹ requires public companies to identify uncertain income tax positions, and de-recognize part or all of previously booked tax benefits where uncertainty exists. Under FIN 48, the company must establish a reserve for the “uncertainty”—a new term of art seemingly replacing the old notion of “tax exposure.” In circumstances where the position is *not* “more likely than not” sustainable by a company, the company must accrue a reserve equal to 100% of the uncertainty. Even if a position is deemed “more likely than not,” if uncertainty exists and the item is material the company still must accrue a reserve based on a probability formula.

CHARLES F. BARNWELL, JR., CPA, is President of Barnwell & Company LLC, in Atlanta, Georgia. The firm, founded in 2000, specializes in state and local taxation. Mr. Barnwell has more than 20 years of state and local tax experience, the first 15 of which were spent in Big Four public accounting. Admitted as a partner with KPMG LLP in 1991, he was instrumental in establishing and leading the firm's national State Tax Minimization(SM) program for five years. Mr. Barnwell received the Elijah Watts Sells Award for outstanding achievement on the CPA exam, and he has spoken extensively on state and local taxation before state CPA societies, the Tax Executives Institute, COST, the Federation of Tax Administrators, the Institute for Professionals in Taxation and other professional associations. He has previously written for THE JOURNAL.

The adoption of FIN 48 within corporate America required significant effort. The effort absorbed the resources of the accounting and tax departments of public companies, requiring an in-depth historical review of tax postures. For most public companies, the review encompassed various states, international jurisdictions, and federal income taxes. In instances where companies determined uncertainty as to nexus, the analysis usually extended to prior periods—sometimes involving a look-back in excess of ten years. FIN 48 analyses were further complicated by the multitude of exposure issues—due in large part to the complex nature of income tax authority, and the multi-jurisdictional environment in which virtually all public companies operate.

Upon adoption of FIN 48, companies were permitted to charge retained earnings for the reserve for uncertainty, thus bypassing the income statement. This approach enabled companies to set up the required FIN 48 reserve without adversely affecting the company's income tax rate and current-period earnings. If the uncertainty resolves, however (i.e. becomes "certain"), the company may reverse the reserve balance into income, creating a favorable impact on tax rate. In many cases, FIN 48 reserve balances exceed tens of millions of dollars.

State Taxes and FIN 48

For myriad reasons, FIN 48 reserves are often mostly for state and local income taxes. As one might expect, state FIN 48 issues tend to revolve around "economic nexus," an evolving concept whereby states assert the right to tax companies that lack a physical presence in the taxing state but are deemed "doing business" there through the exploitation of the state's markets—usually via use of intangibles or direct marketing activities such as Internet or mail-order sales. Another leading issue is "agency nexus"—the states' argument for asserting taxing jurisdiction over an out-of-state company based on the company's in-state use of agents or affiliates. Still another issue involves uncertainty associated with transfer pricing regarding intercompany transactions—usually royalties for the use of intangi-

bles, interest from intercompany financing, or management fees between affiliates.

Until now, accounting and tax departments have been preoccupied with the gargantuan task of meeting the requirements of FIN 48. In most cases, the analysis has resulted in thick binders full of arcane accruals, with overlapping theories. In the aftermath of this initial gargantuan effort, the last thing companies want to do is open up those binders again and begin the analysis anew for the upcoming year when the company must re-evaluate each uncertain position, adjust it, and then consider whether new uncertain positions have arisen. In this latter regard, "new" uncertainty will result in a direct charge to earnings.

For the most part, it seems that practitioners, accountants, and tax professionals within reporting entities see little use for FIN 48, and seem convinced that the utility added to financial statements pales in comparison to the effort required. This perspective seems justified in view of the judgment required to properly book "uncertainty." FIN 48 is unique in that it requires judgment—an inherently uncertain notion—to lend greater certainty to uncertainty. It is noteworthy that the International Accounting Standards Board (IASB) has not "converged" with FIN 48 principles.² At a minimum, it would seem that the FASB could reconsider FIN 48's complexity and try to simplify it.

As if the complexity and paradox of using judgment to account for uncertainty were not bad enough, companies face another new challenge as a result of FIN 48, i.e., state taxing authorities are aware of the existence of FIN 48 workpapers. Whether these taxing authorities will request this information remains to be seen.³ In light of state audit departments' tight budgets, however, and the sheer dollar magnitude of FIN 48 reserves (which may be discerned by state auditors merely by looking at a public company's financials), companies can hardly rest easy that the related workpapers are not up for grabs.

Another classic issue exacerbated by FIN 48 arises from the assumption in "tax world" that the statute of limitations—the time period in which a ju-

risdiction can assess tax or a taxpayer may apply for a refund—remains open ad infinitum in instances where a company has not filed a return. While on the surface the failure to file a return may appear egregious, such circumstances are quite common. There exists a significant gap in perspective among taxpayers and states (or jurisdictional subdivisions) as to whether a company is required to file. In large part, this gap pivots on the ambiguity of "nexus," and indeed its evolution, most notably as regards "economic nexus."

The translation of this issue for FIN 48 purposes is that, at least theoretically, a state could go back to the first point in which a taxpayer began to exploit a market "economically" (that is, without traditional physical presence). This awkward reality winds up getting booked as a tax accrual—often an accrual over unreasonably long time periods—and the prospect of the accrual's remaining on the books *forever*. Even worse, if the entity continues a policy of not filing it must continue to add to the FIN 48 accrual every year. Companies find themselves with a real dilemma: an unending accrual of uncertainty, and the possibility that at some point in the future a state auditor will demand FIN 48 workpapers. If the statute never expires, and the dollars are growing year by year, might that possibility become instead a probability?

Ray of Sunshine?

With so little good news in view of the foregoing, perhaps there is a "ray of sunshine" for companies—after they recover from the initial effort of FIN 48 accounting. The bad news about this ray of sunshine is that it may require additional effort on the part of accounting and tax executives who are already just plain sick and tired of FIN 48 and are facing another year of drudgery in doing the accrual once again. The good news is this: companies often have the opportunity to think strategically about what can be done to resolve uncertainty—and if strategies do exist, resolving uncertainty can actually become a

powerful means of reducing a company's effective tax rate.

While FIN 48 uncertainty comes in all shapes and sizes, consider the following examples of possible strategic steps for a company with significant FIN 48 reserves.

FIN 48 problem: Economic nexus with no statute of limitations, and growing reserves with no end in sight.

Possible solution: Voluntary disclosure.

As state tax practitioners may know, most state revenue departments have standing, informal amnesty procedures, usually called "voluntary disclosure" programs. If nexus is arguable, under FIN 48 companies must accrue a reserve. Before FIN 48, the aggressive stance not to file translated into a lower

accounting?), and may have to accrue for penalties. The synthesis of these facts and theories may actually change the company's analysis: the same facts that heretofore compelled a nonfiling stance now compel the company to file. If the conclusion is to file, the company finds itself in a bind since filing prospectively will likely trigger a controversy with the state regarding when the company initially should have filed—possibly triggering an aggressive audit with the threat of penalties and interest on any assessed back taxes.

A reasonable conclusion from the preceding is that, in a post-FIN 48 world, the company should re-evaluate its decisions not to file. The conclusion may well be that the taxpayer should consider entering into voluntary disclosure

ing, and usually the reserve covers several years (in principle, the period in which (1) the taxpayer has had economic nexus or (2) the state has had an economic nexus rule, whichever is shorter). If the reserve period was greater than four years, in many cases the taxpayer can reverse those earlier years, since most states require only a three- or four-year "look back" and, presumably, forgive the taxpayer for failure to file in earlier periods.

A look-back controversy. One controversial issue in this regard arises when a company has accrued a FIN 48 reserve for economic nexus for a term in excess of the state's published look-back period. For example, if a state has a written policy to accept a specified number of look-back years, is it necessary or

A reasonable conclusion from the preceding is that, in a post-FIN 48 world, the company should re-evaluate its decisions not to file.

tax rate, but now the taxpayer is, at least theoretically, left with an unending reserve, growing by the fiscal quarter. In addition, since ultimately a state will audit the nonfiling position (an assumption that must be made under FIN 48), the company may face penalties and interest. At a minimum, the company must accrue for tax, interest (remember the "conservative" principle of

programs. There are a several attractive benefits that the company may achieve and, ironically, the actual act of asking for forgiveness and paying tax may in the final analysis result in a lower book tax rate. The lower rate stems from the fact that, in most cases, the taxpayer has already charged retained earning for the initial accrual of tax exposure for economic nexus/nonfil-

appropriate to book a reserve for earlier years? In most cases, perhaps in the interest of conservatism, companies have reserved for longer periods than a state's look-back policy would require. The question then becomes when can the company reverse the accrual for pre-look-back years.

There appear to be two possibilities. Perhaps the company can reverse

¹ Issued by FASB in July 2006, FIN 48 clarifies rules regarding income tax accounting for purposes of a company's financial statements, and provides a recognition threshold and measurement in connection with evaluating and reporting the benefit of an uncertain tax position. FIN 48 is effective for fiscal years beginning after 12/15/06. For more background on this pronouncement, with a particular focus on state tax matters, see Sutton, Jorgensen, and Yesnowitz, "State Tax Issues Regarding FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes," 16 JMT 18 (January 2007).

² The IASB is an independent accounting standard-setting body based in London. The organization's website is www.iasb.org. IAS 12, *Income Taxes*, is silent on the issue of tax uncertainties. In its forthcoming exposure draft of proposed amendments to IAS 12, the IASB proposes to add the following requirements (which are not the same as FIN 48): "Uncertainty over whether the amounts submitted by the entity to the tax authorities will be accepted may affect the amount of current tax and deferred tax. An entity shall measure current and deferred

tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the taxing authorities will review the amounts it submitted. Changes in the probability-weighted average amount of all possible outcomes must be based on new information, not a new interpretation of previously available information." The IASB is proposing different requirements because the general requirements regarding uncertainties under IFRS ("international financial reporting standards") are different from those under U.S. GAAP ("generally accepted accounting principles"). E-mail from Anne McGeachin, IASB Senior Project Manager, 2/25/08.

³ See "Memorandum: FIN 48 and Tax Accrual Workpaper (TAW) Policy Update" (Deborah M. Nolan, IRS Commissioner, Large and Mid-Size Business Division, 5/10/07; LMSB-04-0507-044), in which the IRS pledged to observe a "policy of restraint" with respect to FIN 48 workpapers, which IRS has determined to be "Tax Accrual Workpapers." This memorandum is available on the IRS website at www.irs.gov (click on "Businesses," "Corpora-

tions," and select "FASB Interpretation No. 48, 'Accounting for Uncertainty in Income Taxes'"). See also *U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138, 100 AFTR2d 2007-5848 (DC R.I., 2007), *app. pending* CA-1, No. 07-2631, holding that Textron did not have to produce federal income tax accrual workpapers prepared by attorneys because such documents were protected by the attorney "work-product privilege," notwithstanding disclosure of those workpapers to the taxpayer's auditor.

⁴ The company believed it was protected under P.L. 86-272 but, under the FIN 48 microscope, financial auditors detected unprotected activity. P.L. 86-272 (15 USC § 381-384, the "Interstate Commerce Tax Act") limits a state's ability to assert income tax jurisdiction over a business whose only activity in the state is the solicitation of orders for sales of tangible personal property, provided the orders are sent out of the state for approval and are filled by shipment from outside the state. P.L. 86-272 does not protect other types of activities in a state and does not apply to non-income taxes (e.g., sales or use taxes) or to the sale of intangibles.

the reserve when it obtains from the state an identifying case number or similar acknowledgement that the company intends to voluntarily disclose its prior years' tax liability. Alternatively, the company can reverse the reserve when the voluntary disclosure process has been resolved and taxes for the required look-back years are paid. In most cases, following the former alternative would seem safe. In North Carolina, however, a company should proceed with caution. While that state will issue a case number, it reserves the right to reject the voluntary disclosure application. In most other jurisdictions, it would appear that once a company has obtained a case number, it is de facto accepted into the program.

FIN 48 problem: A "whipsaw" effect, where a taxpayer files retroactively in a "sales destination" state but had thrown back those sales to the state of origination.

Possible solution: Protective refund claims—before the statute of limitations tolls.

Consider a company with economic exposure in state "A," where it has no property or employees but it has customers to whom it ships goods from state "B," which has a "throwback" rule. In a pre-FIN 48 world, the company judged the destination-state landscape as "don't file—nexus is uncertain."⁵ Thus, in determining its income apportionment formula, the company's receipts from sales in state A were thrown back to state B. In the post-FIN 48 world, the company decided to enter

into destination-state A's voluntary disclosure program. Now that the company intends to file in the destination state, it has the opportunity to amend its previously filed origination-state returns to eliminate throwback sales.

This opportunity, like many in the state arena, comes paired with a trap. The taxpayer will be "whipsawed" if the origination state's statute of limitations for claiming a refund has expired for a year for which the company voluntarily discloses and files a return in the destination state. Also, this lack of correspondence of fiscal periods may create another FIN 48 paradox: in some circumstances it is theoretically possible that the company is better off with a *greater* look-back period. This strange circumstance may be illustrated by the following example.

Example. A company ships all its goods from its home state, which uses throwback and a single sales factor apportionment formula, into a state that use an equally weighted three-factor formula. The single-factor origination state has an 8% tax rate and the three-factor destination state has a 6% tax rate. The origination state imposes tax on 100% of the throwback sales at 8%. The effective tax rate on those same sales in the destination state would be 2%, since the company presumably has no payroll or property in that state. In such circumstances, the company would be better off filing with the destination state for four years instead of three, but only if the company could amend its origination state return for that fourth year back.

Practice Note: What About FIN 48 Workpapers?

In *U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138, 100 AFTR2d 2007-5848 (DC R.I., 2007), *app. pending* CA-1, No. 07-2631, a federal district court held that Textron did not have to disclose to the IRS its federal income tax accrual workpapers prepared by attorneys because the documents were protected by the attorney "work-product privilege," notwithstanding disclosure of those workpapers to the taxpayer's auditors. Shortly before that opinion was issued, the IRS pledged to observe a "policy of restraint" with respect to FIN 48 workpapers, which the Service has determined to be "Tax Accrual Workpapers." See "Memorandum: FIN 48 and Tax Accrual Workpaper (TAW) Policy Update" (Deborah M. Nolan, IRS Commissioner, Large and Mid-Size Business Division, 5/10/07; LMSB-04-0507-044), available on the IRS website at www.irs.gov (click on "Businesses," "Corporations," and select "FASB Interpretation No. 48, 'Accounting for Uncertainty in Income Taxes'").

The lesson learned from the foregoing is that now is the time to carefully analyze economic nexus and the opportunity for voluntary disclosure and amended returns for throwback. Putting it off, companies risk "whipsaw"—long look-back periods for accrual and exposure, even as the statute of limitations for refunds expires in origination states.

FIN 48 problem: Intangible holding company files only in Delaware or Nevada ("income concentration point"), or income gets "washed" in unitary state.

Possible solution: Liquidation.

In this situation, a company may have determined that an intangible holding company (IHC), while having to establish a FIN 48 reserve for economic nexus, should continue a nonfiling posture in certain states. As in the preceding example, however, the IHC has the same issue of a never-ending build-up of exposure with no expiring statute of limitations for assessments based on economic nexus.

While the author is not recommending liquidation of the IHC solely

⁵ See "North Carolina Voluntary Disclosure Program" (N.C. Dept. of Revenue, Discovery & Special Projects, 9/19/06), stating: "This program is not available to corporate and individual income taxpayers who have engaged in income shifting tax strategies or other tax shelter activities that minimize or eliminate North Carolina state taxes."

⁶ Generally, under IRC § 482 the IRS can adjust the incomes of related companies that engage in intercompany transactions with each other, if IRS determines that the price charged did not reflect fair market value or the transaction otherwise did not reflect arm's-length terms. The purpose of § 482 is to prevent the avoidance of taxes by ensuring that taxpayers clearly reflect income resulting from a controlled transaction. Treas. Reg. § 1.482-1(a)(1).

⁷ Maryland follows IRC § 482 and the regulations thereunder. See Md. Code Ann. Tax-Gen § 10-109. (Apparently, Maryland enacted this statute in response to a court decision, *Gannett Co., Inc. v. Comptroller of the Treasury*, 356 Md. 699, 741 A.2d

1130 (1999), in which the Maryland Court of Appeals (the state's highest court) ruled that the Maryland tax authority could not rely on the state's conformity statute to invoke IRC § 482. For more background, see McBurney, "Conformity Statute Does Not Encompass IRC Section 482-Type Powers," Maryland High Court Says," 10 JMT 6 (Mar/Apr 2000). Most other states, however, do not follow § 482, either because the state specifically rejects § 482 or because the state has its own rules concerning intercompany pricing. States that arguably do follow IRC § 482 do so "impliedly" because the starting point for calculating state taxable income is federal taxable income. See, e.g., Conn. Gen. Stat. § 12-213(a), 12-226a, 12-225(a) and (b)(1); Ga. Code Ann. § 48-7-21(a), 48-7-58(a); Mass. Gen. Laws ch. 63, § 30.4, 33; N.J. Rev. Stat. § 54:10A-4(k), 54:10A-10; N.Y. Tax Law § 208.9(i); N.C. Gen. Stat. § 105-130.2(5c), 105-130.5(a)(9), 105-130.6; Ohio Rev. Code Ann. § 5733.04(I), 5733.031(C); 72 Pa. Stat. Ann. § 7401(3)1(a); Va. Code Ann. § 58.1-402.A, 58.1-446.

to avoid tax liability, it may be worth considering what would happen if the company were to liquidate under applicable state law. Perhaps other good business reasons exist for liquidation that could be paired with the elimination of exposure and, perhaps, resolve the never-ending FIN 48 accrual cycle in which the company is trapped.

Tax professionals should ask the following question: If the IHC has no plans to voluntarily file returns, what happens to unasserted claims by the states if the company liquidates? Even if no returns have been filed, is there some other statute of limitations, such that a state must bring a claim against a liquidated company within a certain period of time? Does the answer vary by state? Is liquidation of an IHC therefore a means of dealing with the “never-ending statute” question in situations where economic nexus leads to the necessity of reserving under FIN 48, but is not sufficient to compel the intangibles company to file?

FIN 48 problem: Transfer pricing is not at arm’s length.

Possible solution: Amend federal return to properly state income reported among affiliates.

In many cases, companies must establish a reserve for FIN 48 based on erroneous or overly aggressive transfer pricing. For example, perhaps a com-

pany has an IHC that charges an 8% royalty, when a transfer pricing study would conclude a fair rate of 4%. The paying entity, which files a separate return on which it has deducted the 8% intercompany royalty, may have a FIN 48 reserve for the difference in tax. In addition, or perhaps in the alternative, the IHC may have to establish a reserve based on economic nexus. The company must determine whether these two accruals overlap, or whether only one accrual is necessary. In some states (e.g., North Carolina), the taxpayer may have

the authority to accrue one or the other—but even in North Carolina in view of its voluntary disclosure program, this possibility may not exist.⁵ If an affiliated group establishes a FIN 48 reserve related to an unreasonably high royalty rate in separate filing states, what action might be appropriate? One alternative, if within the company’s ethical standards, may be to batten down the hatches and simply wait for the statute of limitations to run. As the statute runs, presumably the company may reverse the FIN 48 reserve. If, however, the royalty rate is wrong—i.e., the charge is so far off as to be equivalent to an error—is there an alternative? Should (and “may”) the taxpayer amend the federal return, with no change to consolidated federal taxable income, to “correct” reporting in separate filing states?

On the surface one’s gut reaction might be “certainly not”—the company would have to pay additional tax in separate filing states ... why do that? If, however, one analyzes the question from a book standpoint in view of FIN 48, perhaps the company reaches the opposite conclusion in view of the “whipsaw” effect. Similar to the discus-

erroneous “system” of intercompany transactions lead to a higher book state income tax rate in view of FIN 48? To reach a proper conclusion in this regard, the company must look at the question both in the aggregate and state by state.

Inaccurate or erroneous domestic intercompany transfer pricing presents an extraordinary dilemma for companies. May a company amend a federal return, for a net change of zero on a consolidated basis, to correct inaccurate intercompany pricing as it relates to separate entities within a group? Under Treas. Reg. § 1.482-1(a)(3), in connection with such intercompany transactions, a taxpayer may file an amended return to report only an increase in taxable income, not a decrease.⁶ If a taxpayer conducts a retroactive domestic transfer pricing study and discovers that the intercompany pricing is wrong, do the provisions of that federal regulation apply to states? What should the state tax practitioner conclude if the net effect on the federal consolidated return is zero, but income increases for one entity in certain states, and decreases for another entity in certain states?

State-by-state research on this issue indicates a fabric of conflicting authority. Most states, however, do not explicitly adopt the federal regulations

The IHC has the same issue of a never-ending build-up of exposure with no statute of limitations for assessments based on economic nexus.

tion above regarding throwback, ignoring a transfer pricing problem may well create a “whipsaw” issue, where the IHC must continue to accrue exposure year after year based on the 8% royalty rate, while the statute of limitations is expiring in separate filing states. While the latter tolling is a mitigating factor, does the book exposure in the IHC outweigh the book exposure associated with the benefit from the tolling statute in separate filing states? In effect, does the current

under IRC Section 482.⁷ It would therefore seem reasonable to amend returns for clearly erroneous transfer pricing on a separate company basis, but the situation may present the company with a troubling ethical issue. To *not* amend state returns in such a situation may put the tax executive in a position of knowing of a material error on the return, while at the same time knowing that—if one analyzes the question on a separate-company basis—federal regulations prohibit the use of Section 482 to decrease income retroactively.

Conclusion

Should FIN 48 apply only to federal items, with the “companion” state tax accrual? Is there an aggregate materiality test in the alternative? The foregoing problems only scratch the surface. Private companies may eventually face similar issues—although FASB recently extended the date for their adoption of FIN 48; time will tell if private companies will ultimately be forced to adopt. Moreover, if accounting for *income tax* uncertainty under FIN 48 makes financial statements more accurate, it is hard to understand why similar rules regarding uncertainty in

non-income taxes would not also enhance the quality of financial reporting. Perhaps the proliferation of income tax shelters created the perception of a need for FIN 48 in the income tax area. But what about nexus regarding sales/use tax collection? In many cases, a company’s failure to collect sales or use tax involves significantly greater dollars than do the issues associated with income tax uncertainty. But it is this author’s conclusion that the assumptions inherent in a FIN 48 accrual exercise for state income taxes often border on the absurd, and the subjectivity seems to lead to confusion—not

clarity—regarding an enterprise’s state income tax posture. Perhaps more definitive rules on materiality are in order, or perhaps FASB should consider a significant rework of FIN 48.

The good news is that tax executives have a real opportunity to do a new kind of tax planning by carefully analyzing the new FIN 48 reserve balance. The strategies mentioned in this article are only a sliver of the strange paradoxes and new, unique opportunities brought about by FIN 48. Careful attention to the FIN 48 reserve, and good creative insight can often move the effective tax rate. ■