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An Accounting Perspective – Financial Statement Implications of Audits and Uncertain Tax Positions

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Speakers

Drew VandenBrul
Managing Director, Philadelphia
Drew.VandenBrul@us.gt.com
(215) 531-8612

Michael Cronin
Senior Manager, Boston
Michael.Cronin@us.gt.com
(617) 848-4999

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Learning Objectives

- Overview of ASC 740 and ASC 450
- Uncertain tax positions (UTP) and how they arise
- ASC 740-10 (FIN 48)
- Levels of authority
- State administrative practices
- Resolution of tax matters

ASC 740 vs ASC 450

- **ASC 740**
  - Applies to taxes based on income (but term is not defined)
    - Gross receipts taxes are operating expense, not income tax
    - Modified gross receipts and margin taxes are income taxes
- **ASC 450**
  - Applies to contingencies (non-income tax contingent liabilities)
    - Sales & use Tax
    - Gross receipts taxes
    - Abandoned & unclaimed property
    - Other indirect taxes

ASC 740

ASC 740

- **Two primary objectives when accounting for income taxes:**
  - Recognize the amount of taxes payable or refundable for the current year
  - Recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns.

- The **measurement** of current and deferred tax liabilities and assets is based on **enacted law** and the possible effects of future changes in the law or future changes in the rates are not anticipated.
  - The tax effect of changes in tax laws or rates is required to be recognized in the period in which the law is enacted.

ASC 740

- **"Change in Accounting Estimate"** relates to changes resulting from new information.
  - May include adjustments of prior period accruals resulting from new information, changes in facts or circumstances, or subsequent identification of information that was not reasonably knowable and that results in improved judgement.
  - Does not include changes resulting from information that was reasonable knowable or that should have been readily accessible.
- **Examples:**
  - A settlement is reached with a taxing authority related to an uncertain tax position
  - There is a change in interpretation of tax law
  - New administrative rules or guidance was issued
  - Additional expert opinion was obtained on a highly technical or complex area of law
  - New information becomes available

ASC 740

- State adjustments due to non-conformity with the IRC can create significant temporary or permanent differences that impact the current or deferred provision as well as the effective rate.
- **Permanent Differences**
  - State tax addback
  - Related party royalty and interest expense disallowance
- **Temporary Differences (& Deferred Tax Assets and Liabilities)**
  - Bonus depreciation
  - Interest expense limitations
- **Valuation Allowance**
  - A valuation allowance must be established for deferred tax assets when it is more likely than not that they will not be realized.

ASC 740

- A tax benefit from an uncertain tax position may be recognized in the financial statements only if it is more likely than not that the position is sustainable based upon the technical merits.
- **More likely than not means > 50%**
- Examples of Tax Positions
  - A decision not to file a tax return
  - An allocation or shift of income between jurisdictions
  - The characterization of income or a decision to exclude reporting taxable income in a tax return
- When evaluating the state tax implications resulting from federal tax reform (TCJA) and *Wayfair*, consideration has to be given to the technical merit of the positions taken.

ASC 740
State Hot Topics & Top Risk Areas

ASC 740 & Wayfair

Wayfair

Revisit positions taken in states regarding physical presence nexus and applicability of PL 86-272

Consider income tax nexus for affiliate members (including foreign affiliates and lack of treaty protection)

Analyze the impact on the tax provision and whether any new liabilities for uncertain tax positions need to be recorded, including potential retroactive application

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ASC 740 & TCJA

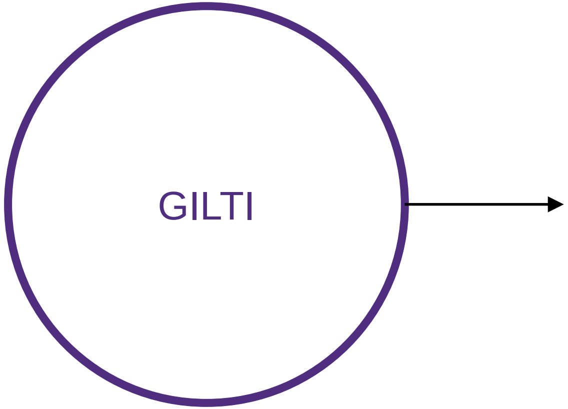
§965 and Repatriations

DRD provisions and the §965(c) exemption may not apply for state purposes and vary greatly from state to state

Consideration must be given to world-wide versus water's-edge, separate versus combined filing methodologies, and differences between federal and state previously taxed earnings and profits

Analyze impact on current rate, deferred taxes, and valuation allowances

ASC 740 & TCJA



Determine if and to what extent GILTI provisions are included in the state tax base

Consider inclusion of GILTI or CFC’s underlying factors in the taxpayer’s apportionment computation

Consider worldwide versus water’s-edge filing options and qualification for 80/20 company rules when determining combined group

Consider the impact on the state effective tax rate & impact on valuation allowances of effected taxpayers

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ASC 740 & TCJA

Full Expensing

Most states don’t conform to bonus depreciation and federal full expensing provisions

Differences may create significant deferred tax assets where one doesn’t exist for federal

Analyze the impact on the state effective tax rate, deferred tax assets, and valuation allowances

ASC 740 & TCJA

Interest Expense Limitations

State-specific related party addback rules may create state interest expense limitations even when one doesn't exist for federal

Significant adjustment may be required for states that do not conform to the IRC

Consideration should be given to the impact of separate versus consolidated filing methodologies on the interest expense limitation

Analyze the impact on the state effective rate, any deferred tax assets required to record state limitations, and impact on valuation allowances

ASC 740 & TCJA

Net Operating Losses

Careful consideration needed in this area due to substantial lack of conformity

Consider state-specific NOL attributes and state specific limitations

Consider state-specific valuation allowances given substantial decoupling from unlimited carryforwards

Analyze the impact on the deferred tax assets valuation allowances

ASC 450

ASC 450

- ASC 450 determines whether a potential loss must be
  - Accrued
  - Disclosed
- Pertains to *non-income tax* exposures, such as:
  - Sales/use taxes
  - Excise/gross receipts taxes
  - Abandoned or unclaimed property (escheat)
  - State income tax withholding paid on behalf of flow-through entity owners
  - Litigation liabilities
  - Property taxes

ASC 450

What is a **contingency**?

- An existing condition, situation or set of circumstances involving uncertainty as to possible gain or loss that will ultimately be resolved when one or more future events occur or fail to occur

What is **not** a contingency?

- Liability: Known obligation – does not implicate the provisions of ASC 450 as there is no uncertainty

ASC 450

- Under ASC 450, contingencies include such common uncertainties as:
  - Pending litigation (liability exposure)
  - Disputed tax obligations (costs of settlement)
  - Transaction taxes (e.g., nexus questions)

- Triggering events include:
  - Audit assessments
  - Appeals
  - Expiring statutes of limitations

ASC 450

- Company must:
  - Identify if a contingency under ASC 450 has occurred
  - Identify the period in which the underlying cause of action occurred
  - Assess the likelihood of an unfavorable outcome before accruing and/or reporting loss contingency

- Likelihood of an unfavorable outcome, and the ability to estimate the amount/range of the potential loss, determines accruing and reporting requirements

ASC 450

The likelihood of an unfavorable outcome of a loss contingency can be classified as either:

- **Probable**: The future event(s) are likely to occur
- **Reasonably Possible**: The chance of the future event(s) occurring is more than remote, but less than likely
- **Remote**: The chance of the future event(s) occurring is slight

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ASC 450

Probability standard:

- Higher threshold than "more likely than not"

- Means "likely to occur," but no specific guidance provided – generally considered a 65% to 75% chance of occurring

ASC 450

If an item is a "contingency", when is it booked?

The likelihood that the future event or events will confirm the incurrence of the liability can range from probable to remote:

Probable

Future event(s) are likely to occur (higher than more likely than not)

Reasonably Possible

Chance of the future event(s) occurring is more than remote, but less than probable

Remote

Chance of the future event(s) occurring is slight

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ASC 450

- A contingency must be **accrued** only if:
  - Its occurrence is **probable** (likely to occur at the date of the financial statements); **and**
  - The amount of the loss is reasonably **estimable**

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ASC 450

Under the current rules, an estimated loss from a loss contingency, such as a sales/use tax liability, shall be **disclosed** (but not booked) if **either** of the following conditions are met:

1. It is **probable** that the liability has been incurred at the date of the financial statements **and** the amount of the liability is **NOT** reasonably **estimable; or**

2. It is **reasonably possible** that the liability has been incurred at the date of the financial statements and the amount is **material** to the financial statements

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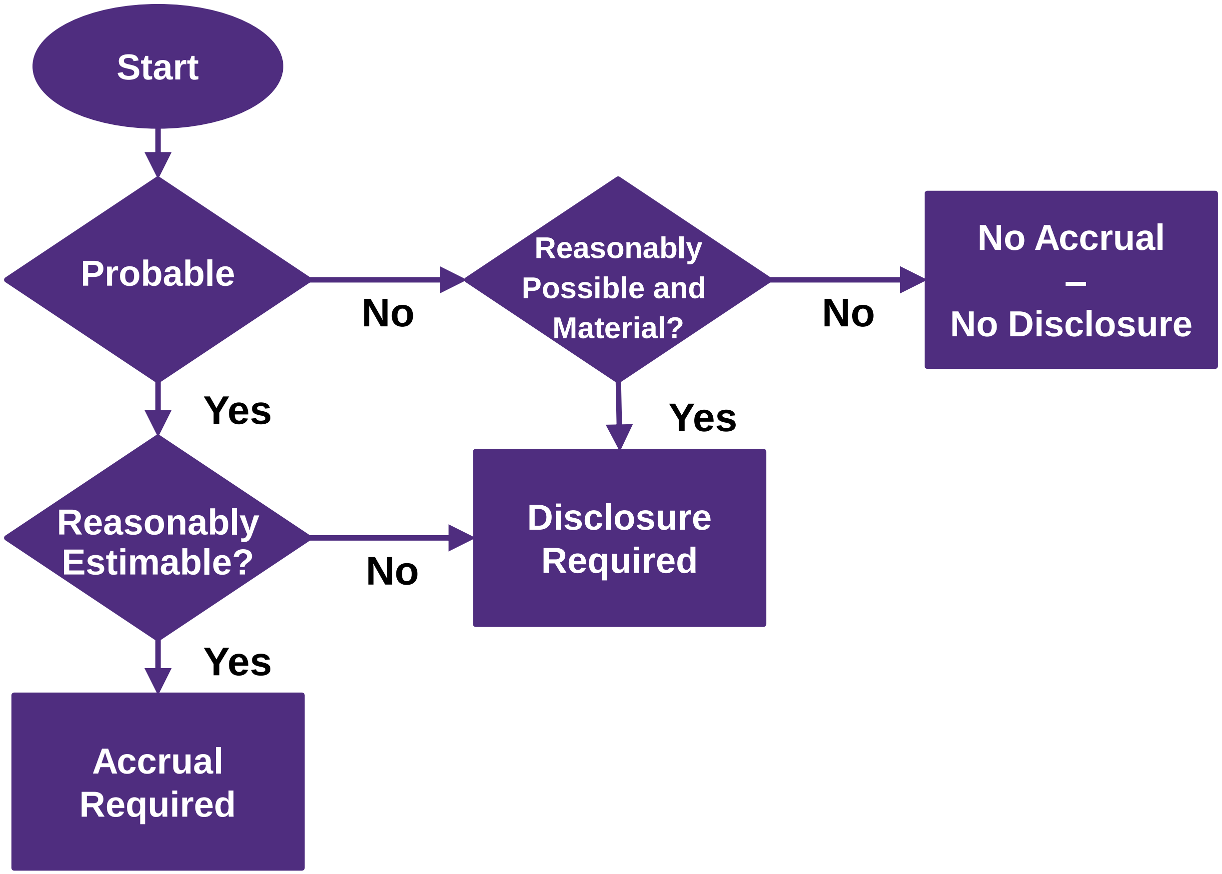
ASC 450

Unasserted claims only require disclosure when:

- Potential claimant manifests awareness of a possible claim; **or**
- Assertion of the claim is **probable**; **and**
- There is a **reasonable probability** that the outcome will be unfavorable

ASC 450 Decision Tree



ASC 450

Situations that may drive loss contingencies:

- Audits: in progress, significant audit assessments, appeals, litigation
- System errors
- Failure to obtain/maintain exemption certificates
- Inadequate tax decisions
- Non-filing/uncertain nexus positions
- Business expansion/acquisitions/dispositions
- Evolution of state tax laws (i.e., nexus, sourcing, product taxability)

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ASC 450 vs. ASC 740-10

What assumptions must be made regarding both the likelihood of an audit and the likelihood that all transactions will be reviewed?

- ASC 740-10 (formerly FIN 48) assumes that all entities will be audited and that auditor has same knowledge as the business ("all-knowing auditor standard")
- No explicit requirement in ASC 450 (formerly FAS 5)

Recognition Standards

ASC 450 Accrual	ASC 450 Disclosure	ASC 740-10 Recognition
Probable	Reasonably Possible	More Likely Than Not
65% to 75% chance of occurring	Greater likelihood than "remote," not as likely as "probable"	Greater than 50% likelihood

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Q&A

