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# United States Senate

COMMITTEE ON  
GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

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Financial Accounting Standards Board  
Technical Director -- File Reference No. 1215-001  
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**RE: Accounting for Uncertain Tax Positions**

To Members of the Financial Accounting Standards Board:

This letter is written in support of the Financial Accounting Standards Board's proposed Interpretation of Statement No. 109, *Accounting for Uncertain Tax Positions*. This proposed Interpretation would establish that a company is allowed to recognize the benefits of a tax position in its financial statements only if that position is "probable" of being sustained on audit by a taxing authority.

The proposed Interpretation would also set a high standard for determining when a tax position would meet the "probable" threshold, requiring a fact intensive review that, among other factors, would have to consider whether the tax position is supported by unambiguous tax law and an unqualified *should prevail* tax opinion issued by a tax professional. Longstanding practice in the accounting profession is to issue an unqualified *should prevail* opinion for purposes of advising on tax strategies and tax returns only when there is a judgment that the tax position has a 70% or higher probability of surviving a challenge by a taxing authority such as the Internal Revenue Service (IRS). Requiring this level of confidence is also appropriate before allowing uncertain tax benefits to be incorporated into audited financial statements.

Audited financial statements provide essential information to investors, lenders, financial analysts, government regulators, policymakers, and others. The integrity of these statements is critical to well-functioning U.S. markets and the efficient allocation of capital. Allowing financial statements to incorporate tax benefits without taking into account the probability that those benefits will be sustained would undermine the integrity, reliability, and comparability of reported financial results. The proposed Interpretation would clarify what should be common sense and common practice: that to recognize a tax benefit, a company must apply a realistic assessment of whether it will be able to sustain that benefit in the event of an audit by a taxing authority.

## Subcommittee Investigations Support Proposal

Over the past several years, the U.S. Senate Permanent Subcommittee on Investigations, on which I serve as the senior Democrat, has conducted investigations into a variety of issues related to abusive tax shelters and misleading financial statements. The Subcommittee's investigative work provides a factual foundation for many of the provisions in the proposed Interpretation.

The Subcommittee has seen repeated instances of abusive tax shelters being used by businesses to claim substantial, but dubious, tax benefits. These dubious tax benefits typically lead businesses to understate current or deferred tax liabilities and overstate earnings or assets on their financial statements. For example, in 2002, the Subcommittee held a hearing on an abusive tax shelter called Slapshot which Enron Corporation had purchased for \$5 million and determined would enable the company to claim inflated earnings on its financial statements over five years totaling \$65 million.<sup>1</sup> Slapshot was just one of a number of abusive tax positions which were undertaken by Enron and resulted in inflated earnings or assets on Enron's financial statements.<sup>2</sup> In 2003, we issued a report which, in part, detailed how an accounting firm had sold an abusive tax shelter to more than 50 small private corporations to enable their shareholders to avoid payment of taxes on corporate income and also enable the corporations to invest income that should have been used to pay taxes.<sup>3</sup> The financial statements of the corporations who used this abusive tax shelter necessarily presented lower current or deferred tax liabilities and higher earnings or assets than should have been reported.

These case histories are part of a larger trend in which U.S. businesses are paying a significantly reduced percentage of our federal taxes, due in part to the use of dubious tax shelters. U.S. FY2005 budget data shows that corporations now pay about 10% of the total federal tax burden, compared to 30% during the 1940s and 50s.<sup>4</sup> A recent GAO report shows that, during the last five years, over 60% of large U.S. publicly traded corporations paid no tax at all, and 94% paid only 5% of their income in taxes.<sup>5</sup> Over the

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<sup>1</sup> "Fishtrail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions," Subcommittee staff report (S.Rpt. 107-82)(1/2/03), reprinted in "Oversight of Investment Banks' Response To The Lessons of Enron," a hearing before the Subcommittee (S.Hrg. 107-871)(12/11/02), at 27, footnote 83.

<sup>2</sup> See, e.g., prepared statement of The Joint Committee on Taxation staff on "The Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," at a hearing of the Senate Committee on Finance, (JCX-10-03) (Feb. 13, 2003) at 7.

<sup>3</sup> See, e.g., information related to the S Corporation Charitable Contribution Strategy or SC2 which involved the misallocation of substantial corporate income to a charitable organization, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2," Subcommittee Minority Staff Report, reprinted in "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," a hearing before the Subcommittee (S.Hrg. 108-473) (Nov. 18 and 20, 2003), at 145, 197-98, 266-67.

<sup>4</sup> Office of Management and Budget, Budget of the US Government FY 2006, Historical Tables, Table 2.2.

<sup>5</sup> "Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000," United States General Accounting Office (Report GAO:04-358)(Feb. 2004).

past few years, combating abusive tax shelters has been identified by the IRS as a top enforcement priority.<sup>6</sup>

The Subcommittee has documented that the sale of potentially abusive and illegal tax shelters has become a lucrative business in the United States, involving tax professionals at accounting firms, banks, investment advisory firms, and law firms mass marketing these shelters to multiple taxpayers across the country. The abusive tax shelters examined by the Subcommittee have shared one defining characteristic: they had no real economic or business rationale other than tax avoidance. In some cases, abusive tax shelters may have also been sold as a way to improve a company's financial statements through the reporting of lower current or deferred tax liabilities and higher earnings or assets.

Some of the businesses we examined, when purchasing a pre-packaged tax shelter, were warned by the tax shelter promoter that the schemes were risky and might affect their bottom lines. Not only might the companies ultimately have to pay back taxes plus interest, they also faced the possibility of significant penalties from the IRS. If companies knew that they were required to meet a "probable" standard before they could incorporate a tax position into their financial statements, it would not only protect the integrity of their financial reports, but also reduce the incentive to buy a risky tax shelter for the purpose of reporting more favorable financial results.

### **Analysis of Key Provisions**

Currently, FASB's Statement 109, *Accounting for Income Taxes*, does not provide an explicit standard indicating when the benefits of an uncertain tax position may be recognized in a financial statement. As a result, differing accounting practices have produced inconsistent results, including, on occasion, the recognition of highly suspect tax benefits. The proposed Interpretation is needed to establish a reasonable analytical approach and bring greater consistency to how businesses handle uncertain tax benefits in their financial reports.

The comments in this letter focus on three key issues in the proposed Interpretation, each of which offers important principles that merit strong support:

1. **"Probable" Threshold:** a tax position must meet a "probable" threshold for a tax benefit to be recognized in a financial statement;
2. **Derecognition:** a previously recognized tax position that no longer meets the "probable" recognition threshold should be derecognized when it becomes more likely than not that the position will not be sustained on audit; and
3. **Presumed Audit:** a company must presume a taxing authority will audit the tax position in question on its technical merits, without consideration of the likelihood that the taxing authority will actually detect and audit the position.

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<sup>6</sup> See, e.g., prepared statement of IRS Commissioner Mark Everson at a hearing of the Senate Committee on Finance on "The \$350 Billion Question: How to Solve the Tax Gap," (Apr. 14, 2005), at 6.

**“Probable” Threshold.** The Interpretation’s proposed principle, that a tax position must meet a “probable” threshold for a tax benefit to be included in a company’s financial statement, is key to restoring integrity to the financial reporting of uncertain tax positions. This threshold will promote more reliable and comparable financial statements and discourage companies from entering into dubious tax avoidance schemes in part to achieve improved financial results.

Under the proposed Interpretation, determining whether a tax position meets the “probable” threshold involves a fact intensive review. The proposed Interpretation sets forth clear and useful examples of “specific facts and circumstances that may ... demonstrate a probable level of confidence.” The proposed Interpretation also identifies as two key factors whether a business can cite “unambiguous tax law supporting the tax position” or “an unqualified *should prevail* tax opinion.”

Evidence found during the Subcommittee’s investigations strongly supports this approach. The Subcommittee has seen numerous tax shelter schemes built on hyper-technical readings of tax statutes or regulations that ultimately have no basis in existing tax law, much less unambiguous legal support.<sup>7</sup> While filing a tax return that relies on a dubious interpretation of the tax code may be lawful, it defies common sense to allow audited financial statements to assume such speculative tax benefits will be sustained.

Citing reliance on an unqualified *should prevail* opinion in determining whether a reporting position is “probable” is another useful approach that takes advantage of long-standing practice in the accounting and tax professions. In our investigations, the Subcommittee has observed significant differences in how accounting and tax professionals approach a *should prevail* opinion versus a *more-likely-than-not* opinion, generally requiring greater legal support, seeking greater consensus, and exercising greater caution before issuing an unqualified *should prevail* opinion. For example, KPMG, a major accounting firm, instructed its accountants that a *should prevail* opinion required a 70% or higher probability of surviving an IRS challenge, while a *more-likely-than-not* opinion required only a better than 50% probability.<sup>8</sup> Tax professionals in other organizations appear to use similar percentages. In contrast, allowing a company to claim tax benefits supported by only a *more-likely-than-not* opinion would enable companies to report financial benefits that tax professionals have analyzed as having as much as a 49% chance of being rejected by the IRS. That level of uncertainty is too speculative to allow in audited financial statements that are so heavily relied on by investors, lenders, analysts and others in American markets. The level of confidence provided by an unqualified *should prevail* opinion is clearly the more defensible standard for GAAP-compliant financial statements.

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<sup>7</sup> See, e.g., “U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2,” Subcommittee Minority Staff Report, reprinted in “U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals,” a hearing before the Subcommittee (S.Hrg. 108-473) (Nov. 18 and 20, 2003), at 155-88 (describing how KPMG developed 4 abusive tax shelters).

<sup>8</sup> See *id.* at 107.

**Derecognition.** A second key principle set forth in the Interpretation is its proposal that a previously recognized tax position that no longer meets the “probable” recognition threshold should be derecognized whenever a company concludes that it is more likely than not that the position would not be sustained on audit.

Updated financials are essential to keep markets informed in the face of changing circumstances or when new information becomes available. At the same time, a company should not have to teeter back and forth between recognition and derecognition of tax benefits in the event of minor changes, since such revisions may lead to more confusion than transparency. Derecognizing a tax position when a company believes there is less than a 50% chance that it is entitled to the benefits is a reasonable compromise. Delaying derecognition longer, until there is a virtual certainty that a tax benefit is unjustified, could irresponsibly mislead investors and others about the financial status of the business.

Like the standard for recognition of uncertain tax positions, the proposed derecognition standard does not impose a bright line rule for when tax benefits must be eliminated from a financial report; it relies instead on auditors exercising professional judgment about how to take into account specific facts and circumstances. At the same time, by utilizing the *more-likely-than-not* standard, the Interpretation utilizes a long-standing analytical approach among accounting and tax professionals that should increase consistency in the handling of this issue and thus increase comparability among financial statements.

**Presumed Audit.** Finally, the proposed Interpretation articulates the important principle that, when evaluating whether to recognize a tax benefit, a company must presume a taxing authority will audit the tax position on its technical merits. In addition, the Interpretation essentially prohibits companies from considering the likelihood that the IRS will actually detect and audit the company’s use of a questionable tax position.

Subcommittee investigations have found that promoters of aggressive tax shelters are well aware of the fact that the IRS cannot audit every tax return, and have candidly used this fact to game the system. KPMG, for example, advised its tax professionals to tell corporations considering buying an abusive tax shelter called SC2 that the risk of audit was low, because “this transaction is very stealth. We are not generating losses or other highly visible items on the S-corp return.”<sup>9</sup> KPMG took other steps as well to reduce the likelihood that the IRS would “get wind” of this abusive tax shelter, including limiting sales, minimizing related information on client tax returns, and limiting discussion of the tax shelter’s risks in writing to avoid providing a “roadmap” for IRS auditors.<sup>10</sup> This type of conduct essentially encourages businesses to incorporate suspect tax benefits into their financial statements, thereby lowering the reliability of their reported financial results and handing a financial advantage to less scrupulous businesses.

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<sup>9</sup> *Id.* at 241.

<sup>10</sup> *Id.* at 238-45.

In 2004, due in part to limited resources and funding, the IRS audit rate for businesses dropped to just 2 audits for every 1,000 businesses.<sup>11</sup> This statistic practically invites businesses to take a chance on risky tax scams, in light of the low odds of being audited. If, for financial statement purposes, a business were also allowed to consider this audit statistic when assessing whether it was "probable" that questionable tax benefits would be sustained, the low probability of audit would consistently skew such assessments towards allowing even highly suspect tax benefits to be reflected in financial reports. In addition, even companies audited by the IRS often work out settlements that may aggregate questionable tax positions with less questionable tax positions or allow tax benefits that would normally be prohibited. Allowing businesses to take into consideration the likelihood of such settlements, however, would, again, skew "probability" assessments towards including even highly suspect tax benefits in financial statements.

Permitting the consideration of analytical factors, such as low IRS audit rates or settlement opportunities, that encourage companies to include dubious tax benefits in their financial statements is contrary to public policy, since such factors undermine not only our tax system, but also reliable and comparable financial reporting. In contrast, prohibiting companies from considering low audit rates or settlement opportunities when assessing uncertain tax positions -- forcing attention instead solely on the technical merits of the tax position itself -- encourages honest accounting based upon full compliance with the tax law. For these reasons, the proposed Interpretation would not only strengthen the integrity of financial statements, but also eliminate existing analytical approaches that undermine the federal tax system.

For our economy and capital markets to prosper, it is essential that investors, lenders, analysts, policymakers and others have confidence in companies' financial statements. The proposed Interpretation would help ensure that companies treat uncertain tax positions in their financial statements with a reasonable standard that promotes consistency, reliability and comparability in financial reporting and also encourages corporate compliance with existing tax law.

Thank you for this opportunity to comment on the proposed Interpretation.

Sincerely,



Carl Levin  
Ranking Minority Member  
Permanent Subcommittee on Investigations

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<sup>11</sup> IRS data compiled by Transactional Records Access Clearinghouse, Syracuse University, <http://trac.syr.edu/tracirs/highlights/current/businessG.html>.