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**Subject: FIN 48 and State and Local Taxes**

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To Our Clients and Friends:

The adoption of FASB Interpretation No. 48 ("FIN 48") has forced taxpayers to focus more closely on their state and local income tax filing positions. FIN 48 (which interprets FASB Statement No. 109) requires taxpayers to analyze their uncertain income tax filing positions and disclose certain potential tax liabilities on their financial statements. A taxpayer's FIN 48 workpapers generally describe in detail the taxpayer's most vulnerable filing positions, and highlight weaknesses in such filing positions.

FIN 48 disclosures and workpaper details may serve as a roadmap for tax authorities in a corporate tax audit. At a minimum, FIN 48 reserves mitigate a taxpayer's negotiating leverage with respect to the taxpayer's vulnerable tax filing positions. Moreover, with information sharing, FIN 48 information obtained through an audit inquiry may end up in the hands of multiple taxing jurisdictions.

In this regard, taxpayers are closely monitoring two federal cases (Textron and Regions Financial) that address whether company workpapers are within the purview of IRS scrutiny. While each taxpayer won at the district court level, the IRS has appealed both cases. It remains to be seen whether these cases will ultimately provide taxpayers with any protection against FIN 48 workpaper requests at the state and local level, especially since the cases are fact intensive and address years prior to the adoption of FIN 48.

Based on FIN 48, taxpayers must evaluate their state and local income tax filing positions annually and on a state-by-state basis. Common issues include modifications to federal taxable income, allocation and apportionment of income, the components of the apportionment formula, business/nonbusiness income classification, alternative filing methodologies (including consolidated returns and unitary combined reports), utilization of net operating losses, utilization of credits, intercompany transfer pricing, and utilization of tax planning vehicles such as intangible holding companies (which dovetails into issues such as business purpose, economic substance, economic nexus, affiliate nexus, and expense disallowance).

The issue that has garnered the most attention is whether a taxpayer has sufficient contacts in a particular taxing jurisdiction to permit the jurisdiction to impose an income tax filing requirement on the taxpayer. If a taxpayer with questionable nexus contacts in a taxing jurisdiction opts not to file there, some or all of the tax benefit may not be recognized on the financial statements. In this regard, the taxpayer may be required to accrue a FIN 48 reserve for the taxation of income in all nonfiling jurisdictions where potential nexus exists. Since the statute

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of limitations generally does not begin to run in a nonfiling situation, a FIN 48 nexus reserve, with interest and penalties, can result in a substantial liability. And as stated above, the nonfiling issue may be "red flagged" in the taxpayer's FIN 48 disclosures and workpapers.

One solution to alleviate a significant FIN 48 nexus reserve is the implementation of voluntary disclosure. Voluntary disclosure allows a taxpayer to approach a taxing jurisdiction anonymously through a representative. An agreement is negotiated with the taxing jurisdiction in which the taxpayer files returns (or provides return information) and pays back taxes for a limited number of years (typically the three or four most recent years), and timely pays taxes on a going forward basis. In return, the taxing jurisdiction agrees to waive unpaid taxes for years prior to those covered by the agreement, as well as all penalties that could be imposed. Interest on the taxes paid pursuant to the agreement is generally required, although in certain instances, interest can be waived by the taxing jurisdiction. Confidentiality is preserved during the voluntary disclosure process by not revealing the name of the taxpayer or any information that could identify the taxpayer until the voluntary disclosure agreement is finalized. In certain instances, voluntary disclosure can be initiated on a multijurisdictional basis.

If I can be of assistance with respect to a FIN 48 review of your company's uncertain income tax filing positions, including those related to nexus issues (and the potential resolution thereof through voluntary disclosure), please do not hesitate to contact me.

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