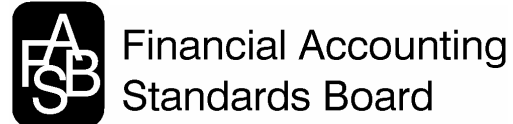


## MINUTES



**To:** Board Members

**From:** Short-Term Convergence—Income Tax Team (Gagon, Ext. 322)

**Subject:** Minutes of the July 27, 2004 Board Meeting                      **Date:** August 2, 2004

**cc:** Bielstein, Smith, Petrone, Leisenring, FASB Project Team, IASB Project Team, Mahoney, Thompson, Vincent, Sutay, Gabriele, Swift, Polley, Posta, FASB Intranet (e-mail)

Topic: Recognition of Tax Benefits

Basis for Discussion: Board memorandum 5 (Proposed FSP FAS 109-a) dated July 16, 2004

Length of Discussion: 11:10 a.m. to 12:20 p.m. (EST)

Attendance:

Board members present:	Herz, Trott, Schipper, Batavick, Crooch, Seidman, and Schieneman
Board members absent:	None
Staff in charge of topic:	Thomas
Other staff at Board table:	Smith, Cassel, Golden, Gagon
Outside participants:	Leisenring (IASB), Bugg (IASB staff, by phone)

**Summary of Decisions Reached:**

The Board discussed several issues relating to (1) the recognition and measurement of tax benefits (including those related to uncertain tax positions), (2) the subsequent accounting for those benefits, (3) classification and disclosure of those benefits in financial statements, (4) interim reporting considerations, and (5) effective date and transition requirements.

The Board made the following decisions at this meeting:

1. Require a *probable* level of confidence before reflecting a tax benefit in an entity's financial statements. *Probable* is meant to have the same meaning as used in FASB Statement No. 5, *Accounting for Contingencies*.
2. The amount of liability recorded, if any, reflecting the difference between the "as filed" tax basis and the tax basis meeting the probable level of confidence should not be recorded as a deferred tax liability, but should be recorded as a current liability in the financial statements.
3. Constituents should refer to paragraph 17 of Statement 5 for disclosure requirements associated with any recognized liabilities.
4. Recognition of a tax benefit should occur when the *probable* threshold is met and derecognition should occur when the *probable* threshold is no longer met.
5. The staff should discuss the accounting for interest and penalties with the IASB to determine if any convergence issues exist.
6. Changes in judgment about realizability of a tax benefit should be recognized in the current interim period and not be spread over future interim periods.

The Board also considered whether to direct the staff to issue a proposed FSP concerning those issues but decided instead to add a project to its agenda and directed the staff to prepare a proposed Interpretation, which gives the Board the opportunity to include a basis for conclusions section. The Board decided that the comment period for the proposed Interpretation should be 60 days. Furthermore, the Board decided that an entity should recognize the cumulative

effect of initially applying the proposed Interpretation as a change in accounting principle with a cumulative-effect adjustment in the statement of operations. The Board directed the staff to further research issues related to the effective date.

**Objective of Meeting:**

The objective of the meeting was for the Board to determine the proper accounting for (1) the recognition and measurement of tax benefits (including those related to uncertain tax positions), (2) the subsequent accounting for those benefits, (3) classification and disclosure requirements of those benefits in financial statements, and (4) related interim reporting considerations. The objective of the meeting was met.

**Matters Discussed and Decisions Reached:**

The following paragraphs contain a brief background of the issues as discussed at the Board meeting and any decisions made by the Board concerning those issues.

**Background**

Mr. Thomas began the meeting by providing the background to the recognition of tax benefits (including those related to uncertain tax positions) in financial statements. He stated that while the issues being presented to the Board were raised in the context of tax advantaged transactions or uncertain tax positions; the staff believes that the guidance promulgated by the Board should apply equally to all deferred tax assets or benefits.

Mr. Thomas stated that uncertain tax positions can arise from so-called “tax-advantaged transactions,” aggressive filing positions, clerical errors, or other more routine vagaries of tax law. Furthermore, tax benefits may arise as a result of (1) initial recognition of a deductible temporary difference or reduction in a taxable temporary difference or (2) recognition of an income tax receivable or a

reduction in income taxes currently payable with no corresponding deferred tax liability.

Mr. Thomas said that the staff does not intend to ask the Board to promulgate guidance on what level of confidence financial statement issuers must meet to recognize positions in tax returns. Rather, the staff intends for the Board to promulgate guidance on the level of confidence of tax positions in tax returns that are required in order to qualify as temporary differences for financial reporting purposes.

### **Initial Recognition Criteria**

Mr. Thomas stated that the staff recommends that deferred tax assets continue to be evaluated using an impairment approach. He also stated that the staff recommends that the FASB promulgate guidance which requires that tax benefits be recognized based on tax positions in tax returns that are probable of being sustained on audit. Mr. Golden clarified that probable in this sense is meant to have the same meaning as probable in paragraph 17 of Statement 5.

Ms. Seidman stated that some preparers are recognizing tax benefits in the financial statements from a “should” level tax opinion; she asked if there is any relationship between a “should” level tax opinion and “probable” level of GAAP. Mr. Thomas said that it is the staff’s understanding that those two levels approximate one another. Mr. Golden stated that the staff has spoken with the Public Company Accounting Oversight Board (PCAOB) and the thought is that the FASB could promulgate accounting guidance for tax benefits, but that the level of evidence or required tax opinion level would be left to the PCAOB as an audit issue.

Mr. Trott stated that he believes that this issue is incorporating into an on/off switch uncertainty as to whether a tax position or tax basis is correct or not, so he believes that a Statement 5 probable threshold is appropriate. He stated that he believes it would be more practical to state that probable is the appropriate recognition threshold but that probable is meant to be a similar level as a

“should” level tax opinion. He believes by stating that these two terms are meant to have similar meanings, there would be communication between the two parties (financial and tax accountants), and how to apply guidance would be more clear. He supports having a threshold and supports probable as being that threshold.

Ms. Schipper asked if the “should” opinion is sufficient or is necessary. Mr. Golden stated that if the literature discussed an unqualified “should” level opinion, a “should” opinion would be sufficient but it may not be necessary because the scope of this is dealing with all tax benefits. Some tax benefits are explicitly allowed under current tax law, and he believes it would not be appropriate to require a “should” level opinion for positions explicitly allowed by tax law before they can be recognized in the financial statements.

Ms. Schipper stated that a “should” opinion should only be discussed in the basis for conclusions. However, she would not suggest that the FASB say that a “should” opinion is equal to the probable threshold.

All members agreed with the staff’s recommendation that Statement 5 probable should be used as a recognition threshold for recognizing tax benefits in the financial statements.

### **Classification**

Mr. Thomas stated that the question of classification is being addressed in the context of tax benefits that have been recognized in a tax return and do not meet a level of confidence consistent with Statement 5 probable. The question is therefore how to classify the liabilities recognized pursuant to this guidance related to so-called aggressive filing positions. Mr. Thomas stated that the staff does not believe these amounts should be recorded as deferred tax liabilities, because the amount is more accurately described as an inappropriate deduction and receipt of cash and, therefore, is not a deferred tax liability. The staff recommended that the amount be recognized as a regular tax liability that is classified as a current liability.

The Board unanimously agreed with the staff that these liabilities are not deferred tax liabilities. However, some Board members expressed concern in classifying the liability as a current liability. Mr. Batavick stated that these types of issues take years to resolve, which would not cause a draw on current assets. Therefore, he is concerned with booking these liabilities as current if they may in fact be resolved a few years in the future. He believes companies should be allowed to decide if these liabilities will be resolved in the near or long term and classify the liability accordingly.

Mr. Trott stated that there are two things to consider when classifying a liability as current. First, whether or not the liability arose as part of a normal business cycle, or second, that the liability will be due within twelve months. He stated that he believed taxes arise because of the normal business cycle of an entity and should, therefore, be classified as a current liability. Additionally, he stated that if an entity had a scheduled payment with the taxing authorities, then an entity would be able to determine if it is current or noncurrent; however, without a scheduled payment, these liabilities could come due at any time.

Mr. Herz stated that he is hesitant on calling these current liabilities simply because they fail to meet the threshold for asset recognition. He agrees with Mr. Batavick and would leave judgment to the entity to determine if the liability is current or noncurrent.

Ms. Schipper stated that it is only because of limits on a revenue agent and its schedule that an entity is able to forebear paying the liability. If revenue agents weren't limited, it is likely that these liabilities would be settled in the current period. These liabilities could be recorded like a "due-on-demand note." Ms. Schipper stated that she agreed with the staff's recommendation that these liabilities should be recorded as current liabilities.

Ms. Seidman pointed out that Chapter 3 of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, (paragraph 7) states:

The term *current liabilities* is used principally to designate obligations...and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries ...and income and other taxes.

The Board decided to record these as regular liabilities and to classify them as current in the financial statements.

### **Disclosure**

Mr. Thomas stated that the staff believes there are two disclosure issues—both relating to the disclosure of potential future benefits as a result of aggressive filing positions in past returns. First, the disclosure of the amount of the recorded liability for an aggressive filing position. Second, the disclosure of the unrecorded deferred tax asset since the asset did not meet the required confidence level to be recorded. Given that a future benefit may result from a prior transaction, the staff recommends that financial statement users be provided with the information.

The Board generally disagreed with the staff's recommendation concerning disclosures. The Board believes that there is no need for disclosure since a current liability has already been recognized in the financial statements. The Board believes that the current liability arises because the threshold for asset recognition has not been met; if the threshold is subsequently met, an asset will be recognized in the financial statements. Therefore, the Board believes these current liabilities should be reported in a similar manner as gain contingencies in Statement 5 and would direct entities to look to Statement 5 for guidance on the requisite disclosures associated with these transactions.

### **Subsequent Recognition**

Mr. Thomas stated that when an issuer concludes that a tax benefit does not qualify for initial recognition, the question arises of when and how to subsequently recognize the tax benefit. Additionally, if an asset was initially

recognized and subsequent events indicate the asset is not realizable, the question arises of how to impair or derecognize the asset. The staff recommended that tax benefits be recognized at any time in which the recognition threshold is met and derecognized when the threshold is no longer met.

Mr. Thomas stated further that there are two views concerning this issue. The first view is the one that the staff recommends. The second view is that once tax benefits have been booked as assets, then they should only be impaired when it becomes probable that they will no longer be realized. The second approach is more akin to the impairment approach under Statement 5.

Mr. Herz asked how valuation allowances play into this issue. Mr. Thomas responded by stating that a valuation allowance is used to reduce a legitimate tax asset when it becomes more likely than not that an entity will not have sufficient taxable income in the future to realize the asset. This issue addresses whether or not a legitimate asset exists in the first place.

Mr. Cassel pointed out that one of the issues, at least historically, the Board has had to address is that small changes in confidence levels can introduce a level of volatility in financial reporting that is unacceptable. The Board may have to address this issue again if it chooses to adopt the staff's recommendation and use probability as an on/off switch for recognition and derecognition.

The Board accepted the staff's recommendation to recognize assets when a probable threshold has been met and to derecognize the assets when that threshold is no longer met. The Board believes this is a more symmetrical answer than recognizing an asset and then derecognizing the asset when it becomes probable that the asset will not be realized (Statement 5 approach).

### **Interest and Penalties**

Mr. Thomas stated that the staff believes that interest is more properly classified as a financing cost of an entity and recommended that interest on additional tax

liabilities should be classified as interest expense in the statement of operations. Furthermore, he stated that the staff does not believe that detailed guidance concerning penalties is necessary and that any reasonable allocation method, applied consistently, would be acceptable.

The Board generally agreed with the staff recommendation; however, the Board directed the staff to talk with the IASB to determine if there are any convergence issues. If any convergence issues exist, the FASB and IASB should jointly address those issues. However, if no convergence issues exist concerning interest and penalties, the Board believes the FASB does not need to address this issue further.

### **Interim Reporting**

Mr. Thomas stated that consistent with paragraph 194 of FASB Statement No. 109, *Accounting for Income Taxes*, the staff does not believe that it is appropriate to spread the effect of changes in judgments—that, by definition, occur at a discrete point during the year—over future interim periods.

The Board unanimously agreed with the staff's recommendation and believes that GAAP is already clear on this issue. Therefore, the GAAP guidance can be reiterated, but the Board does not believe anything new needs to be addressed.

### **Form of Guidance**

Mr. Thomas indicated that the staff had proposed to issue a Board-directed FSP; however, it has become clear that this is not the preferable form of guidance for these issues.

The Board decided to elevate these issues to an Interpretation due to the magnitude and prominence of the issues. Furthermore, an Interpretation can have a basis for conclusions that will allow the Board to delineate its thinking concerning these issues.

### **Effective Date and Transition**

The Board decided that the Interpretation should have a comment period of 60 days. Furthermore, the Board decided that an entity should recognize the cumulative effect of initially applying the proposed Interpretation as a change in accounting principle with a cumulative-effect adjustment in the statement of operations.

The Board discussed making the Interpretation effective for either fiscal years beginning after January 2005 or periods ending on or after March 31, 2005. It was unclear the amount of time that would be feasible for entities to make the necessary changes. Therefore, the staff was directed to perform additional research on issues related to the effective date and transition requirements and discuss that research with the Board at a later date.

**Follow-up Items:**

The staff was directed to perform additional research on issues related to the effective date and transition requirements and discuss that research with the Board at a later date.

**General Announcements:**

None