

## M E M O R A N D U M

To: Technical Director  
From: John Ferry  
Date: 9/12/05  
Re: File Ref # 1215-001

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This memo provides my comments with respect to the Exposure Draft on Accounting for Uncertain Tax Positions, File # 1215-001. Clearly the Board intends to implement a brighter line test for determining tax assets and reserves and I tend to agree with the theory behind updating the rules in this area. However, after analyzing the implications of such new standards to my own company, I have come up with several areas that truly need to be considered before enacting the Draft as is. Below are the areas that I believe merit further analysis and discussion by the Board.

1. The recognition standard of "probable" or "should prevail" will create material, (make that massive) over-accruals for reserves and under-reported tax assets. The threshold for recognition should be more likely than not and valued as the amount that is probable of being realized.
2. The recognition standard will create tax rate volatility as tax assets are eventually recognized that did not meet the probable standard.
3. The recognition standard will result in increased costs (both internal & external professional costs) to companies for substantiating a probable position.
4. The proposed rules would provide the Internal Revenue Service with yet an even stronger hand in auditing tax positions and companies will become reluctant to take positions that may not rise to the "probable" threshold for fear of having to report tax reserves.

### Discussion & Analysis:

1) The Draft probable standard will indeed give rise to widespread over-accruals of reserves. I firmly believe that the standard for recognition should be more likely than not

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and then measured or valued as to the amount that is probable of recognition. It is evident that the Board would like to create a standard that is less subjective and more on even ground with other assets on the balance sheet. It is understood that having a better than 51% chance of success is not how most accountants would go about recognizing other non-tax assets. The problem however, is that the tax law is often gray. Having an all or nothing standard does not provide financial statement readers with a clearer understanding of the tax items. Just stop and think of the volumes of tax code and regulations, the number of tax professionals, & the number of judicial proceedings attributable to uncertain tax positions. Most tax professionals agree that at least some amount of benefit is probable of being realized even when the position amounts to a more likely than not. Why not reflect that benefit in the financials?

It is conceded that financial auditors may find it more challenging when auditing a more likely than not standard because it is less of a bright line than a "should" position. However, a revised rule with guidelines on how companies should measure the assets would provide the consistency in application and a methodology for financial auditors to objectively verify.

It is useful to look at an example to illustrate how the "probable" standard will result in over accruals. Lets say a California business has Nexus in five other states and has sales that may be characterized for state apportionment purposes as either a license of intangible property or sales of tangible personal property (TPP). The law in each state is uncertain on whether sales should be characterized as intangibles or TPP. Also assume that each state apportions taxable income using the standard three factor formula and that the sales factor includes all intangible sales but is zero for TPP sales because the sales are sourced to the customer destination. Now assume that the company files tax returns under the presumption that the sales are TPP and sourced to the customer destination which is all 50 states. Under the Exposure Draft, the company would need to book a reserve in California and in each of the states it has nexus since the tax position is uncertain. Again, the company would accrue for taxes on the same revenue in each state jurisdiction because potentially each state could determine under audit that the sales are sourced to its jurisdiction. Because the law is not clear the same result would apply if the company filed returns using the intangible sales method. The point to illustrate here is that the company would accrue for reserves even though it is very unlikely that the company will end up owing a worst case tax in each of the five states. There are many instances where conflicting state tax laws could produce distorted financial statements according to the Exposure Draft. Of course the uncertainty in Federal tax areas including International, M&A, and even simple capitalization policies for fixed assets can generate uncertainty regarding the application of the Exposure Draft.

2) The recognition standard will create tax rate volatility as tax assets are eventually recognized that did not meet the probable standard. I'm sure you are aware of this one so I won't elaborate but just imagine my example above if a company were in 30+ states.

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There is no question that if the probable standard remains, companies will have huge volatility in their rate. By adopting a more likely than not standard coupled with a probable measurement standard, companies will record tax assets that more clearly reflect realization.

3) The probable standard will vastly increase costs for public companies, particularly in outside tax professional fees. In the new Sarbanes world, any time a public company has an issue that is uncertain as to whether it rises to the "probable" level they will no doubt engage a tax professional. If they don't and they take the probable position, it has a greater chance of being challenged by the audit firm and could raise control issues if the audit firm disagrees with the conclusion of the in house tax department. Most tax directors won't chance this and will seek outside opinions to support their financial statements. Worth noting is that "should prevail" positions cost a great deal more than a lesser standard particularly if tax firms know their positions will support the "probable" standard in the financial statements.

4) This is self explanatory and will no doubt drive tax departments into either taking pro-IRS positions or seeking advice from tax professionals to establish a position on a tax return. Many companies will be adverse to taking positions that are less than should prevail even if they know they could settle with the IRS.