# MorganStanley

Letter of Comment No: 109
File Reference: 1215-001
Date Received: 91605

September 9, 2005

Ms. Suzanne Q. Bielstein
Director – Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1215-001, An Interpretation of FASB Statement No. 109 – Accounting for Uncertain Tax Positions (the "Exposure Draft")

Dear Ms. Bielstein:

Morgan Stanley appreciates the opportunity to provide comments in response to the above referenced Exposure Draft. We agree with the Board's conclusion that there is diversity in practice in accounting for uncertain tax positions and we commend the Board's efforts to achieve greater clarity and consistency in the criteria used to recognize, derecognize, or measure the economic benefits associated with uncertain tax positions. However, we do not believe that the provisions of the Exposure Draft will achieve the Board's objective of providing consistency and comparability in financial reporting. We have specific concerns regarding the following provisions within the Exposure Draft:

"Probable" Recognition Threshold (paragraph 6)
Dual Recognition / Derecognition Thresholds (paragraphs 6 and 10)
Reliance on Prior Experience with Taxing Authorities (paragraph 11)
Classification of Interest and Penalties (paragraph B37)
Income Tax Returns Not Filed (paragraph B14)

Our comments are detailed below.

#### "Probable" Recognition Threshold

We have several comments on this subject. First, we respectfully disagree with the Board's adoption of a "probable" threshold for the initial recognition of the financial statement effects of an uncertain tax position using the underpinning of Statement of

Financial Accounting Standards No. 5 ("SFAS 5"), Accounting for Contingencies. Although the term "probable" defined in SFAS 5 is that a "future event or events are likely to occur," in practice it is interpreted to be a threshold of 70-80%. Under the proposed Interpretation, an enterprise will be required to establish a 100% reserve for an uncertain tax position with less than a 70% probability of being sustained upon audit. We believe that this will lead to a systematic over-accrual of an enterprise's income tax liability at the time reserves are established, followed by systematic reversals of such income tax liabilities into income upon subsequent developments, the settlement of tax issues or the expiration of the statute of limitations. As a result, there will be diminished matching of an enterprise's operating results and its income tax rate and significant artificial volatility in an enterprise's income tax rate.

Second, we believe that the term "probable" will likely result in more disagreements about the necessary judgments to determine the amount of benefit to be recognized for an uncertain tax position. "Probable" has a different meaning for different enterprises and accounting firms may apply different standards for determining "probable." We do not believe the Board's mission to achieve enhanced comparability and consistency in financial reporting will be achieved. To the extent that a probable recognition threshold is required, paragraph 9.a. of the Exposure Draft refers to "unambiguous tax law supporting the tax position" as an example of a fact and circumstance that may, in the absence of opposing evidence, demonstrate a probable level of confidence. One may conclude from this reference, that, only statutory tax law may be relied upon to demonstrate a probable level of confidence. The Board should broaden this concept to include other published guidance, including, but not limited to, regulations, revenue rulings and legislative history. This further emphasizes the point that the use of a "probable" recognition threshold will not address the Board's concerns regarding diversity in practice in this area given the complexity of tax law and the need for judgment to be applied.

With respect to the application of the "probable level of confidence," paragraph 9.b. of the Exposure Draft refers to an "unqualified should prevail tax opinion" and a "should prevail" criterion in paragraph B21, as another example of a fact and circumstance that may, in the absence of opposing evidence, demonstrate a probable level of confidence. In practice, neither of these terms are used in issuing tax opinions. The Board should either clarify the meaning of the terms or revise the wording to refer to a "should level" opinion. In either case, the same terminology should be used in both instances.

Overall, we believe that a "more likely than not" threshold for the initial recognition of the financial statement effects of an uncertain tax position will more often result in a reliable and relevant estimate of an enterprise's eventual actual income tax liability. In practice, uncertain tax positions are often resolved through settlement negotiations with taxing authorities wherein the taxpayer agrees to surrender a portion, but not all of a tax benefit. A recognition threshold of "more likely than not" will result in the recognition of the income tax effects of an uncertain tax position which better approximates management's best estimate of the ultimate actual outcome of such position. We believe the phrase "more likely than not" is better understood and more simply applied in practice. Consequently, we believe that the application of a "more likely than not" recognition threshold will result

in the consistency, comparability and relevance of the financial reporting of the tax effects of uncertain tax positions that the Board desires to achieve.

As a conceptual matter, Statement of Financial Accounting Concepts No. 6 ("CON 6"), Elements of Financial Statements, defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" and defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity..." Probable is then noted within CON 6 as "used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain or proved (emphasis added)." The basis for recognizing the benefit of a tax position (i.e., an asset) would seem to be the threshold set forth in the definition of an asset within CON 6. As such, a "more likely than not" threshold appears more closely aligned with the CON 6 definition of an asset and use of the term "probable" than that appearing within SFAS 5.

## **Dual Threshold for Recognition / Derecognition**

In paragraph B18 of the Exposure Draft, "the Board acknowledges that the dual threshold required by the proposed Interpretation may lead to noncomparable financial reporting for tax positions whose probabilities of being sustained lie between the two thresholds." We believe that the resulting noncomparability will significantly decrease the meaningfulness of financial statement information to users of such information. The adoption of a "more likely than not" threshold for initial recognition of the financial statement impact of an uncertain tax position will allow for a more meaningful single threshold for recognition and derecognition of income tax benefits. The Board expresses "concern that a single threshold could result in significant period-to-period changes in tax expense, solely because of changes in the assessment of a tax position." In practice, we believe that changes in the assessment of tax positions occur infrequently. An assessment of a tax position is typically changed or resolved only upon the settlement of an issue with taxing authorities. Consequently, we believe that a dual recognition threshold will result in greater volatility and noncomparability between periods/enterprises than a single "more likely than not" recognition/derecognition threshold.

# Reliance on Prior Experience with Taxing Authorities

We agree with a two-step approach for recognizing and measuring the income tax benefits of uncertain tax benefits as set forth in paragraphs 6 and 11 of the Exposure Draft. However, we believe that reliance on prior experience with taxing authorities and on the results of potential settlement negotiations is appropriate in both the recognition and measurement steps of the analysis and should not solely be limited to "similar positions" as referenced in paragraph 9.c. of the Exposure Draft. For example, there are many instances where the tax law is gray on a particular issue that is not specifically comparable to prior issues discussed with taxing authorities. In practice, there is an expectation that a settlement will be reached other than an all or nothing outcome; and therefore, prior experience with the taxing authorities should not be limited to just similar positions. This further reflects that a "more likely than not" threshold for recognition is both more

operational and leads to more meaningful representation of an enterprise's economic tax position.

## Clarification for Classification of Interest/Penalties

In paragraph B32 of the Exposure Draft, the Board acknowledges the fact that "periods of several years may elapse between the filing of a return and settlement of an audit." As a result, interest incurred on the settlement of tax controversies will, in many instances, represent a large percentage of payments to or from tax authorities. Interest and penalties may therefore have a material impact on the financial results of an enterprise. The Board states in paragraph B37 of the Exposure Draft that it believes it is "inappropriate to provide clarification on the classification of interest and penalties in this Interpretation." We believe, given the diversity that currently exists in the classification of interest and penalties (i.e., reflected in income before tax versus within income tax expense) relative to uncertain tax positions, that the Board should provide guidance as to the proper classification of interest and penalties in order to address the Board's objective surrounding comparability in financial reporting. We recommend that such interest and penalties be classified in income before tax as they are not, in fact, income taxes.

### **Income Tax Returns Not Filed**

Paragraph 7 of the Exposure Draft states that "it shall be presumed that the tax position will be examined by the relevant taxing authority." In discussing "detection risk," the Board notes in paragraph B14 of the Exposure Draft that "tax returns generally are required to be filed" and that, therefore it is presumed "that a tax position will be evaluated by taxing authorities." In practice, an enterprise may believe, based on a more likely than not argument, that a state income tax return is not required to be filed due to a lack of nexus with a state or that a non-US income tax return is not required to be filed due to a lack of a permanent establishment in a particular jurisdiction. These are uncertain tax positions for which an enterprise may be required to accrue an income tax liability. We believe that applying a probable standard in these instances in not appropriate. Furthermore, because an income tax return is never filed, the statute of limitations never expires in these instances. Therefore, an established income tax liability for uncertain tax positions where a tax return was not filed would never be reversed under the provisions of the Exposure Draft. The Board should address this matter in any final guidance by allowing for consideration of prior experience with taxing authorities in determining the need to establish an income tax liability or by limiting the number of years an income tax liability is required to remain recorded.

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In summary, we believe that investor confidence in the reliability of corporate financial statements can be better achieved by recording income tax benefits based on the amount an enterprise ultimately believes will be sustained upon audit by taxing authorities. A recognition threshold of "more likely than not" will result in a better approximation of an enterprise's best estimate of the ultimate outcome of an uncertain tax position than a

threshold of "probable" and therefore improve the representational faithfulness of the financial reporting of the tax effects of uncertain tax positions to the extent possible. We would be pleased to discuss our comments with the Board or Staff. Please contact Karen Dealey at (212) 276-2452 or myself at (212) 276-2620 with any questions or comments.

Sincerely,

/s/ David S. Moser
Managing Director
Principal Accounting Officer