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Technical Director
Financial Accounting Standards Board
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Subject: File Reference No. 1215-001

Dear Director:

The Edison Electric Institute (EEI) appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB or the Board) Exposure Draft (ED) of a Proposed Interpretation, Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109 (Statement 109).

EEI is the association of the nation's shareholder-owned electric entities, international affiliates, and industry associates worldwide. Its U.S. members serve 97 percent of the ultimate customers in the shareholder-owned segment of the industry and 71 percent of all electric utility ultimate customers in the nation. EEI members generate almost 60 percent of the electricity produced by U.S. electric generators.

### **General Comments**

EEI does not believe that significant diversity in practice exists among its members in applying existing Generally Accepted Accounting Principles (GAAP) with respect to the recognition of tax benefits in entities' financial statements. The proposed Interpretation may result in *more* diversity in practice and, in its current form, is a substantive **revision** to the rules for recognition of uncertain tax positions rather than an interpretation of existing GAAP. For the reasons stated below, the FASB should issue guidance that clarifies that tax benefits should be accounted for under the existing loss contingency rules of Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (FAS 5) rather than creating a new standard for the recognition of tax benefits.

### The "Asset Approach"

Statement of Financial Accounting Concepts, No. 6, Elements of Financial Statements (CON 6) defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Liabilities are defined as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (CON 6). The proposed Interpretation takes an "asset approach" to accounting for tax positions. The use of an "asset approach" to establish and measure income taxes liabilities is not appropriate since the recognition of a tax benefit is generally through a reduction in current taxes payable resulting in the retention of cash.

Under a self-assessment reporting system, an entity is required to report the amount due to the taxing authority based on the applicable tax laws. Therefore, there is generally no uncertainty as to whether an asset has been realized under the definition established in CON 6; instead there is uncertainty as to whether the taxing authority will impose an additional liability on the entity. Since there is a risk that an additional liability will be required as a result of an audit by the taxing authority, there is a potential liability under the current FAS 5 standard. Instead of addressing the recognition of such positions as "assets," the proposed Interpretation should focus on providing guidance for determining whether a contingent liability to pay additional taxes and related interest has been incurred pursuant to FAS 5. Under FAS 5, a contingent loss is recorded if it is "probable" that the tax position ultimately will be disallowed and the amount of the resulting liability can be reasonably estimated.

Moreover, the use of the "asset approach" will result in financial statements that fail to reflect management's realistic assessment of the expected outcome of the tax position. This appears to violate a basic concept of financial reporting under Statement of Financial Accounting Concepts No. 1 Objectives of Financial Reporting by Business Enterprises, paragraph 40, which states:

"Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources."

The ED's proposed approach will result in overstated tax liabilities, which is in direct conflict with the above objective as well as the stated objective of the proposed Interpretation<sup>1</sup>. The "asset approach" would result in overstated tax expense and related interest in certain periods followed by understatements in others and therefore would

<sup>&</sup>lt;sup>1</sup> The stated purpose for issuing the Interpretation is that diverse accounting practices have led to "noncomparability in reporting income tax expense that is not discernable by the users of the financial statements."

compromise the comparability of the financial statements from period to period. If the initial recognition threshold under the "asset approach" is not met, a tax liability will need to be recorded even though management may believe that the most likely outcome is that no liability (or a lesser liability) has been incurred. The proposed Interpretation results in an entity recording tax liabilities that it does not realistically expect to pay simply because it does not initially meet the standard for initial recognition under the "asset approach".

Further, because the related interest accrual would be required to be based on the "aggregate difference between the as-filed tax basis and the amount recognized in the financial statements" (Paragraph B39), the interest accrual would also be overstated. For example, an entity may take a position on a tax return that is subject to interpretation, but for which the entity believes it is "more likely than not" that the entity's position would prevail on audit. Although the entity's position would generally result in a lower liability than might be interpreted by the taxing authority, based on the proposed Interpretation, without the ability to assert that the entity's position is "probable" of prevailing, the entity would be required to record a higher interest liability than it ultimately expects to pay.

Additionally, the use of the "asset approach" distinguishes contingent tax (and tax related) liabilities from other contingent liabilities that are subject to FAS 5, a distinction that EEI believes is not appropriate. This inconsistency is further exacerbated by the reversals of these unnecessary accruals in future income when the entity's tax returns are audited or the statute of limitations expires, causing misleading fluctuations in income from period to period. The result is a mismatch between the recognition of earnings and the recognition of the related tax effect in the financial statements simply because the tax effect of the transaction does not meet the "probable" requirement under the "asset approach" and therefore, cannot be recorded in the year in which the transaction occurs. Alternatively, the "asset approach" could lead to the creation of permanent liabilities. For example, an entity's management may believe that it is not subject to tax in a particular state and therefore does not file a tax return in that state. Under most state statutes, if a return is not filed the statute of limitations does not begin<sup>2</sup>. If a tax position of not being required to file a tax return does not meet the "probable" standard under the "asset approach", the potential tax liability (including interest) would be recorded on the books and would be increasing indefinitely.

Additionally, subjective management judgment is still required to determine whether the standard for initial recognition under the "asset approach" is met. This subjectivity could lead to increased diversity in the timing of the recognition of the tax benefit. The "asset approach" can also impact the recognition of tax liabilities simply because the entity and its auditors have differing opinions as to the probability of the ultimate outcome. Under the current FAS 5 approach, it is less likely there will be a controversy between an entity and its auditor regarding a tax liability since this approach is relatively well understood by taxpayers and their advisors in the context of other contingent liabilities.

<sup>&</sup>lt;sup>2</sup> See discussion later on whether the accrual of such liability is required under the proposed Interpretation.

In summary, the "asset approach" would hold contingent income tax liabilities to a much higher standard than other contingent liabilities as to whether a liability should be reported for financial statement purposes. This standard would lead to overstated tax expense in certain periods followed by understatements in others and therefore would compromise the comparability of the financial statements from period to period.

# Suggested Modifications to the "Asset Approach"

Although the contingent liability approach described above is the proper accounting, if the Board decides instead to adopt an "asset approach" to recognize income tax benefits, the following modifications to the proposed approach would make it more viable in practice.

## Limitation of Scope

The language as written seems to require an analysis to be performed of all tax positions. The broad scope of the proposed Interpretation could lead to unintentional, overly burdensome documentation requirements and inconsistency as entities attempt to apply both the recognition threshold to every tax return position and the derecognition threshold to every tax position that previously met the recognition threshold. EEI suggests that the term "uncertain tax position" be defined in a manner to avoid the potential application of the proposed Interpretation to all tax positions and to avoid inconsistency caused by subjective interpretation of that term by entities and their auditors. For example, if the Board is concerned that entities are reporting tax benefits in their financial statements related to non-meritorious and non-sustainable tax positions taken on filed tax returns, then the scope of this Interpretation should address those tax positions where the Internal Revenue Service (IRS) is known to take exception. This would include tax positions that the IRS has designated as reportable/listed transactions.

## Initial Recognition

The Board decided, in the ED, to require that an entity recognize, in its financial statements, the best estimate of the impact of a tax position only if it is "probable" of being sustained on audit based on the technical merits of the position. In evaluating whether the "probable" threshold has been met, the entity is required to presume that the tax position will be evaluated during an examination by the taxing authority. While EEI agrees that there should be a consistent standard for the recognition of tax assets and liabilities, we do not agree with the "probable" standard for initial recognition. EEI believes that a "more likely than not" standard is a more appropriate threshold, if the "asset approach" is used.

The "probable" standard does not correspond to what is required by the tax law for avoiding a penalty on a tax return position. Most taxing authorities use a "substantial authority" threshold as the confidence level required to avoid a penalty for a tax return position. However, a "more likely than not" is the highest standard for avoiding a

penalty under tax law for tax return positions that are considered to be tax motivated transactions. Many non-tax motivated transactions that meet the "substantial authority" or "more likely than not" threshold for tax return reporting purposes, would not meet the "probable" standard required under the proposed Interpretation. For example, normal "repair vs. capital" positions taken on tax returns involve such an unsettled area of the tax law that an entity's return position could fail to meet the "probable" standard even though, based on management's judgment, the position is valid under the tax law.

A "more likely than not" threshold will still result in somewhat overstated liabilities due to the inherent nature of the "asset approach"; however, it is a more appropriate standard than the "probable" standard because it significantly reduces the amount of the overstated liabilities and corresponds to the tax return reporting standard to avoid penalties for most transactions.

#### Measurement

After an uncertain tax position meets the appropriate recognition threshold, the ED advocates the use of a "unit of account", an undefined term that has created much confusion with regard to the amount of benefit to be recognized. However, as illustrated in Appendix A of the ED, the unit of account approach is administratively burdensome. The necessary documentation to divide each tax position into its components would be overwhelming, particularly for a large company. Additionally, some tax positions are not easily susceptible to this type of division, which would create uncertainties as to how to apply the approach. The documentation burden and associated uncertainties would also create issues from a Sarbanes-Oxley compliance perspective.

Accordingly, the measurement guidance in Appendix A of the ED should be clarified to include any reasonable method that would adequately document management's assessment of the amount of the tax benefit that would meet the required threshold. Management's assessment would need to be based on the weight of available evidence, but not be constrained to any particular computational approach.

#### Change the Effective Date

The implementation of the new standard as written would subject entities to significant implementation issues and resource constraints considering the existing requirements for compliance with Section 404 of the Sarbanes-Oxley Act. Therefore, EEI recommends that the effective date of the pronouncement be delayed until the first fiscal year beginning after December 15, 2006. This would allow an appropriate period for entities and accounting firms to evaluate and resolve all implementation issues and requirements, including compliance with Sarbanes-Oxley Section 404.

#### Conclusion

As stated above, uncertain tax positions should be evaluated under the current provisions of FAS 5, whereby a contingent loss is recorded if it is "probable" that the tax position

ultimately will be disallowed and the amount of the resulting liability can be reasonably estimated. The liability approach is more representative of the overall tax posture of the entity and reflects the self-assessment income tax reporting system. The filing of a tax return based on an uncertain tax position creates a contingent tax liability for the potential assertion of a claim against the entity by the taxing authority.

If the Board decides to pursue an "asset approach", the scope of the ED should be narrowed. The term "uncertain tax position" should be defined in a manner that does not require the application of the proposed Interpretation to all tax positions of an entity. Additionally, a "more likely than not" recognition standard should be substituted for the proposed "probable" standard. A "more likely than not" threshold reduces the overstatement of the liabilities that are expected to be paid. Such a threshold would achieve the FASB's objective of consistency by creating a clear and meaningful standard for entities. It should be noted that the "asset approach" inherently causes the overstatement of liabilities. However, a "more likely than not" threshold would mitigate some of the overstatement and would lead to less overstatement than the proposed "probable" threshold. Furthermore, the "more likely than not" standard is more consistent with the threshold required for reflecting a position that is considered to be a tax motivated transaction on a tax return.

We appreciate your consideration of our views on the Exposure Draft. If you have any questions regarding these comments, please call 202-508-5494.

Sincerely,

David K. Owens
Executive Vice President
Business Operations