

FIN 48*: A PRACTICAL APPROACH TO ADOPTION AND COMPLIANCE

Not-for-Profit Companies Must Begin Complying Now

**Although the launch of the Codification changed the authoritative reference of FIN 48 to Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 740, this article continues to use the more familiar terminology of FIN 48 throughout.*

Due to inconsistencies in both accounting treatment and financial statement disclosures over the past several years, the Financial Accounting Standards Board (FASB) adopted Interpretation 48 (FIN 48), Accounting for Uncertainty in Income Taxes, the standard by which entities must account for uncertain tax positions. Since 2006, all public companies and some non-public companies have been accounting for their uncertain tax positions under FIN 48.

Not-for-profit organizations—as well as calendar-year-end, non-public companies, including S-corporations, and partnerships—are required to adopt FIN 48, effective as of January 1, 2009, in their annual financial statements for the year ending December 31, 2009.

The goal of FIN 48 mirrors the intent of the new Internal Revenue Service (IRS) Form 990, *Return of Organization Exempt from Income Tax*—greater financial transparency between the organization and its donors, creditors, and other related or interested parties. FIN 48 applies to all 501 and 401 entities as well as those 403(b) retirement plans that now require an audit under new Department of Labor regulations.

A Brief Primer

FIN 48 provides guidance on recognizing, “derecognizing,” measuring, classifying, and disclosing the tax effects of uncertain

exemption under Internal Revenue Code (IRC) Sec. 501(c) (3) should take special care to substantiate their position as the IRS will examine this criteria very carefully.

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tax positions. A tax benefit may be reflected in an entity’s financial statements only if it is “more-likely-than-not” that the entity will be able to sustain the tax return position based on its technical merits. Assuming that the respective tax authorities (Federal, state, and foreign) have full knowledge of all known facts, the organization must be able to conclude that the applicable tax law, case law, and regulations provide enough supporting evidence that the tax position will be sustained at a more than 50 percent likelihood. If the tax position cannot meet the “more-likely-than-not” threshold, the entire tax benefit must be reserved as an uncertain tax position in the financial statements. A tax position is a filing position that an entity has taken or expects to take on its tax return. For tax-exempt organizations, exempt status and unrelated business income are two major tax positions that must be analyzed.

Exemption Itself as a Tax Position

It’s important to note that the tax-exempt status of an entity itself is an uncertain tax position. Entities that claim tax

When looking to “prove” whether your entity or organization is truly exempt, review the original, stated mission of the organization. Is the entity’s original charter truly reflected in the services you provide? In other words, “Are we doing what we said we would?” Do current activities match the information contained in the IRS Form 1023¹ or 1024²?

Providing services that may be outside of the entity’s original charter may result in taxable activity, such as providing management services to unrelated tax exempt organizations. In addition, any political activity or significant lobbying could invite further scrutiny. Both of these scenarios could potentially jeopardize an entity’s tax-exempt standing and should be carefully reviewed by you and your tax advisor.

Unrelated Business Income: Another Critical Area

The second major category of tax positions that must be considered is the inclusion or exclusion of unrelated

¹ Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.

² Application for Recognition of Exemption Under Section 501(a) for Determination under Section 120 of the Internal Revenue Code.

business income (UBI). UBI is of special concern as organizations struggling with tight budgets search for alternative revenue sources.

In determining what activities could possibly generate UBI, a good place for not-for-profit organizations to start is the Form 990, the Form 990-T, *Exempt Organization Business Income Tax Return*, if one was filed, as well as the current year's general ledger or chart of accounts, with a particular focus on "non operating or other income." Is there net income resulting from a particular activity or association? A thorough inventory of all previous tax positions should be taken as well as any prior tax rulings, audits, agreements, or contracts that are material to the categorization of this income.

For income to be taxable and therefore excluded from an entity's exempt function, it has to meet three fundamental requirements, according to the IRS:

- It is a trade or business
- Regularly carried on
- It is not substantially related to furthering the exempt purpose of the organization³

However, the UBI sections of the Code incorporate a number of modifications, exclusions, and exceptions to the general definition of "unrelated trade or business." Any tax position analysis will have to take into consideration the many statutory and regulatory exceptions as well as those exceptions and exclusions developed in court cases and private letter rulings. Looked at in its entirety, does it meet the more-likely-than-not threshold that the tax benefit will be sustained? Your accountant can provide valuable guidance.

Recommended Steps to Successful Adoption

The level of scrutiny that all organizations—both exempt and not-exempt—must comply with today is unprecedented. To maximize the success of your FIN 48 compliance effort, careful documentation and established processes and procedures are a must. Following are a few steps you should follow:

- **Communicate with key personnel:** An initial meeting between your chief financial officer, finance departments at multiple locations, if applicable, and external consultants (where financial and tax functions are outsourced) is essential. All parties must understand the technical requirements of FIN 48 in order to gather the information the organization requires to develop a process to properly assess any uncertain tax positions.

coordination with the financial reporting group. All organizations are required to disclose the total amount of interest and penalties recognized in the financial statements; the nature of uncertainties that could significantly change within 12 months; and a description of tax years that remain subject to examination by major jurisdictions. In addition, these very same footnotes must be included with the publicly available Form 990.

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- **Coordinate with the organization's external audit team:** Ensure timely and thorough communications with your external auditors. Specific points to cover include materiality, scope, and documentation; timing; and disclosures.
- **Materiality, scope, and documentation:** If the finance or accounting department require the assistance of outside tax-exempt specialists, the contract or other arrangement with these professionals should clearly document the agreed-upon scope and materiality while performing their review of uncertain tax positions. A memorandum that describes the processes the company performed when analyzing its overall tax positions will be required, including a list of source documentation and a final conclusion summarizing the review.
- **Timing:** Ideally, your FIN 48 implementation plan and documentation should be completed and reviewed by your auditor prior to the company's year-end. Trying to complete the documentation requirements of FIN 48 during the year-end close will inevitably cause timing issues both internally and with your external audit firm.
- **Disclosures:** Drafting the required financial statement footnote disclosures also necessitates

Watch for These High-Risk Areas of Concern

- **Alternative investments:** Due to an ever-increasing demand for higher rates of return on investments, tax-exempt organizations have turned to alternative investments including partnerships or limited liability companies. If the partnerships conduct trades or businesses or if borrowed funds are used to purchase investment assets, these investments could generate UBI. A thorough review of all partnership Form K-1s must be conducted. K-1s inform investors about such factors including income, loss, credit, and deductions. For example, if your K-1 includes ordinary business income on line 1, it is quite likely that you have unrelated trade or business income. You should find an explanation of the amounts reported on line 1 in box 20V, indicating whether and how much of the line 1 income is unrelated business income. However, if there is no information reported in Box 20 V, you may have to contact the partnership or LLC directly.

Your organization must also review all state tax implications with regard to gains and losses. A Federal K-1 reporting a \$100,000 loss might be comprised of a \$2.9 million gain in New York and a \$3 million loss in California, resulting in a substantial tax liability in New York.

³ Source: Internal Revenue Code.

■ **Foreign tax credits:**

Partnerships located in a foreign country may be subject to foreign taxes on any income earned. Your accountant can help you determine the appropriate tax rates and if any foreign taxes can be offset against other UBI.

■ **Nexus:**

State and foreign nexus issues have been one of the most significant exposure areas under FIN 48. Companies must examine both their domestic and foreign operations carefully and will need to perform a thorough analysis of property locations, rents paid, payroll and employee location, as well as fundraising activities and associated locales in order to conclude whether any uncertain tax positions exist.

If your organization has operations in other states or foreign countries in addition

to the “home” state, you must also determine if your exempt status is valid in these jurisdictions and, if there are deemed to be tax positions, whether you must file tax returns in each state.

J.H. Cohn Can Help

Not-for-profit organizations depend on their image and reputation to attract the continued support of donors, members, and other stakeholders. In today’s environment, the slightest doubt about the soundness of an organization’s internal controls or financial reporting can impact an organization’s mission. Income tax laws and regulations for not-for-profits are complex, and mistakes can result in penalties or, worse, loss of tax-exempt status.

As the largest independent accounting and consulting firm headquartered in the Northeast, J.H. Cohn’s Not-for-Profit Industry Practice is uniquely qualified to help not-for-profit organizations address

many of today’s complex challenges, including FIN 48. The Firm can assist you with all aspects of FIN 48 compliance, including monitoring the status of the tax positions you’ve taken and whether or not they’ve changed throughout the year.

Working together, you and your accountant can successfully work through the complex issues of FIN 48. Expect the unexpected and give yourself plenty of time to address its requirements. ■

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