# McGladrey & Pullen Certified Public Accountants

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> 3600 American Boulevard West, 3rd Floor Bloomington, MN 55431 **O** 952-835-9930 **F** 952-921-7702 jay.hanson@rsmi.com

September 12, 2005

Director of Technical Application and Implementation Activities Financial Accounting Standards Board 401 Merritt 7 P. O. Box 5116 Norwalk, CT 06856-5116

# Re: Proposed Interpretation, Accounting for Uncertain Tax Positions, File Reference 1215-001

McGladrey & Pullen, LLP appreciates the opportunity to submit written comments on the Exposure Draft for a Proposed Interpretation of FASB Statement No. 109, Accounting for Uncertain Tax Positions dated July 14, 2005.

McGladrey & Pullen generally agrees with the proposed Interpretation's objective of clarifying the accounting for uncertain tax positions. However we do provide the following comments for your consideration.

# Scope

#### Issue 1

The proposed Interpretation applies to tax positions taken in tax returns previously filed as well as positions anticipated to be taken in future years. We agree with this approach, except as it relates to transition. See our comments later in this letter on transition alternatives.

# **Initial Recognition**

# Issue 2

The proposed interpretation concludes that the recognition threshold should presume a taxing authority will, during an audit, evaluate a tax position taken or expected to be taken when assessing recognition of an uncertain tax position. We agree with this interpretation. We observe the definitions in the glossary of Statement 109 include the following:

#### **CURRENT TAX EXPENSE OR BENEFIT**

The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year.

## TAXABLE INCOME

The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.

We believe the proposed interpretation is consistent with the concept of "as defined by the governmental taxing authority".

We also note the guidance published by the FASB Staff shortly after Statement 109 was issued in the "Guide to Implementation of Statement 109 on Accounting for Income Taxes". While this guide does not have the same authority as the Statement itself, it presumably reflected the Staff's best views at the time and presumably was not inconsistent with the Board's views. We reference the original guidance in Question 17 that states in part:

17. Q -- In a taxable purchase business combination, an enterprise allocates for tax purposes the purchase price to the assets acquired and liabilities assumed so as to maximize the potential income tax benefits from the combination. Although the enterprise has a basis under the tax law for the allocations claimed in initial filings with the tax authority, that enterprise believes that portions of the allocation will be denied by the tax authority and the amount assigned to goodwill will be increased. Should deferred income taxes at the date of the business combination be based on (a) the tax basis of acquired assets and liabilities as claimed in initial filings or (b) the best estimate of the tax basis that will ultimately be accepted by the tax authority? What is the appropriate accounting in periods subsequent to the business combination for changes in the purchase price allocation for tax purposes?

A -- The tax basis of an asset or liability is a question of fact under the tax law. The tax basis of most assets and liabilities is not subject to dispute and can be determined from initial filings with the tax authority. However, the tax basis of some assets and liabilities is unclear and will be determined by tax regulations, negotiations with the tax authority, appeals procedures, or, in some cases, litigation. The tax basis of those assets and liabilities may not be appropriately determined from initial filings with the tax authority because those filings are only the first step in the process to establish the tax basis. Deferred tax assets and liabilities at the date of a business combination should be based on management's best estimate of the tax basis of acquired assets and liabilities that will ultimately be accepted by the tax authority.

The concept of "management's best estimate of the tax basis of acquired assets and liabilities that will ultimately be accepted by the tax authority" in this context of a business combination seems consistent with proposed interpretations guidance that presumes the position will be examined.

### Issue 3

The proposed threshold for recognizing the benefit of an uncertain tax position is "probable" as the term is used in FAS 5. While we don't disagree that "probable" is an appropriate threshold for determining the amount of a tax benefit that can be initially recognized, there is one aspect of this standard that we believe is problematic.

Given the vague definition in FAS 5 that probable means "likely to occur", we believe that this allows for a strong possibility of inconsistent application of this threshold by different financial reporting entities. Many preparers and firms have historically believed that "probable" in the context of financial statement recognition equates to a high likelihood of occurrence; e.g., in excess of 80%. Other preparers and firms consider "probable" to be in the 70-75% range. Although, paragraph B19 refers to a common understanding among financial statement preparers, auditors and regulators that a probable recognition threshold is not inconsistent with a "should" tax opinion, we are not convinced that this language is sufficient to eliminate the potential for wide variation in the interpretation. Different financial reporting entities could conceivably arrive at a probable threshold anywhere within the range of 70% to 80% probability (or wider) of the position prevailing. We suggest that the standard would be applied more consistently if the Board provided more guidance on what "probable" means.

We have several broad comments on the recognition, derecognition, change in judgment, and measurement after the initial determinations are made. Paragraph 16 of the Exposure Draft implies, by its reference at the end of the sentence to "shall be recognized entirely in the interim period in which the change in judgment occurs.", that management must reassess all previous decisions and judgments at each interim period. We believe this is a burdensome and unworkable standard. We believe that all subsequent changes to the initial accounting should be based on a reconsideration event or some other triggering consideration. Examples of other standards that establish

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this include Statement 144 and Interpretation 46. We agree with the views expressed by the Board dissenters of "Once established, any liability related to uncertain tax positions would be remeasured only when there are clear and substantive changes in the relevant facts and circumstances." We believe such an approach would be less complex and more operational for the accounting and reporting of the effects of uncertain tax positions. It would eliminate the need to reconsider numerous tax positions at each reporting date.

# Subsequent Recognition

#### Issue 4

Tax positions that did not previously meet the probable recognition threshold should be recognized in any later period in which the enterprise subsequently concludes that the probable recognition threshold has been met. We agree with this, subject to a standards referenced in our broad comments such as "Once established, any liability related to uncertain tax positions would be remeasured only when there are clear and substantive changes in the relevant facts and circumstances."

We also believe the final interpretation should include guidance for situations where there is no statue of limitations as indicated in paragraph 8c or a statute does not commence until the filing of a tax return. We believe there could be many situations, such as state tax nexus issues, where a liability could be established under this proposed interpretation and never be removed from the financial statements.

## Derecognition

#### Issue 5

We agree that a previously recognized benefit from a tax position that no longer meets the probable recognition threshold shall be 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, subject to our broad comments above.

We also believe that clearer language is necessary when describing this derecognition criteria. While "more likely than not" appears to be the appropriate threshold for derecognition when the event being measured is the likelihood of not sustaining the position on audit, we question why the event being measured for derecognition is the opposite of the event being measured for initial recognition? In other words, for initial recognition, paragraph 6 requires us to evaluate the probability that the position **will** be sustained. However for derecognition, paragraph 10 requires us to evaluate the probability that the position **will not** be sustained. We suggest rewording the phrase "more likely than not that the tax position would not be sustained" to incorporate positive language such as "likely to be denied".

# **Change in Judgment**

#### Issue 8

See comments above regarding reconsideration events or other triggering considerations.

#### **Interest and Penalties**

# Issue 9

We believe that interest should be accrued only to the extent it is probable of being paid. We do not believe that penalties should be accrued. A penalty is not an expense unless and until the time taxing authorities have actually imposed it. Therefore, it is not appropriate to accrue a penalty prior to the date, if any, that it has been imposed.

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#### **Disclosures**

Issue 10

We believe the final interpretation should not impose any new disclosure requirements but merely reference that disclosures required by other standards should be followed.

## **Effective Date and Transition**

Issue 11

Under the proposed Interpretation, these rules would take effect as of the end of the first fiscal year after December 15, 2005. The cumulative effect of initially applying the 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.

With comments due September 12 and the timeframe for releasing the final interpretation not yet known, December 31, 2005 (this would be the first calendar year end after December 15, 2005) is not nearly enough time for companies to evaluate the impact of these rules, evaluate their tax positions, compute and record the necessary adjustments and develop the computational models to track current and deferred tax assets, liabilities, benefits and expenses. We believe the effective date should be no earlier than annual periods ended after December 15, 2006. Any date sooner than December 15, 2006 will cause significant issues for companies and their independent auditors.

Additionally, regardless of the effective date the Board ultimately selects, private entities and smaller public entities may lack the adequate staff or financial expertise to readily apply the provisions of this proposed Interpretation and, therefore, the Board should consider the following for private entities and small public entities:

- 1. Using a more extended (or "phased") effective date(s) than that to be used for large public entities.
- 2. A prospective approach. A prospective approach would apply the new Interpretation only to tax positions to be taken in tax returns after the effective date of the proposed interpretation and leaves intact the accounting for tax positions taken in tax returns previously filed. A prospective approach would accomplish the primary goals of the proposed Interpretation but would be less complex and more operational than would a retroactive approach. It would provide a more orderly transition for private entities and small public companies.

# Comments on Issues Not Specifically Identified in Notice for Recipients

We feel the Proposed Interpretation is not consistent with the Board's simplification goal. One of the Board's strategic goals is simplification. This proposed Interpretation seems to move in the opposite direction. The proposed Interpretation is unduly complex and would be difficult to apply in practice. An Interpretation that is more principals-based, rather than rules-based, would seem to be more in line with the goal of simplification.

We appreciate the opportunity to express our views on the proposed interpretation. If you have questions concerning these comments, please contact Jay Hanson (952-921-7785) or Michael Hoffman (952-921-7758).

Sincerely,

McGladrey & Pullen, LLP

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