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FIN 48 Delay Offers Small Cos. Breathing Room on Taxes

While private companies have longer to comply with FASB's new rule on uncertain tax positions, that doesn't change the balance sheet consequences.

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The Financial Accounting Standards Board has decided to allow small non-public companies and partnerships to put off compliance with FASB's disclosure rule on uncertain tax positions. Originally issued in June 2006, the rule, FIN 48, went into effect for public companies last December.

FASB's decision on Wednesday postpones FIN 48 implementation for entities like partnerships and S Corporations for about a year. (An S corporation is an Internal Revenue Service designation for private companies with less than 500 investors.)FASB's action has been issued as a staff position requiring a 30-day public comment period before it's issued.

Via its vote, FASB will allow small private companies and partnerships that start their fiscal years after December 15 to file FIN 48 disclosures and book attendant tax liabilities in 2008, when they file next year's financials. Before the board's decision, the companies would have been forced to comply by the end of this year. "For FASB to do this, it had to be overwhelmed with questions from practitioners and companies," thinks George Victor, a partner with accounting and advisory firm Holtz Rubenstein Reminick. "The deferral was not made on a whim,"

Indeed, FIN 48 has already caused a stir among public companies about the requirement that they disclose uncertain tax positions and record the related liabilities this year. Tax managers at those companies took issue with the idea that an accounting rule was affecting corporate tax planning and policy. They argued that, among other consequences, FIN 48 reveals proprietary tax strategies to the IRS, Congress, and competitors.

FIN 48 governs how companies should account for uncertain tax positions on their financials. The rule requires that corporations disclose how much they have kept in reserve to cover the possibility that the IRS or state tax officials might disallow certain tax treatment. Fed or state auditors, could, for instance, disallow a company's claim for credits and deductions, exclusion of revenue from taxable income, or the decision that a merger or other transaction can be considered tax-free. Companies must record the estimated reserve as a tax liability on their balance sheets.

Before FIN 48, companies kept estimates related to such reserves under wraps for fear of tipping off the IRS or their competitors about possible weaknesses in tax positions.

Although they will have a bit more time to prepare, private companies that adhere to generally accepted accounting principles will have to implement FIN 48 and face the same scrutiny and disclosure requirements as their public counterparts. And like public companies, they will now have to perform FIN 48 analyses even if their tax issues remain relatively straightforward. Thus, companies big and small will be spending time and money to test whether a tax position is "more likely than not" to be challenged by authorities and therefore deemed an uncertain position.

As a result, it's likely that smaller companies will be "whipsawed by the nexus problem," comments Steve Henley, a national tax practice leader at CBIZ, an accounting and financial consultancy. The nexus problem revolves around the tax principle that if a company creates a connection, or nexus, with a state or other jurisdiction, the business could be subject to the tax laws of the local authority.

Larger public companies that operate in a number of domestic and foreign markets usually deal with income tax nexus issues on a daily basis. However, Henley points out, smaller private companies may not be used to dealing with the consequences of establishing such a connection.

For instance, a company can usually sell or deliver products to another state without having to pay income tax in that state. But if a business has employees or facilities in a state (for instance, a sales representative) or accepts a credit application from an entity located in a different state, a nexus is established. Many smaller companies never bothered to test for nexus requirements because owners reckoned that it was unlikely that a connection had been established. But under FIN 48 they no longer have the option to skip the test.

Further, the statute of limitations on collecting back taxes doesn't start until a company files an income tax return in a state. So companies will be unable to use the statue of limitations as a shield. Although states usually only look back 10 years or less, repayment could include stiff interest payments and penalties, according to Henley.

FIN 48 could also spawn balance sheet problems, says Barry Nagler, a senior tax manager at Holtz Rubenstein Reminick. Public companies have already complained that the reserves they have to book as tax liabilities weigh down balance sheets and equity-related ratios and may reduce working capital.

Of cours, most larger companies have the liquidity and credit rating strength to compensate for the added liability. But that may not be the case with small private companies that can barely meet lender demands for particular asset-to-liability ratios. By recording the FIN 48 tax- reserve expense, some companies might find themselves in default of loan agreements, explains Nagler. Depending on the loan agreement, a company could be forced to ask its lender for a default waiver,

renegotiate the terms of the loan, or pay off the loan immediately, for example.

Companies in the construction industry that regularly require projects to be bonded may also experience FIN 48's sting. Bonding companies have strict requirements related to a company's mix of assets and liabilities, says Nagler.

"The deferral is good news for smaller companies" because it gives them time to work out their FIN 48 analyses and prepare for the balance sheet implications of the rule, says Henley. At same time, adds Victor, the deferral "is just postponing the inevitable."