



## ***Uncertain Tax Positions***

### ***Summary of Comment Letter Analysis<sup>1</sup>***

#### **INTRODUCTION**

1. This memorandum summarizes the 116 comment letters received in response to the July 2005 FASB Exposure Draft, *Accounting for Uncertain Tax Positions, an Interpretation of FASB Statement No. 109*. The staff analyzed all comment letters received by September 23, 2005.
2. Many of the letters addressed all 11 issues identified in the *Notice for Recipients* section of the Exposure Draft (ED). However, some letters only addressed certain issues. When a comment letter did not specifically address an issue, we did not presume that the letter's silence on certain items was implicit support. This summary focuses on comments received related to each of the 11 issues identified in the *Notice for Recipients* section of the ED. The breakdown of those letters by category is as follows:

<b>Category</b>	<b>Number of Letters</b>
Academics	2
Accounting and Tax	14
Advocacy Groups	19
Big 4 firms	4
Financial Institutions	23
Other	4
Preparers	50
<b>TOTAL</b>	<b>116</b>

#### **ISSUES OF MOST CONCERN**

3. Most respondents were concerned with:
  - a. Use of a dual threshold
  - b. Use of probable as the recognition threshold

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<sup>1</sup>The staff prepared this comment letter summary to facilitate constituent's understanding of the issues provided by respondents to a particular Exposure Draft. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

- c. Nexus issues
- d. Unit of account
- e. Use of best estimate for measurement
- f. Effective date.

## **ISSUE ANALYSIS**

4. The following sections summarize the comments for each major issue.

### **Scope**

*This proposed Interpretation would broadly apply to all tax positions accounted for in accordance with FASB Statement No. 109, Accounting for Income Taxes, including tax positions that pertain to assets and liabilities acquired in business combinations. It would apply to tax positions taken in tax returns previously filed as well as positions anticipated to be taken in future tax returns.*

### **Agree with Proposal**

5. Most respondents to this issue agreed with the scope provisions of the proposed Interpretation, noting that all tax positions should be accounted for in a consistent manner. Some respondents who agreed asked for clarification of the term *uncertain tax positions (UTPs)* and/or suggested renaming the ED to eliminate confusion regarding to which tax positions it applies.

### **Disagree with Proposal**

6. Some respondents disagreed with the scope of the proposed Interpretation. Respondents expressed concern that the ED was too broad to practically apply. Some of the respondents who disagreed with the scope of the ED suggested that there are normal business transactions, including timing differences, which may require onerous documentation and expense to demonstrate they had met a *probable* standard. Respondents questioned whether that exercise would provide any useful financial information for users.
7. Respondents suggested that normal business transactions be excluded from the scope of the ED such that only tax positions that are truly uncertain would fall under this guidance.

Respondents expressed a desire for the ED to only apply to tax shelters, aggressive positions, and listed transactions. Alternatively, some respondents suggested the scope be limited to only material positions or permanent differences. One respondent wanted an explicit statement that making an election is a tax position (that is, making the S Corp election).

8. Some respondents also wanted a scope exception for sales and usage taxes, and other state or local taxes not based on income. The requests were made despite the fact that Statement 109 explicitly states that it only applies to taxes based on income, and the FASB has previously held that gross receipts taxes (in Washington and Ohio) are outside the scope of Statement 109.

### **Initial Recognition**

*This proposed Interpretation would allow recognition of the financial statement effects of a tax position when that position is probable of being sustained on audit by taxing authorities based solely on the technical merits of the position.*

9. Issue 2 of the ED addresses the Board's conclusion that an entity should presume a taxing authority will evaluate a tax position. Issue 3 addresses the dual threshold approach and the confidence level required for recognition. In addition to Issues 2 and 3, respondents raised the following sub-issues related to initial recognition: (a) relying solely on the technical merits, (b) nexus, and (c) unit of account.

### **Agree with Issue 2**

10. Most of the respondents on this issue agreed that the recognition threshold should presume that a taxing authority will evaluate an UTP. Many of the respondents reasoned that considering detection risk is fundamentally inconsistent with our self-assessing tax system, and the possibility that a position will not be audited is not relevant in determining if it is sustainable upon audit.
11. One respondent asked the Board to state that the taxing authority will know all of the relevant facts and take its most advantageous position in the basis for conclusions. Because the IRS

does not have the final say in a tax dispute, another respondent urged the Board to replace the phrase “upon audit” with something that better reflects the resolution process.

### **Disagree with Issue 2**

12. Some respondents disagreed with the presumption that a tax authority will evaluate an UTP. Several respondents felt that this was an unrealistic assumption to make that would prevent entities from recognizing the benefits of certain tax positions. The respondents asserted that the entity’s true financial position would be unknown to users because the income tax liability would not represent management’s best estimate. Other respondents thought that detection risk should only be presumed for material or aggressive positions, while some disagreed because of the nexus issues that would be raised.

### **Agree with Issue 3**

13. A minority of respondents agreed with the use of dual threshold for recognition. One respondent (KPMG) felt that a “dual threshold approach appropriately addresses the operational difficulty under a single threshold approach which would require an entity to initially determine, and thereafter monitor, with a necessarily high level of precision whether a position is probable of being sustained.”
14. Several respondents agreed that *probable* should be the recognition threshold. Respondents stated that probable established a sufficiently high level of confidence to be consistent with the benefit recognition approach. Additionally, one of the Big 4 firms (KPMG) asserted that, “Many entities currently use a probable threshold in accounting for the tax effects of certain transactions and those entities have been able to operationalize such policies.”

### **Disagree with Issue 3 Proposal**

15. A large majority of respondents disagreed with the use of a dual threshold for recognition. Many of these respondents thought that a dual threshold would cause a lack of consistency between periods and a lack of comparability across entities. These respondents generally favored the use of a single threshold at a lower confidence level. Several of these respondents stated that a dual threshold was too complex to apply, and some stated that

financial statements would lack transparency under a dual threshold approach. In regards to the Board's assertion that a dual threshold would decrease income volatility for those positions close to the recognition threshold, several respondents disagreed by stating that UTPs have such a slow pace of resolution that changes to the probability of sustainability occur infrequently. Some respondents even thought a dual threshold would increase volatility.

16. Almost all respondents disagreed with the proposed recognition threshold of probable. These respondents believed that a probable threshold would cause the income tax liability to be systematically overstated. When the UTPs are ultimately resolved, the over-accrued liability will be reversed, causing volatile swings in income. Some felt that the probable threshold would be inconsistently applied and would therefore cause a lack of comparability between entities. Others argued that the cost of obtaining sufficient evidence to meet the probable threshold would be greater than the benefit of doing so. Several argued that because the threshold was so high, the benefit that many UTPs will provide to entities will not be reflected until resolution; this in turn will cause financial statements in the interim to not be representationally faithful. A majority of the respondents who disagreed with a probable threshold preferred a recognition threshold of more likely than not, while others preferred a lower threshold, such as substantial authority.

#### **Technical Merits**

17. Some respondents felt that management should consider all of the facts and circumstances related to a position, not just its technical merits. By disregarding management's experience with the taxing authorities and the administrative practices of taxing authorities, these respondents asserted that the financial statements will not purport the company's true financial position. Other respondents asserted that negotiations with the IRS are not necessarily decided only on the technical merits of the position. Recognition and measurement should take into account a taxpayer's willingness to settle and the collective bargaining with taxing authorities on a number of issues.

#### **Nexus**

18. Many respondents raised the nexus issue in their comment letters. When an entity determines that it does not have nexus in a jurisdiction, it will not file a return. These respondents were concerned that an entity's income tax liability would always be overstated if the entity were not able to reach the probable threshold for its nexus position. Because the statute of limitations never expires on an unfiled tax return, a company would maintain an indefinite accrual.
19. Many of these respondents felt that the nexus issue would be resolved if the recognition threshold were more likely than not, while some felt that a loss contingency approach on an unasserted claim would be appropriate for this issue. One constituent argued that this is a good example of why an entity should be able to rely on more than just the technical merits of a position; the constituent asserted that after a certain length of time, professional judgment says the position is probable of being sustained.

#### **Unit of Account**

20. Many respondents asked for more guidance on determining the unit of account. Some felt that the Board needed to clarify whether the approach taken for determining the unit of account in the examples was for illustrative purposes; recommended or required. There were differing views on what the proper unit of account should be, ranging from each dollar in a position to aggregating similar positions. Some respondents favored using an approach that would be consistent with how their UTPs would be documented, supported, and analyzed in a review by the taxing authorities. A few wanted additional examples that discussed higher levels of aggregation to reduce the burden of documenting at a lower level. Finally, one public accounting firm suggested that the examples clarify why the unit of account selected in the example was the appropriate level under that fact pattern.

#### **Subsequent Recognition**

*This proposed Interpretation would allow for the recognition of tax benefits even if the probable recognition threshold is not initially met. Recognition of the benefit of a tax position shall occur in the interim period that (a) the probable recognition threshold is subsequently met, (b) the tax*

*matter is ultimately resolved through negotiation or litigation with the tax authority, or (c) the statute of limitations for the relevant taxing authority to examine the tax position has expired.*

### **Agree with Proposal**

21. Most respondents supported the recognition of tax benefits when the recognition threshold is subsequently met. These respondents had mixed views on whether a triggering event should be necessary for subsequent recognition. One respondent (PwC) stated that:

Although we do not believe that, in all cases, an identifiable triggering event is necessary, we believe that the Board should acknowledge, in paragraph B22, that a change in judgment regarding the technical merits of a position will result, more often than not, from a specific event rather than from a gradual shift in judgment from reassessing the relevant facts and circumstances.

### **Disagree with Proposal**

22. A few respondents did not agree with the Board's position regarding subsequent recognition. These respondents felt that the evidence supporting a change in judgment should be objectively verifiable and that a triggering event was normally required to subsequently recognize a tax benefit. A respondent (Keyspan) stated that:

A change in a tax position resulting from a subsequent judgment require clear and convincing evidence that the situation has significantly changed in a manner that would indicate a revision is both necessary and appropriate. Normally, but not always, this should require an external event such as a meaningful and relevant change in the prevailing tax authorities, expiration of the statute of limitations, or a settlement of a tax examination.

### **Derecognition**

*This proposed Interpretation would result in a previously recognized benefit from a tax position that no longer meets the probable recognition threshold being derecognized by recording an income tax liability or reducing a deferred tax asset in the period in which it becomes more likely than not that the tax position would not be sustained on audit.*

23. Some respondents suggested that FASB Statement No. 5, *Accounting for Contingencies*, paragraph 39 be amended to refer to property or sales taxes, rather than income taxes. These respondents preferred that the proposed Interpretation stand on its own and be the single source of accounting guidance for UTPs. These respondents asserted that amending Statement 5 would eliminate any confusion that may linger.

#### **Agree with Proposal**

24. Most respondents who commented on this issue agreed with the derecognition threshold. Many of these respondents favored a single recognition derecognition threshold at more likely than not; however, if the Board keeps probable as the recognition threshold, these respondents prefer a derecognition threshold at more likely than not for the reasons stated in the proposed Interpretation.

#### **Disagree with Proposal**

25. Some respondents disagreed with the Board's conclusions on derecognition. Of those, several preferred to use a valuation allowance as a substitute for derecognition. Others favored accounting for changes in the level of confidence through measurement rather than derecognition. A few favored the Statement 5 probable loss threshold, while one preferred a single threshold at probable. One of the Big 4 firms (PwC), while supporting a single more-likely-than-not threshold, asserted that a probable loss threshold should be used if the Board maintains probable as the recognition threshold. This firm reasoned that if a benefit required such a high level of confidence to be capitalized, a liability should not be accrued unless the associated loss was also at such a high level of confidence.

#### **Measurement**

26. Paragraph 11 of the proposed Interpretation states:

An enterprise shall measure the amount of benefit recognized for a tax position that meets the probable recognition threshold as the best estimate of the amount that is probable of being sustained upon audit by the taxing authority, including final resolution of any related litigation or appeals process...the term *best estimate* means the single most-likely amount in a range of possible estimated amounts.

27. Several respondents were confused by the wording in paragraph 11 and wanted a reconciliation of the terms *probable* and *possible*. These respondents wanted the Board to clarify whether the best estimate is the "mode of all outcomes," "the mode of outcomes that are probable of occurring," or some other number. The scenario from Ernst & Young's comment letter typifies the concern:

Assume Company A reports a \$100 charitable deduction for a donated work of art in its 20X0 tax return and it is probable a charitable deduction will be sustained. However, due to subjectivity in the determination of the fair value of the donated work of art, the following outcomes are present:

	Amount	Likelihood of Sustaining Deduction	Cumulative Probability of Sustaining Amount*
Substantial authority	\$100	35%	35%
(as filed deduction)	90	20%	55%
	75	15%	70%
	65	10%	80%
	55	20%	100%

\* Likelihood a deduction of at least that amount will be sustained

While \$100 is the most-likely amount in the range of possible outcomes (i.e., the mode of possible outcomes), the largest deduction that meets the minimum level of confidence to denote probable of occurring is \$75 (assuming Company A concludes 70% is an appropriate measure of probable) or \$65 (if Company A concludes 80% is the appropriate measure of probable). Noteworthy is that the most-likely amount in the range of probable outcomes in this fact pattern is the \$55 minimum deduction (in all cases a deduction of \$55 will prevail). As written, the Exposure Draft would indicate either \$100 (single most-likely amount in the range of possible estimated amounts) or \$75 (the probable amount).

28. Another respondent was confused about what the Board's intent would be in the following situation. The respondent asserted that sometimes the best estimate equals 100 percent of the benefit even when the probability of success is less than 100 percent. If there is a greater than 80 percent chance of prevailing, this constituent asserted that a taxing authority will usually concede 100 percent of the benefit to the entity. If there is less than a 20 percent chance of prevailing, the taxing authority will not concede any benefit.

**Agree with Proposal**

29. About half of the respondents on this issue agreed with the Board's view on measurement. Some of these respondents were concerned that the financial statements may become misleading if there is a wide dispersion of outcomes, each with a low probability. Others actually preferred an undiscounted expected value; however, these respondents understood the constraints of Statement 109 and supported best estimate.

#### **Disagree with Proposal**

30. A slight majority of respondents to this issue disagreed with the use of best estimate. Of these, a minority preferred an expected value approach. Some respondents asserted that they could predict the percentage yield settlements and should be allowed to consider previous experiences in the appeals process in determining measurement. Others wanted to reflect *management's* best estimate of the amount that was expected to be paid, as opposed to the *accounting* best estimate as defined in Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.

#### **Classification**

*The Board concluded that the liability arising from the difference between the tax position and the amount recognized and measured pursuant to the proposed Interpretation should be classified as a current liability for the amounts that are anticipated to be paid within one year. Unless the liability arises from a taxable temporary difference, it should not be classified as a deferred tax liability.*

31. One of the Big 4 firms (E&Y) felt that:

It is unclear as to how the Board concluded that the timing of expected payment should factor into the classification of a liability for uncertain tax positions but that the expected timing of payment for other liabilities (e.g., a deposit for a resident in an assisted living facility) cannot factor in the expected timing of payment. If the Board decides to retain the proposed classification guidance, we believe the Exposure Draft should be explicit as to why and whether such guidance is restricted solely to income tax matters and how to plan for resolution other than through payment (e.g., close of the statute or settlement).

We also recommend that the implementation guidance be expanded to include a discussion and example of the balance sheet classification and disclosure for uncertain tax positions that move between the recognition and derecognition categories (e.g., from probable to more-likely-than-not to less than more-likely-than-not and vice versa).

**Agree with Proposal**

32. Most of the respondents who addressed this issue agreed with the Board's conclusions on classification. One respondent (KPMG) believed that "classification guidance appropriately incorporates the statutory administrative processes unique to income tax systems." Some of these respondents distinguished taxing authorities from entities that have the right to demand payment.

### **Disagree with Proposal**

33. A minority of respondents to this issue disagreed with the Board's conclusions on classification. Some argued that ARB No. 43, Chapter 3A, "Working Capital–Current Assets and Current Liabilities," requires all tax positions to be classified as current because of their similarity to due on demand notes. Others felt that the Board's decision on classification implicitly allows consideration of detection risk for classification purposes, and that is contradictory to not allowing consideration of detection risk for recognition and measurement.

34. Because the timing of payment is uncertain, some respondents stated that the liability must be classified as current. One of the Big 4 firms (Deloitte) asserted that:

All liabilities in which the entity could be required to sacrifice assets in the operating cycle should be classified as current liabilities. Accordingly, the difference between the benefit of the tax position and the amount recognized and measured under the proposed Interpretation should be classified as current liabilities, unless a repayment schedule with the taxing authorities exists.

35. A few respondents were concerned with the impact this provision could have on debt covenants. By having the ability to classify the liability as non-current, the current ratio could be manipulated.

### **Change in Judgment**

*This proposed Interpretation would require that a change in recognition, derecognition, or measurement of a tax position be recognized entirely in the interim period in which the change in judgment occurs.*

36. Many respondents agreed with the Board's conclusion as it relates to UTPs taken in a prior annual period; however, for positions taken in the current annual period, many respondents felt that the guidance in APB Statement No. 28, *Interim Financial Reporting*, was more appropriate.

### **Agree with Proposal**

37. Most respondents who addressed this issue agreed with the Board's conclusions. Several of these respondents requested additional examples and guidance on what would cause a change in judgment. Because of the large number of UTPs, one respondent preferred to treat UTPs like goodwill; just as companies test for impairment once a year, so should they reexamine their UTPs annually.

#### **Disagree with Proposal**

38. A few respondents stated that they disagreed with the Board's conclusion on changes in judgment. Almost all of them cited current year changes as the reason. These respondents argued that APB Statement 28 be followed for changes that affect the current year, which would result in adjusting the estimated annual effective tax rate. One respondent commented that Statement 109 rejects the discreet approach and its use of the integral method provides the most meaningful information.

#### **Interest and Penalties**

*The Board concluded that if the relevant tax law requires payment of interest on underpayment of income taxes, then accrual of interest should be based on the difference between the tax benefit recognized in the financial statements and the tax position in the period the interest is deemed to have been incurred. Similarly, if a statutory penalty would apply to a particular tax position, a liability for that penalty should be recognized in the period the penalty is deemed to have been incurred. Because classification of interest and penalties in the income statement was not considered when Statement 109 was issued, the Board concluded it would not consider that issue in this proposed Interpretation.*

#### **Agree with Proposal**

39. Some respondents agreed with the proposed Interpretation's stance on interest while slightly more agreed with its stance on penalties. One respondent (Deloitte) who agreed noted that the Board's conclusion on the measurement of interest and penalties "should be consistent with the accounting for the tax position." Another respondent (BDO Seidman) suggested the Board emphasize in the proposed Interpretation that classification may be a significant

accounting policy to be disclosed in accordance with APB Statement No. 22, *Disclosure of Accounting Policies*.

### **Disagree with Proposal**

40. Just less than half of respondents to this issue disagreed with the proposed Interpretation's stance on interest while even fewer disagreed with its stance on penalties. Most respondents who disagreed with the Board's conclusion on interest and penalties did so because they believe the Board should issue guidance regarding the classification of these items in the income statement to increase comparability.
41. Many respondents also felt that the Board's decision to accrue interest and penalties on the full amount of the difference, rather than management's estimate of the amount to be paid, would lead to a systematic overstatement of liabilities followed by subsequent reversals (although some of these same respondents would support the Board's decision on this issue if the recognition threshold was lowered). One such comment written by PwC noted:

If the Board were to agree with a lower initial recognition threshold...we would support the accrual of interest on the full amount of the resulting tax liability....As currently proposed, however, we do not agree with the Board's decision to require interest to be accrued on the entire liability resulting from positions taken that are not probable of being sustained. In the self-assessment mechanism present in most income tax regimes, we do not believe that taxpayers are likely to pay interest on an entire tax position that does not meet the proposed probable threshold but for which the preponderance of evidence supports the position. The requirement to accrue interest on the entire balance of such positions would further exacerbate the liability overstatement situation and widen the gap between the prescribed financial reporting and the underlying economics.

A few respondents felt that penalties should not be recognized until they were assessed.

### **Disclosures**

*The Board concluded that loss contingencies relating to previously recognized tax positions should be disclosed in accordance with the provisions of paragraphs 9–11 of Statement 5. The Board also concluded that liabilities recognized in the financial statements pursuant to this*

*proposed Interpretation for tax positions that do not meet the probable recognition threshold are similar to contingent gains. Therefore, those liabilities should be disclosed in accordance with the provisions of paragraph 17 of Statement 5.*

#### **Agree with Proposal**

42. Most respondents agreed with the Board's conclusion on contingent gain disclosures, while of those, fewer respondents agreed with the Board's conclusion on contingent-loss disclosures. One respondent (FPL Group) requested the Board clarify whether the disclosures required or just encouraged the existing disclosure guidance in Statement 5:

The disclosure requirements in paragraph 18 state that 'an enterprise shall disclose loss contingencies relating to previously recognized tax positions in accordance with paragraphs 9-12 of Statement 5.' The words 'shall disclose' in connection with paragraph 9 of FAS 5 are likely to cause confusion. Paragraph 9 of FAS 5 states that disclosures *may* be necessary for the financial statements not to be misleading.

Several respondents asked for examples to illustrate the disclosures and/or discussion included in the basis for conclusions indicating what the Board expects regarding disclosures.

#### **Disagree with Proposal**

43. Some respondents agreed with the Board's conclusion on contingent gain disclosures, while slightly more respondents disagreed with the Board's conclusions on contingent loss disclosures. Most respondents noted that the existing Statement 5 disclosures were sufficient. Some respondents suggested the Board create a "stand-alone" statement where the reference to Statement 5 would be removed, while others suggested there was no need for disclosure requirements at all since Statement 5 was already applicable to these positions. Many respondents expressed that these disclosures would provide a "roadmap" to taxing authorities for audits and might limit the entity's ability to negotiate a tax settlement. Additional suggestions were the disclosure of the amount the entity actually expects to pay and the tax years remaining open.

## **Effective Date and Transition**

*The Board concluded that this proposed Interpretation should be effective as of the end of the first fiscal year ending after December 15, 2005. Only tax positions that meet the probable recognition threshold at that date may be recognized. The cumulative effect of initially applying this proposed Interpretation would be recognized as a change in accounting principle as of the end of the period in which this proposed Interpretation is adopted. Restatement of previously issued interim or annual financial statements and pro-forma disclosures for prior periods is not permitted. Earlier application is encouraged.*

## **Agree with Proposal**

44. Few respondents agreed with the Board's decision on effective date while more respondents agreed with its conclusions on transition. Many respondents asked the Board to clarify the interaction between EITF Issue 93-7, "Uncertainties Related to Income Taxes in a Purchase Business Combination," and the proposed Interpretation in regards to tax positions acquired in a business combination. Several respondents wanted Issue 93-7 to remain in effect.

## **Disagree with Proposal**

45. A large majority of respondents disagreed with the Board's decision on effective date while far fewer respondents disagreed with its conclusions on transitions. The most common reasons cited by respondents concerned the inability of companies to analyze all their outstanding tax positions, both foreign and domestic, and obtain needed documentation (including "should-level" opinions) before the end of the 2005 fiscal year (less than 6 months). An additional reason cited by many respondents for a delayed effective date was the need to put in proper internal controls and documentation concerning UTPs to comply with Sarbanes-Oxley. Respondents also emphasized that the Board would need adequate time to consider the comments received, possibly including a re-exposure period.
46. Of those respondents who disagreed with the Board's conclusion on transition, most objected to derecognizing tax positions that did not meet the probable threshold. Some of those respondents suggested using a more-likely-than-not threshold for derecognition upon adoption. One respondent (Emerson) summarized the feeling of many respondents by saying: "This is inconsistent with the derecognition requirements after the effective date, which allow a previously recognized tax position to remain on the books until it is more likely than not that the tax position would be not sustained on audit." They felt that tax positions that were once probable but are now more likely than not should be recognized in the financial statements since these same tax positions would remain after the proposed Interpretation takes effect. Additionally, respondents noted that this transition guidance is not the retrospective application preferred in FASB Statement No. 154, *Accounting Changes and Error Corrections*.