



UNCERTAIN TAX POSITIONS

Financial Accounting Standards Advisory Council
September 2004

Background of the Interpretation

During a December 2003 speech at the AICPA Conference on SEC Developments, an SEC Professional Accounting Fellow indicated that the SEC continued to be concerned about the application of FASB Statement No. 109, *Accounting for Income Taxes*, to “tax advantaged transactions.” The SEC staff member indicated that it is not appropriate to recognize tax assets when it is not probable that the registrant will realize the related benefit.

On March 3, 2004, a Board member and members of the FASB staff met with representatives of the SEC’s Office of the Chief Accountant and representatives of major public accounting firms to discuss practice issues related to uncertain tax positions. Participants of the meeting discussed alternative views about the recognition of deferred tax assets when uncertainty exists about the ultimate realization of the benefit recognized in the tax return. Based on the different views expressed and different methodologies deemed acceptable between the major accounting firms, participants realized that significant diversity in practice exists.

For instance, some financial statement issuers will record tax benefits in the financial statements on an “as-filed” basis. The tax benefits recognized in tax returns reduce current or deferred tax liabilities or result in the recognition of deferred tax assets based on the amounts included in the entity’s tax returns. The entity then uses the valuation allowance for deferred tax assets (using the more-likely-than-not criterion) to reduce the deferred tax asset to a lower number.

Note: These materials are provided to facilitate understanding of the issues to be addressed at the September 23, 2004 FASAC meeting. These materials are presented for discussion purposes only; they are 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.

Additionally, an allowance or liability may be recorded for tax positions that may not be ultimately sustained on audit. In contrast, some issuers have created lists of attributes of aggressive transactions. When a transaction contains one of the potentially aggressive attributes, the related tax benefit is accounted for as a gain contingency in accordance with the provisions of FASB Statement No. 5, *Accounting for Contingencies*.

Due to the diversity in practice, the SEC staff asked the FASB staff to discuss the issuance of authoritative guidance with the Board. The FASB staff undertook a significant research effort. The FASB staff spoke with:

1. Tax directors of several large public companies known to the staff.
2. Subject matter experts who are principally national office partners at large accounting firms.
3. Tax partners at large accounting firms.
4. Selected members of the User Advisory Council who have agreed to act as members of the project resource group.
5. Members of the Office of the Chief Accountant at the SEC.

The FASB staff sought to learn and understand more about the existing practice in the recognition of tax benefits and to understand, anecdotally, the factors (including transactions) that lead to the recognition of tax benefits when the tax basis is not probable of realization.

The FASB staff then presented its findings and recommendations to the FASB at the July 27, 2004 Board meeting and recommended the issuance of a Board directed FASB Staff Position. At the July 27 meeting, the Board added this project to its agenda as a proposed Interpretation to Statement 109.

Statement 109 Requirements

Statement 109 requires the accrual of current and deferred tax assets and liabilities using the following principles:

A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards

Additionally, Appendix E of Statement 109 defined a temporary difference as:

“A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.”

Accordingly, an issuer taking positions in tax returns that are not probable of being sustained upon audit would create a temporary difference that, when tax effected, results in the reduction of a current or deferred tax liability or recognition of a current or deferred tax asset.

Statement 109 does not allow current and deferred tax assets and liabilities to be initially or subsequently measured at fair value. Additionally, the deferred tax valuation allowance only relates to the availability of future taxable income to realize a previously recognized deferred tax asset. The valuation allowance is not meant for adjustments to the amount of the calculated deferred tax asset for sustainability uncertainty.

FASB Deliberations on the Proposed Interpretation

The following issues were discussed with the Board at the July 27 meeting.

- Initial Recognition and Measurement
- Classification
- Subsequent Accounting
- Disclosure
- Interim Reporting Considerations
- Transition

Initial Recognition and Measurement

The Board tentatively concluded that a threshold for the recognition of tax benefits should be promulgated. Tax benefits, whether the tax benefit results in recording a current or deferred tax asset or reducing a current or deferred tax liability, are required to be probable of realization. Probable is understood to be as that term is used in Statement 5, meaning that an event is likely to occur. Since Statement 109 does not allow for uncertainty within the measurement, the

uncertainty is dealt with through the recognition threshold of probable (as used in Statement 5).

The Board also considered the appropriateness of different recognition thresholds (including probable as in Statement 5; probable as used in footnotes 18 and 21 of FASB Concepts Statement No. 6, *Elements of Financial Statements*; more-likely-than-not, and “Should” as the term is understood in the context of tax opinions). The Board decided that probable as it is used in Statement 5 is the appropriate surrogate to deal with uncertainty when fair value measurement is not used. Additionally, probable as it is used in Statement 5 is believed to be a threshold which is consistent with a “Should” level tax opinion.

Classification

The Board tentatively concluded that when tax returns are filed with tax positions that are not probable of realization, the resulting liability representing the difference between the as-filed tax basis and the probable tax basis should be recorded as a current liability (not a current deferred tax liability).

The Board considered classification alternatives, such as classification as a deferred tax liability or a non-current tax liability. The Board concluded that the liability resulting from the uncertain tax position has the characteristics of a demand note and should be classified as a current liability. Additionally, in ARB 43, the discussion of current liabilities indicates that a tax liability is a current liability.

Subsequent Accounting

There are two issues concerning the subsequent accounting for uncertain tax benefits. The first issue is how to subsequently account for an uncertain tax benefit when the probable threshold was not initially met, but a change in judgment occurs. The Board considered two views about subsequent recognition when the threshold was not initially met. The first view was that the transaction should be accounted for as a gain contingency and recognized when realized, and the second view was that subsequently meeting the threshold of probable warrants recognition.

The second issue is how to account for an uncertain tax benefit when the probable threshold is no longer met. The Board considered a single threshold for a recognition event—that is, recognition of a tax benefit whenever the threshold is met and de-recognition when the threshold is no longer met. The other view was to account for subsequent derecognition in accordance with the loss contingency model in Statement 5 (when it is probable that the asset will not be realized). The Board believes that a single threshold is more appropriate.

The Board tentatively decided to require subsequent recognition of tax benefits at any time in which the probable threshold is subsequently met. Additionally, at any time the probable threshold is no longer met, the tax benefit must be derecognized. Use of a “valuation allowance” or “tax contingency reserve” is not appropriate.

Disclosure

The Board tentatively decided that disclosure of any tax benefit that was not probable of realization but was filed in the entity’s tax return should be made consistent with the guidance in paragraph 17 of Statement 5, that is, disclosure regarding a gain contingency.

Interim Reporting

The Board tentatively decided that a change in the judgment about the realization of a tax benefit should be recognized in the period in which the change in judgment occurs. The impact of the change (related to amounts previously recorded) should not be “spread” over future periods.

Transition

The Board tentatively decided that the impact of transition should be recognized as the cumulative effect of a change in accounting principle. The Board also directed the FASB staff to perform additional research on the amount of work anticipated by preparers to implement the provisions of the proposed Interpretation. The Board directed the staff to provide a recommendation on an

implementation date after discussing the matter with members of our resource group and others.

Discussions with Constituents

The FASB staff has discussed the issues addressed in the proposed Interpretation as well as the Board's July 27 tentative decision with:

1. Members of our resource group (all Big 4 firms, Grant Thornton, BDO Seidman plus a Statement 109 subject matter expert working for a firm principally representing audit committees).
2. Tax practitioners at Big 4 firms serving small- to medium-sized enterprises.
3. Controllers or tax directors at 12 publicly traded companies with asset bases generally greater than \$5B and revenues generally greater than \$1B.
4. Staff from the SEC's Office of the Chief Accountant.

In our discussions with constituents, the staff attempted to understand the mechanism that constituents would use to identify transactions that needed to be reviewed and the time it would take for constituents to implement the proposed Interpretation.

Based on our discussions, we believe many constituents would attempt to identify transactions using the following process:

1. Identify transactions and tax positions that are based on clear-cut and unambiguous tax law. Most constituents believed little work would be required for this population of transactions.
2. Identify transactions and positions that are interpretations of tax law, or where there is an interpretation as to whether existing tax law applies to a particular fact pattern. This population was believed to require the most significant amount of work due to the number of potentially impacted items.
3. Review the tax exposure items and significant transactions and positions for changes in tax law.

As for transition timing, we generally heard a consistent view that preparers would need one to two quarters to implement the decisions reached to date. No constituents that we spoke with believed that more than two quarters would be required to complete the necessary work.

Remaining Issues

Based on the staff's efforts to date to prepare a draft of the proposed Interpretation and on the input from constituents, the staff has identified certain issues to be addressed in future Board deliberations. Those deliberations will occur in the fourth quarter of 2004. We expect to issue the Exposure Draft of the proposed Interpretation in the fourth quarter.

The following issues may require additional consideration:

1. Effective date
2. Applicability of the proposed Interpretation to leveraged leases
3. Certain measurement issues

Questions for FASAC Members

The Board would appreciate FASAC members' comments and observations on the following matters:

1. Recognition threshold:
 - a. Do you agree with the Board's tentative conclusion about adopting a recognition threshold consistent with probable as used in Statement 5?
 - b. If not, what alternative would you use and why would it be more appropriate than the current tentative conclusion?
 - c. Do you agree that the inability to use fair value measurement is a limiting factor in the selection of a threshold?
2. Derecognition:
 - a. Do you agree with the Board's tentative conclusion about derecognizing tax benefits when the threshold is no longer met?
 - b. If not, what alternative would you use and why would it be more appropriate than the current tentative conclusion?
3. Measurement:
 - a. The staff has discussed measurement with a number of constituents. What issues do you feel are important to consider?

4. Disclosure:

- a. Do you agree with the Board's tentative conclusion about disclosing tax benefits that are not probable of realization in accordance with the provisions of paragraph 17 of Statement 5?
- b. If not, what alternative would you use and why would it be more appropriate than the current tentative conclusion?