TeleStrategies
Communications
Taxation 2015

Calculating & Managing a Sales Tax Reserve

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Panel

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AGENDA

• Summary of ASC 450 Provisions
• Practical Applications/ASC 450
• Exercises
• ASC 450 Exposure Draft
• Establishing a Sales Tax Reserve
Sales Tax Reserves*
Booking a Liability Under Accounting Standards Codification (ASC) 450
(Formerly known as FAS 5)
An estimated loss from a loss contingency, such as a sales/use tax liability, shall be accrued by a charge to income (or capitalized to an asset) if both of the following conditions are met:

- It is probable that the liability has been incurred at the date of the financial statements and
- The amount of the liability is reasonably estimable

*These rules are also applicable to other non-income taxes such as gross receipts, VAT, property, premiums, duties, etc.
Sales Tax Reserves
Booking a Liability Under ASC 450

What is a “contingency”?

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.
Sales Tax Reserves
Booking a Liability Under ASC 450

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.

Examples: audits in progress, under-collection (system) errors, failure to obtain exemption certificates, non-filing/uncertain nexus positions, inadequate tax decisions

Liabilities: mistakes, known exposure that has no basis in law are liabilities and NOT ASC 450 contingencies as there is no “uncertainty”
Sales Tax Reserves
Booking a Liability Under ASC 450

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.

“Future events occur or fail to occur”

Triggering events: audit assessments, appeals, expiring statute of limitations
Sales Tax Reserves
Booking a Liability Under ASC 450

ASC 450 Exclusion for Business Acquisitions

- FAS 141R (FASB delayed issuance of new standard until 2009) sets forth its own rules for acquired companies, and removes “non income tax based contingencies” from ASC 450 (i.e., the “booked” items)
- FAS 141R does NOT impact the disclosure aspects of ASC 450
Sales Tax Reserves
Booking a Liability Under 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 or events are likely to occur (higher than more likely than not)

Reasonably Possible
The chance of the future event or events occurring is more than remote, but less than probable

Remote
The chance of the future event or events occurring is slight.
An estimated loss from a loss contingency, such as a sales/use tax liability, shall be disclosed (but not booked) if 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**

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
ASC 450 DECISION TREE

Start

Probable?

YES

Reasonably Estimable?

NO

NO

Reasonably Possible?

NO

NO

Disclosure Required

NO Accrual

No Disclosure

YES

Accrual Required
Practical Applications/ASC 450
**Establishing the Reserve/Subj ective Language**

Creates Unique Scenarios

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

- FIN 48 assumes that all entities will be audited and auditor has same knowledge as the business
- No explicit requirement in ASC 450
- Either approach can be supported

*Language: “Probability that a liability has been incurred and “Estimating” the amount
“Subjective” Language Creates Unique Scenarios:

Non-filing issues

- How are these identified?
  - Nexus determinations
  - Inherent system or process errors “non filed?”
“Subjective” Language Creates Unique Scenarios

Estimating the amount of the liability

- Tax only?
- What is the proper treatment of interest and penalties?
  - Is it probable?
  - Reasonably estimable?
  - What is audit history with particular states?
“Subjective” Language Creates Unique Scenarios:

Estimating the amount of the liability
Can reserves be established for upcoming audits based on historical audit experience?

- Audit frequency
- Audit results
- Have errors from past audits been corrected?
- Has the business changed—growth, mergers, liquidations, etc.
“Subjective” Language Creates Unique Scenarios:

Estimating the amount of the liability

- How do customer indemnifications impact the reserve?
  - What is the company policy on going back to the customer?
  - Is there any contractual language that could clarify?
  - What is the likelihood of the customer paying the tax?
Common ASC 450 Issues

1. How are “Probable” and “Reasonably Possible” defined?
   ◦ Probable = “Should Opinion” or 70%-80% Likelihood
   ◦ Reasonable Possible = 25% (Remote) - 70%

2. When can you book a receivable for a tax refund?
   ◦ Receipt of Cash/Credit or Letter from State Approving Refund.

3. Do we have to assume an audit / issue discovery or can we consider the “audit lottery”?
   ◦ We often advise clients to assume an audit and that all issues will be discovered. Reserves are booked as soon as it is determined that a loss is “Probable”.

4. What is the SOL for non-filing issues?
   ◦ Most accounting firms now advise clients to assume a SOL similar to a VDA 3 – 5 Years.
Common ASC 450 Issues

5. What is the proper treatment of interest and penalties?
   ◦ Accrued interest needs to be included in reserve.
   ◦ Penalties need to be included in reserve if “Probable” that they will be paid.

6. Can Reserves be established based on historical audit experience?
   ◦ Yes. Reserves can be established based on historical audit experience but are not required.

7. Can we consider customer indemnifications when establishing reserves?
   ◦ Indemnifications can be considered if it is “Probable” that collection will occur. Disclosure is appropriate if material
Common ASC 450 Issues

8. How does materiality factor into the analysis?
   ◦ Materiality is considered on a reporting entity basis. The materiality primarily impacts disclosure.

9. Should we look to FIN 48 for guidance on vague issues?
   ◦ We may look to FIN 48 for indirect guidance but FIN 48 is not directly applicable for non-income taxes.

10. What if State asks for our ASC 450 schedule?
    ◦ States can ask for ASC 450 work papers but historically have not requested this information. Prudent taxpayers will ensure that information is “Privileged” for material transactions
ASC 450 Exercises
**Issue - Differing Expert Opinions**

Shingle Inc. is planning to hire an attorney to handle its tax case. Shingle has obtained the following opinions from these attorneys:

- Attorney 1 – 10-20% chance of success
- Attorney 2 – 50-60% chance of success
- Attorney 3 – 70-80% chance of success

Shingle should:

A. Book a reserve
B. Disclose the potential liability if material
C. Hire Attorney 3 and not reserve or disclose
**Issue - Audit Risk**

Shingle has taken an aggressive yet supportable tax position. Shingle has never been audited and its statute of limitations is about to expire. If audited, an assessment and negative outcome is probable. Shingle should:

A. Not book a reserve or disclose  
B. Book a reserve  
C. Disclose the potential liability

**Related Issues:**

- How many years are open if no return was filed?  
- How are penalties treated?
**Issue - General Reserves**

Shingle has annually incurred tax liabilities of approximately $500,000 for each of the past 5 years. The errors giving rise to these audit liabilities are systematic in nature and have not yet been corrected. Shingle should:

A. Book a tax reserve
B. Not book a reserve but disclose
C. Not book a reserve or disclose
**Issue - Settlement Offers**

Shingle is litigating a $5 MM assessment. Shingle has not booked a reserve or disclosed this liability. To obtain closure Shingle has proposed a $1.0 MM settlement. The State has countered with a $3 MM offer. Both offers have been rejected. Shingle should:

a) Book a $1.0 MM tax reserve  
b) Not book a reserve but disclose the offers  
c) Not book a reserve or disclose

Related Issues:  
- What if a $5 MM reserve had originally been booked. Could the reserve be reduced to $3 MM?
Shingle is protesting an audit assessment. Counsel has opined that it is probable that Shingle will lose its appeal. Shingle has a tax indemnification provision in its customer contracts that it plans to invoke. Shingle should:

A. Book a tax reserve
B. Not book a reserve but disclose the facts
C. Not book a reserve or disclose
State Supreme Court determines Telecommunications equipment qualifies for a sales/use tax exemption as manufacturing equipment. Supreme Court remands case to ALJ to determine which equipment qualifies for the exemption. Telecom Co. has filed a $30M refund claim.

- Do you have a Gain Contingency? If so, do you book the $30M?
Gain Contingency Part II

After Supreme Court decision and prior to ALJ decision you re-submit a “scrubbed” refund claim of $20M. ALJ determines the equipment listed in your “scrubbed” refund claim qualifies for the exemption. The State Appeals and the Supreme Court accepts the appeal.

- Do you have a Gain Contingency? If so, can you book the 20M?
Gain Contingency Part III

Supreme Court rules the equipment contained in your “scrubbed” refund claim qualifies for the exemption. The State does not appeal.

b) Do you have a gain contingency?

c) What if the State wants to audit your “scrubbed” claim?

d) Auditor audits “scrubbed” claim and approves a refund of $18.5M but not the Commissioner of Revenue. Can you book this amount now?

c) State Commissioner of Revenue approves refund of $18M but wants to pay out over 5 years. How much can you book?

e) Can you book this amount after quarter close but before the financial statement is made public for the quarter (a subsequent event)?
ASC 450 Exposure Draft
Sales Tax Reserve
FASB Exposure Draft Changes for “Booked” items

• For “booked” liabilities, a tabular reconciliation must be prepared and updated quarterly (similar to FIN 48)

• Exposure draft does NOT impact the factors that determine whether to book a liability (i.e., probable and estimable); however, these principles are also being revisited by FASB
Sales Tax Reserve
Exposure Draft Changes for “Disclosure”

Disclosure would be required for any potential loss:

- Asserted claims: where the entity has determined that the likelihood of incurring the loss is more than “remote” (i.e., probable or reasonably possible)

- Unasserted claims: where a potential claimant has not asserted the claim, but
  - It is probable that a claim will be asserted; and
  - If asserted, the likelihood of the loss is more than remote

- Unclear whether and to what extent “detection risk” (concept used in FIN 48) must be considered
Sales Tax Reserve Disclosure Required

Quantitative analysis (an estimate) about the entity’s exposure:

- Either the amount of claim or assessment against the entity or
- Best estimate of maximum exposure
- If entity believes the assessment is not representative of actual exposure, a possible loss or range of loss may also be disclosed
- “Aggregation” is allowed by “nature of the loss contingency”
Sales Tax Reserve Disclosure Required

Qualitative information about the possible loss to enable users of the financial statements to understand the risks:

- Description of loss (how it arose, legal or contractual basis, current status, and timing of resolution)
- Description of factors likely to affect the outcome
- Assessment of the most likely outcome
Sales Tax Reserve Disclosure Required

Exemptions from Disclosing Prejudicial Information:

- If disclosure could affect, to an entity’s detriment, the outcome of the contingency, an entity may aggregate the disclosures at a level higher than by the nature of the contingency such that disclosure is not prejudicial;
- In these instances, entity may only forego disclosing the information that is prejudicial, but must disclose all other required information related to the contingency
- Proposal does not allow an entity to forego disclosure
Sales Tax Reserve

FASB Exposure Draft

- Comment period ended August 8, 2008
- Originally proposed effective date for tax years ending after 12/15/08
- PwC Comments
- Delayed at least one year
Upfront Planning/Considerations

Identify what is important to the company

- Accuracy (no surprises)
- Budgeting
- Timing (monthly accrual, annual, upon audit)

Political concerns

- Decentralized process
- Impact on bonuses/budgets
- Importance of “buy in”
Identifying Risk Areas

- Sales Tax Collection
- Use Tax
- Frequency of Law Changes in client’s states/industry
- Nexus
Identifying Risk Areas

Sales Tax Collection

- System Limitations
- Exemption Certificates
  - failure to obtain required certificates or documentation
- Taxability or Exemption Changes

Exemption Certificate
Identifying Risk Areas

Use Tax

- Accuracy of Accrual Process
- Direct Pay Permits
- Inventory Withdrawals
- Manufacturing Exemptions
- Jurisdictional Transfers/Asset Movement/Intercompany
Identifying Risk Areas

Frequency of Law Changes

• Rates
• Exemptions
• Availability of guidance and relevant authority
Identifying Risk Areas

Nexus

• Changes in operations
  - Review frequently
• Business acquisitions
  - Pre and post due diligence
• Successor Liability
  - Applies to stock and asset transactions
Reducing Risk Areas

- Voluntary Disclosure Agreements
- Managed Compliance Agreements
- Amnesty Programs
- Remediation of known issues
  - Audit History
  - Legacy knowledge
Methodologies

Audit History
- Specific dollar amounts
- Error percentage

Self Audit/STAR
- System tests
- Process tests

Issue by issue

Combination
**Calculations**

Analyze audit history by state

- Nature of errors
- Recurring
- Unique issues per state
- Multistate issues
- Frequency of audits

Focus on material states issues
Documentation

- Keep sales and use taxes separate
- Segregate by jurisdiction
- Calculate tax, interest and penalty
Releasing Tax Reserves

Reserves should be released when the liability or contingency has been cleared

- Payment of liability
- Audit finalized
- Statute closed
- New relevant information
Thank you...