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Microsoft.

September 8, 2005

Ms. Suzanne Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 Norwalk, CT 06856-5116

Re: File Reference No. 1215-001

Dear Sue:

Microsoft appreciates the opportunity to respond to the Exposure Draft (ED), "Accounting for Uncertain Tax Positions". We strongly disagree with the ED's underlying principle that uncertain tax positions should be accounted for under an asset recognition model. Microsoft believes that uncertain tax positions should be accounted for under the premise that they are contingent liabilities and we believe this is supported by paragraph 39 of FAS 5, Accounting for Contingencies, which includes an example of an income tax loss contingency, and paragraph 69 of FAS 5, which makes reference to accruals for a probable tax assessment as an example of a loss contingency. Furthermore, we believe that the ED is fatally flawed, as it includes no basis for conclusion for the underlying principle that uncertain tax positions should be accounted for under an asset recognition model.

The Summary to the ED indicates that, "Because income taxes are not measured on a fair value basis, this proposed Interpretation would require that an enterprise's tax position meet a specific confidence threshold as a condition for recognizing an asset or reducing a liability as a result of that tax position" [Emphasis added]. However, there appears to be no discussion or basis for conclusion of whether it would be more appropriate or conceptually correct to look at the condition for recognizing a liability or reducing an asset as a result of a tax position, especially given the fact that income tax loss contingencies are specifically mentioned in FAS 5.

We reviewed the Board meeting minutes on this project and failed to find a discussion of this pivotal issue, but consistently found what we believe to be a bias towards an asset recognition model (including using terms such as "tax benefits") without any debate on whether this is appropriate or conceptually correct. In fact, at the first Board meeting for this project, the FASB staff began the meeting "by providing the background to the recognition of tax benefits (including those related to uncertain tax positions) in the financial statements" [Emphasis added]. We note that at the February 16, 2005 Board

meeting an alternative approach was considered (Impairment Approach), but we believe that approach is also based on an asset recognition model, as evidenced by the description of the approach in the context of "... the benefit from a tax position ..." and the debate on whether "... the Impairment Approach violates the definition of an asset ...".

Microsoft believes that uncertain tax positions should be accounted for under the premise that they are contingent liabilities, consistent with current guidance in FAS 5. If the Board believes that uncertain tax positions should be accounted for under an asset recognition model, it needs to more fully debate and document why that is appropriate and conceptually correct. Our responses to the individual issues raised in the ED are attached. If you have any questions, please contact me at (425) 703-6094.

Sincerely,

Bob Laux
Director, Technical Accounting and Reporting

## Scope

Issue 1: This proposed Interpretation would broadly apply to all tax positions accounted for in accordance with Statement 109, including tax positions that pertain to assets and liabilities acquired in business combinations. It would apply to tax positions taken in tax returns previously filed as well as positions anticipated to be taken in future tax returns. Do you agree with the scope of the proposed Interpretation? If not, why not?

Response: We believe the Interpretation should apply to all tax positions.

# **Initial Recognition**

Issue 2: The Board concluded 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. (Refer to paragraphs B12–B15 in the basis for conclusions.) Do you agree? If not, why not?

Response: We agree.

Issue 3: The Board decided on a dual threshold approach that would require one threshold for recognition and another threshold for derecognition. The Board concluded that a tax position must meet a probable (as that term is used in Statement 5) threshold for a benefit to be recognized in the financial statements. (Refer to paragraphs B16–B21 in the basis for conclusions.) Do you agree with the dual threshold approach? Do you agree with the selection of probable as the recognition threshold? If not, what alternative approach or threshold should the Board consider?

Response: No, we do not agree with a dual threshold approach. A probable threshold should be used as the recognition threshold for recording a contingent tax liability and that liability should be derecognized when it is no longer probable.

## **Subsequent Recognition**

Issue 4: The Board concluded that a tax position 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. (Refer to paragraph B22 in the basis for conclusions.) Do you agree? If not, why not?

Response: Consistent with our response above, a probable threshold should be used as the recognition threshold, regardless of whether it is initial recognition or subsequent recognition.

## Derecognition

Issue 5: The Board concluded that a previously recognized tax position that no longer meets the probable recognition threshold should be derecognized by recording an income tax liability or reducing a deferred tax asset in the period in which the enterprise concludes that it is more likely than not that the position will not be sustained on audit. A valuation allowance as described in Statement 109 or a valuation account as described in FASB Concepts Statement No. 6, Elements of Financial Statements, should not be used as a substitute for derecognition of the benefit of a tax position. (Refer to paragraphs B23–B25 in the basis for conclusions.) Do you agree with the Board's conclusions on derecognition of previously recognized tax positions? If not, why not?

Response: No, as we mentioned in our response to Issue 3, a contingent tax liability should be derecognized when it is no longer probable.

#### Measurement

Issue 6: The Board concluded that once the probable recognition threshold is met, the best estimate of the amount that would be sustained on audit should be recognized. The Board concluded that any subsequent changes in that recognized amount should be made using a best estimate methodology and recognized in the period of the change. (Refer to paragraphs B9–B11 and B26–B29 in the basis for conclusions.) Do you agree with the Board's conclusions on measurement? If not, why not?

Response: Microsoft agrees that once a probable recognition threshold is met, the best estimate of the loss contingency should be recognized. However, while it is clearly evident from our response that we strongly disagree with the underlying principle of the ED that uncertain tax positions should be accounted for under an asset recognition model, we also disagree with the guidance that the difference between the best estimate amount recognized in the financial statements and an amount claimed or expected to be claimed on the tax return shall be evaluated to determine whether the magnitude of that difference is sufficient to indicate that the probable recognition threshold has not been met.

First, we do not believe the ED's basis for conclusions provides adequate support for why this guidance is in the ED. Paragraph B29 of the ED indicates that, "... the best estimate of a tax benefit ... can be so different from the claimed benefit as to call into question the conclusion that the probable recognition threshold has been met". We believe this is akin to putting auditing guidance in an accounting standard. Secondly, we believe this guidance mixes the issue of recognition with measurement, similar to a fair value measurement which combines recognition and measurement uncertainty into a single measurement attribute. We find this inconsistent with paragraph B10 of the ED which indicates that, "... the Board decided against further consideration of a fair value measurement attribute for financial statement measurement of uncertain tax positions".

#### Classification

Issue 7: The Board concluded that the liability arising from the difference between the tax position and the amount recognized and measured pursuant to this proposed Interpretation should be classified as a current liability for amounts that are anticipated to be paid within one year or the operating cycle, if longer. Unless that liability arises from a taxable temporary difference as defined in Statement 109, it should not be classified as a deferred tax liability. (Refer to paragraphs B30–B35 in the basis for conclusions.) Do you agree with the Board's conclusions on classification? If not, why not?

Response: Amounts recognized as contingent tax liabilities should be classified as current liabilities if those amounts are anticipated to be paid within one year or the operating cycle, if longer.

# Change in Judgment

Issue 8: The Board concluded that, consistent with the guidance in paragraph 194 of Statement 109, a change in the recognition, derecognition, or measurement of a tax position should be recognized entirely in the interim period in which the change in judgment occurs. (Refer to paragraph B36 in the basis for conclusions.) Do you agree with the Board's conclusions about a change in judgment? If not, why not?

Response: Microsoft believes that changes in the recognition, derecognition, or measurement of a contingent tax liability is a discrete event and should be recognized entirely in the interim period in which the change in judgment occurs, consistent with the guidance in APB Opinion No. 28.

#### **Interest and Penalties**

Issue 9: The Board concluded that if the relevant tax law requires payment of interest on underpayment of income taxes, accrual of interest should be based on the difference between the tax benefit recognized in the financial statements and the tax position in the period the interest is deemed to have been incurred. Similarly, if a statutory penalty would apply to a particular tax position, a liability for that penalty should be recognized in the period the penalty is deemed to have been incurred. Because classification of interest and penalties in the income statement was not considered when Statement 109 was issued, the Board concluded it would not consider that issue in this proposed Interpretation. (Refer to paragraphs B37–B39 in the basis for conclusions.) Do you agree with the Board's conclusions about recognition, measurement, and classification of interest and penalties? If not, why not?

Response: Microsoft believes the accrual of interest should be based on the amount of an income tax loss contingency in the period the interest is deemed to have been incurred. We agree with the Board's conclusion that a liability for a statutory penalty should be recognized in the period the penalty is deemed to have been incurred and the conclusion to not consider the classification of interest and penalties in the income statement.

### **Disclosures**

Issue 10: The Board concluded that loss contingencies relating to previously recognized tax positions should be disclosed in accordance with the provisions of paragraphs 9–11 of Statement 5. The Board also concluded that liabilities recognized in the financial statements pursuant to this proposed Interpretation for tax positions that do not meet the probable recognition threshold are similar to contingent gains. Therefore, those is liabilities should be disclosed in accordance with the provisions of paragraph 17 of Statement 5. (Refer to paragraph B40 in the basis for conclusions.) Do you agree with the disclosure requirements? If not, why not?

Response: Loss contingencies related to uncertain tax positions should be disclosed in accordance with the provisions of paragraphs 9-11 of Statement 5. As previously indicated, Microsoft believes that the concept that an uncertain tax position can result in a contingent gain is fundamentally flawed.

### **Effective Date and Transition**

Issue 11: The Board concluded that this proposed Interpretation should be effective as of the end of the first fiscal year ending after December 15, 2005. Only tax positions that meet the probable recognition threshold at that date may be recognized. The cumulative effect of initially applying this 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. Restatement of previously issued interim or annual financial statements and pro forma disclosures for prior periods is not permitted. Earlier application is encouraged. (Refer to paragraphs B41–B43 in the basis for conclusions.) Do you agree with the Board's conclusions on effective date? If not, how much time would you anticipate will be necessary to apply the provisions of this proposed Interpretation? Do you agree with the Board's conclusions on transition? If not, why not?

Response: We disagree with the Board's conclusion on effective date. It is incumbent on the FASB to more fully debate and document why uncertain tax positions should be accounted for under an asset recognition model and we do not believe this could adequately be done in order to meet the proposed effective date. Microsoft suggests an effective date as of the end of the first fiscal year ending after December 15, 2006. We agree with the Board's conclusion on transition.