

September 14, 2009

**ALERT: New accounting standard requires closer coordination with your auditors related to uncertain tax positions for financial statement audits**

**A new accounting standard** will become effective for your next year-end financial statement. The new standard, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities* (commonly referred to as “FIN 48”), **will require additional communication between you and your AGH client service team about how your income tax positions will affect your financial statements.** We will coordinate closely with you and every effort will be made to minimize any additional fees that may be required by the implementation of this new accounting standard.

Even though the company is a pass-through entity, FIN 48 will still apply and will need to be analyzed for possible built-in-gains tax, possible state tax obligations or S election problems.

In summary, if the company has taken or expects to take a filing position in any open tax year (federal or any state) and it is determined to be an “uncertain tax position” as defined by FIN 48, the company would be required to record an obligation or reduce a recorded tax benefit, if material, if it is “more likely than not” (defined to be more than 50%) that the tax position would not be sustained by a court of last resort.

In assessing the more likely than not criteria:

- It is to be presumed that the tax position will be examined by a taxing authority that has full knowledge of all relevant information, even though that may be unlikely.
- Each position must be evaluated separately without consideration of offset.

The term *tax position* refers to a filing position that a company has taken or expects to take on its tax return. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. A tax deduction is the most common type of tax position. Other common tax positions include:

- A decision not to file a tax return, for example, in a particular state or states
- An allocation or a shift of income between jurisdictions
- The characterization of income or a decision to exclude or defer reporting taxable income in a tax return
- A decision to classify a transaction, entity or other position in a tax return as tax exempt
- A decision to take a deduction on a tax return for a current expenditure rather than capitalize the amount and amortize over future periods
- The calculation of the amount of a research and experimentation credit

A few specific examples that might apply could include (but are not limited to) those following. A specific example is included in Appendix A:

- Inappropriate deferral of income or revenue-recognition policy
- Inappropriate deductions for bad debts when the facts are subjective
- Inappropriate depreciation or expensing of capital assets
- Inappropriate write-down of inventory to lower of cost or market

In connection with the financial statement audit or review, we will discuss this with you and the senior management team in order to obtain reasonable, but not absolute, assurance that the material facts and circumstances will be considered. **Unless you specifically engage us to do so, our tax professionals will not audit, verify or provide any assurance on the company's tax provision or tax accounts.** If the actual facts are different from the facts represented to or understood by us, or if there are other facts of which we are not aware, the reporting of applicable transactions could be materially different than how it is reported on a tax return.

We understand from industry sources that significant confusion exists between the "more likely than not" criteria required by the Interpretation and the "reasonable basis" and "substantial authority" requirements that the Internal Revenue Service (IRS) uses. In order for a paid preparer to sign an income tax return that contains any identified controversial issue, he or she must have concluded that there is a "reasonable basis" for the position, which is generally presumed to be approximately a 20% likelihood that the issue would be sustained. In addition, in order for a taxpayer to avoid potential IRS penalties with respect to an income tax return position, there must exist either "substantial authority" (generally presumed to be approximately a 40% likelihood of sustainability) or "reasonable basis" (defined above) and the position must be adequately disclosed in the income tax return.

In other words, the evaluative process applied by you and your tax professional with respect to your income tax return positions is not the same as the requirements defined by FIN 48. **If your CPA signs your tax return as a paid preparer and agrees with management's assessment that there are no known material uncertain tax positions that are required to be recorded under FIN 48, it does not equate to a guarantee that there will be no adjustments upon examination by the IRS.** If you would like a greater certainty regarding the tax treatment of a specific item, please contact us to discuss the possibility of providing additional tax research or obtaining a ruling from the appropriate taxing authority.

We look forward to working with you on the upcoming audit and will be certain to allow adequate time to address the requirements of FIN 48.

*NOTE: Pursuant to federal regulations imposed on practitioners who render tax advice ("Circular 230"), we are required to inform you that any discussion of tax matters contained herein is not intended or written to be tax advice, and cannot be relied upon as such, nor can it be used for the purpose of: (i) avoiding tax penalties that may be imposed by the IRS or states, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. If you seek definitive tax advice on a matter, please request a written tax memorandum from your AGH tax advisor.*

## Appendix A

### Example of an Uncertain Tax Position

ABC Company, an S corporation located in Kansas, sends personnel to do service work for customers on site at several customer locations in the state of Texas. Under Texas tax law, this "on site" activity could be subject to taxation; however, ABC Company has never disclosed this out-of-state activity to its tax preparer.

As a result, the tax preparer never considered whether a Texas tax return is required, resulting in an uncertain tax position. In this example, further assume that the state of Texas has never asserted a claim for taxes and ABC Company believes it's unlikely that a claim will be asserted.

If a claim were to be asserted, the Texas tax would create an offsetting credit for Kansas taxes that could be claimed (but only for open tax years). Under the old accounting standard, the possible liability for this uncertain tax position would not meet the "probable" test, as previously required by FAS 5, and would therefore not be accrued as a liability.

However, the new accounting standard requires the presumption that it will be examined by a taxing authority that has full knowledge of all the facts without the right of offset. Accordingly, under the new accounting standard, the possible liability for Texas taxes would be accrued, if material to the financial statements. Since this Texas tax is assessed against ABC Company, and not the shareholders of the 'S' corporation, it would be accrued, if material, by the corporation.

In this example, if the matter is material, the company's choices are to conduct tax research to document a determination that the tax position would "more likely than not" prevail or record a liability, even though it believes it is unlikely to be asserted.