Letter of Comment No: 43

File Reference: 1215-001

Date Received: 9/12/05

AMERICAN COUNCIL OF LIFE INSURERS

FINANCIAL SECURITY FOR LIFF

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September 12, 2005

Mr. Robert H. Herz Chairman Financial Accounting Standards Board 401 Merritt 7 Norwalk, Connecticut 06856-5116

RE: Proposed Interpretation, Accounting for Uncertain Tax Positions: An Interpretation of FASB Statement No. 109

Dear Mr. Herz:

The American Council of Life Insurers (ACLI) would like to offer our comments on the Proposed Interpretation – Accounting for Uncertain Tax Positions, an interpretation of FASB Statement No. 109 (Proposed Interpretation). The ACLI is the principal trade association of life insurance companies, representing 356 members that account for, in the aggregate, 80 percent of the assets of legal reserve life insurance companies in the United States.

The Proposed Interpretation recommends taking an asset approach in recognizing benefits for uncertain tax positions. We believe that the asset approach is flawed for several reasons. From a technical perspective, this approach flows from an incorrect and unworkable view on the unit of account. While the Proposed Interpretation does not state what the unit of account should be, there is a strong implication that it is much more granular than current practice. It is unfortunate this question comes before the Board at this time, after this question has been identified as an underdeveloped concept in US and international GAAP. We propose that for taxes, "What we're accounting for" is our obligation (i.e., a liability) to the taxing authority, based on the application of the existing tax code to all of our operations subject to that code. This suggests that the unit of account is at the taxing authority level, or perhaps at the 'filed return' level, for example in cases where more than one consolidated return is filed in a given jurisdiction as is often the case for corporations with complex structures.

The result of the asset approach provides its own set of problems, which we believe also are indications that the approach is not valid. First, the asset approach results in an overly conservative liability because only benefits that have a probable (determined to be about 70%) chance of being sustained upon audit are recognized. Second, it is punitive in that it imposes an interest expense burden on companies' tax positions that are more likely than not to be realized. Third, it adds unnecessary volatility to financial statements as tax

benefits on uncertain tax positions are settled for amounts greater than zero even though those positions were not considered probable of being sustained under audit and hence, the tax benefit had not been previously recorded. Fourth, this approach is inconsistent with FASB Statement No. 5, Accounting for Contingencies (FAS 5) which already addresses the exact scenario of tax contingencies in paragraphs 36, 39 and 69 and provides sufficient accounting guidance (as well as being inconsistent with FASB Statement No. 109, Accounting for Income Taxes (FAS 109) where the Board rejected the probable threshold for deferred tax assets as described later under Issue 3). Finally, this approach creates administrative burdens to maintain tax inventories that cannot be tied into the tax return.

A more appropriate approach would be the current FAS 109 model for deferred tax assets and the FAS 5 liability approach in which management's best estimate is used to assess the recognition/derecognition and measurement of current uncertain tax positions. Following the FAS 5 liability approach, the company would record a tax charge initially based on the filed return, and then, if the company believes it is probable that upon audit some additional amount would be due, then liability for management's best estimate should be recorded. We believe that the accounting for tax contingencies is addressed in FAS 5 and the guidance for the establishment and valuation of the liability is clearly defined.

The Board should revisit the accounting guidance and take an approach to address it with a FAS 5 liability model. We believe that most companies are currently using a FAS 5 liability model in their process of establishing tax liabilities and any diversity in practice is contained within a liability/FAS 5 contingent liability approach. This guidance should seek to focus on providing clarity within a liability paradigm to ensure consistency. Clarification of the FAS 5 model for establishing liabilities for uncertain tax positions will take other approaches off the table and require companies to be able to specifically identify tax liabilities under FAS 5.

In response to the specific issues raised in the Proposed Interpretation, we offer the following comments.

Issue 1 – Scope

We agree that if the accounting guidance is changed for uncertain tax positions, it should apply to all outstanding positions as of the effective date of the guidance.

<u>Issue 2 – Initial Recognition</u>

We agree with the presumption that a taxing authority will, during an audit, evaluate a tax position taken or expected to be taken in a filed return when assessing recognition of uncertain tax positions. We feel that detection risk should not be considered when assessing the ability to recognize a tax benefit in such a situation. However, where the 'position' taken is that the company is not required to file a tax return, it would be appropriate to consider the likelihood that the taxing authority will assert a claim. For example, if a company determines that it is not required to file a tax return in a particular state, then when determining whether to accrue a contingent obligation to that state, the company should include an assessment of the likelihood that the state's revenue authority will question the company's determination that no return is required.

<u>Issue 3 – Initial Recognition</u>

As discussed previously, we disagree with the asset approach taken in the Proposed Interpretation. However, even following an asset approach, we disagree with the selection of probable as the recognition threshold, and as a result we disagree with the dual threshold approach selected by the Board.

Assuming that the Board continues with an asset recognition model, we feel that the probable threshold is too high and will introduce a conservative bias in the measurement of tax liabilities. Concepts Statement No. 2 (CON2) notes that conservatism has a place, but cautions that conservatism should not result in deliberate, consistent understatement of net assets and profits. The understatement of net assets that will result from the application of this guidance will certainly result in the overstatements of profits in the period in which the understatement is corrected. This was the problem that the Board recognized in CON2, in that it would likely raise questions about the reliability and the integrity of the reported financial information. Rather, CON2 suggests the place for conservatism is in situations in which two outcomes are about equally likely – using the less optimistic outcome would be an appropriate use of conservatism in financial reporting.

Many uncertain tax positions are settled for some amount less than that filed on the return, but greater than zero. Management's best estimate takes into consideration its ability to negotiate a settlement as well as the level of risk of the tax position. Using a lower threshold than probable, i.e. more likely than not, would provide for additional tax positions to be valued at management's best estimate and reduce year-over-year volatility that would result from settlements on tax positions that were not recorded because they did not meet the probable threshold.

Additionally, the use of the probable threshold for recognizing a tax asset or liability is contrary to the current language of FAS 109. When adopting FAS 109, the Board chose "more likely than not" as the appropriate criteria for recognizing tax assets. Paragraph 96 of FAS 109's Appendix A states, "The Board believes that the criterion required for measurement of a deferred tax asset should be one that produces accounting results that come closest to the expected outcome, that is, realization or non-realization of the deferred tax asset in future years. For that reason, the Board selected more likely than not as the criterion for measurement of a deferred tax asset." In explaining why it chose "more likely than not" as the appropriate criterion it stated, "The Board intends more likely than not to mean a level of likelihood that is more than 50 percent. Selection of more likely than not as the criterion for measurement of a deferred tax asset is intended to virtually eliminate any distinction between the impairment and affirmative judgment approaches." The guidance in the Proposed Interpretation requiring probable as the recognition criterion was specifically rejected in FAS 109.

Paragraph six of the Proposed Interpretation states that a tax position may be recognized only when it is "probable of being sustained on audit by taxing authorities". This guidance would require an "affirmative judgment approach" as the criterion for recognizing a tax asset. The "affirmative judgment approach" for recognizing a tax asset was specifically rejected by the Board in drafting FAS 109. Paragraph 95a of Appendix A of FAS 109 states, "Affirmative judgment approach – A deferred tax asset would be

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¹ FAS 109 Paragraph 97

recognized if it is probable that the asset will be realized. The problem is that recognition of a deferred tax asset that is *expected* to be realized is prohibited when the likelihood of realizing that asset is considered to be less than probable. The Board believes that result is unacceptable." The Board is now attempting to interpret FAS 109 by adopting a recognition criterion for tax assets, including deferred tax assets arising from deductible temporary differences, which the Board specifically rejected in adopting FAS 109.

We recommend that the recognition threshold be changed to "more likely than not". This would preserve the recognition threshold for deferred tax assets in FAS 109, align the accounting guidance for all tax benefits and provide a single threshold for recognition and de-recognition as well as provide for greater clarity for financial statement users.

<u>Issue 4 – Subsequent Recognition</u>

We agree with the Board's conclusion, however, we reiterate our desire to reduce that threshold to "more likely than not" to avoid volatility and administrative challenges that subsequent recognition will cause.

Issue 5 – Derecognition

In general, we agree with the Board's conclusion. However, in the interest of consistency and ease of application, reconsideration should be limited to those uncertain positions that are affected by changes in tax law, regulatory action or company tax audit.

Issue 6 – Measurement

We agree with the Board's conclusion.

Issue 7 – Classification

We agree with the Board's conclusion.

<u>Issue 8 – Change in Judgment</u>

We agree with the Board's conclusion.

<u>Issue 9 – Interest and Penalties</u>

We agree with the Board's conclusion.

Issue 10 – Disclosures

We do not believe that disclosure guidance should be part of the Proposed Interpretation. Disclosure guidance exists in FAS 5 and FAS 109 and is not necessary within the scope of this document. Further, the additional requirements for disclosure of uncertain tax positions would create an unnecessary conflict with the duty of employees to lawfully minimize their client's or employer's tax liability. Such disclosure requirements could result in certain information being provided to taxing authorities that could compromise the company's ability to resolve the issue in the manner that the company thinks is correct and consistent with shareholder and policyholder interests. We therefore request that the disclosure requirements be removed from the Proposed Interpretation.

<u>Issue 11 – Effective Date and Transition</u>

We believe that given the expected issuance of this Proposed Interpretation in the fourth quarter, companies will not have adequate time to implement this by the December 31, 2005 effective date. We suggest that the effective date be for fiscal quarters ending after December 15, 2006.

Items for Clarification

We request that the Board provide additional information that can provide clarification regarding the following items:

- "Being sustained upon audit" We request language be added to paragraphs six and ten to make it consistent with the language used in paragraphs eleven and A3 with respect to including the final resolution of litigation or appeals in the assessment of a tax position being sustained upon audit.
- The Board references FAS 109 paragraph 194 in paragraph B36 of the Proposed Interpretation, which discusses changes in tax law or a change in circumstances giving rise to a change in judgment. We would like additional examples around what situations could trigger a change in judgment.
- Further clarification is needed in the first illustration described in paragraphs A2 through A11. In this example, a tax benefit is recognized for the first two R&D projects, but not for the third and fourth projects due to the probable threshold not being met. However, in paragraph A9, it states that although historically, expenditures have been disallowed initially, subsequently these expenditures have been settled with the taxing authority resulting in a minor benefit. In addition, management believes it is probable that 10% of the claimed benefit ultimately will be sustained. Therefore, this would seem to imply it is probable a benefit will be realized, and the entity should include 10% of the costs in the benefit calculation. We would like further explanation as to why the Board feels the recording of this 10% would be inappropriate.

Sincerely.

James F. Renz

Director, Accounting Policy