



LETTER OF COMMENT NO. 32

January 8, 2007

Mr. Robert H. Herz  
Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: Request for Delay in Implementing FIN 48

Dear Chairman Herz:

The Council On State Taxation (COST) respectfully requests that the Financial Accounting Standards Board delay implementation of FIN 48, *Accounting for Uncertainty in Income Taxes*. Implementation under the existing timeline will 1) lead to reporting errors due to the pressure of the short implementation deadline and the voluminous review and documentation requirements necessary for a multi-jurisdiction analysis; and 2) fail to realistically reflect companies' state tax positions in their financial statements because of confusing, conflicting and controversial compliance principles that need additional review and discussion before useful and realistic information can be provided to shareholders and the financial markets.

About the Council On State Taxation

COST is a non-profit trade association formed in 1969 to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest corporations in the United States, including companies from every industry segment. COST filed comments with FASB on the initial Exposure Draft and, since the release of FIN 48, has monitored its members' implementation efforts and offered almost weekly educational programs on FIN 48 issues to affected businesses around the country. COST members, because of their size, geographic reach and diversity of industry, comprise a significant segment of businesses subject to the financial reporting rules. Almost all of COST's members are subject to FASB rules and are implementing the FIN 48 standard.

Request for Implementation Delay

COST suggests the Financial Accounting Standards Board delay implementation of FIN 48 to achieve accurate financial reporting and to provide time for clarification and guidance on certain controversial aspects of FIN 48 as applied to unique state and local tax issues.

The implementation of FIN 48 should be delayed in order to promote accurate financial reporting. Businesses subject to FIN 48 had only 5 months between the adoption of the final version and its required implementation. Although an earlier exposure draft was available for public review and comment, this draft contained numerous controversial or incomplete principles, many of which were addressed in the final version and, thus, the exposure draft was not guidance on which companies could rely to begin a compliance effort. At least forty-five states and numerous local jurisdictions impose a tax covered by FIN 48. Because of the extreme variations

in tax law and interpretations between these jurisdictions, and the lack of clear guidance for many ordinary issues, state and local tax practitioners have been anxiously rushing to comply with FIN 48. Compliance for the state and local tax function, as suggested by the outside auditing firms that must sign off on the analysis, includes compiling an inventory of all state and local tax issues by jurisdiction, collecting supporting documentation, and analyzing each position in each jurisdiction under the new FIN 48 standard – a hefty feat under the best of circumstances.

State and local tax professionals responsible for FIN 48 compliance are indeed attempting to perform a Herculean task in a very short time span. Removal of the immediate time pressure will allow state and local tax professionals the opportunity to more thoroughly prepare, and to allow for proper reflection and deliberation on initial conclusions. There is usually a trade-off between immediacy and accuracy. COST suggests that in this instance, and somewhat in hindsight, the trade-off currently imposed is not a good one. An extension of the deadline would significantly reduce errors and thus enhance the overall accuracy of financial reporting.

A second reason for delaying the implementation deadline for FIN 48 is to allow time for additional discussions between corporate taxpayers, their outside auditors and the FASB (and other interested parties) regarding questions surrounding implementation principles. Additional discussions are necessary because some of the results of a strict FIN 48 application are contrary to the stated goals of FASB and FIN 48.

For example, a specific goal of FIN 48 is to increase comparability between financial reports. However, as the process of preparing for FIN 48 compliance has progressed, it has become clear that in some common circumstances FIN 48 will actually decrease comparability. For instance – in the measurement step of FIN 48 each tax asset must be measured on a stand-alone basis. Thus, the overall tax and settlement position of the taxpayer is not a factor in the measurement step. This required myopia could lead to significant comparability problems if two taxpayers have a similar issue but a very different overall tax profile. Looking at the particular issue in a vacuum, each taxpayer could conclude that the proper measurement is a 60% recovery of the benefit. Under FIN 48, each taxpayer would reflect a 60% benefit with a 40% reserve. But each taxpayer does *not* consider the issue in a vacuum; the issue occurs in conjunction with other tax issues. One taxpayer may know it will give up on the issue entirely if another potential tax issue is settled in its favor. The other taxpayer, however, would only agree to any settlement of the issue if its overall tax liability for the year increases by less than 20%. This very different real tax profile is never reflected in the financial statements under FIN 48. Under FIN 48, it appears that each taxpayer will receive the same benefit – even though this is clearly not the case when the audit actually occurs. The result is a required yet potentially opaque-to-the-public non-comparability in the financial statements. The only comparability in this common situation is between taxpayers' ability to comply with FIN 48, not the taxpayers' ultimate tax liability risk.

A second example of why additional time for discussions fleshing out the implementation principles of FIN 48 for state and local tax purposes is that the current application will actually thwart the ultimate goal of FASB rules – *i.e.*, providing better, more transparent, and understandable information to shareholders and the financial markets. Unfortunately for these stakeholders, the reported information required under FIN 48 for state and local taxes will in certain, common situations be completely wrong in reality.

The most prominent instance of this perversion of the goal concerns nexus – the level of contacts required under the United States Constitution that a business must have with a jurisdiction before that jurisdiction may subject the business to tax. The issue of nexus was detailed by COST in its comments to the FASB on the initial Exposure Draft and also listed as an

issue in at least five other comments. Although the final version of FIN 48 added an example addressing nexus, it was unfortunately not an example that involves a realistic situation that would normally be encountered by any taxpayer. Thus, the issue of nexus remains and continues to haunt a significant part of ongoing discussions.<sup>1</sup>

The issue of nexus is of material importance because a) if a business determines it does not have nexus with a jurisdiction it never files a return and thus the statute of limitations never closes, and b) substantial controversy exists over what types of contacts a taxpayer must have with a state for nexus to arise. It is vital to note that the controversy over the level of contacts required to establish nexus (and thus the difficulty in reaching a more likely than not determination) is not because the taxing jurisdiction is more likely than not to prevail and the taxpayer is taking a questionable position. Unlike a tax shelter or other aggressive tax position, where the odds of the taxing authority prevailing are frequently the inverse of the odds of the taxpayer prevailing, the nexus area is the classic grey area of the law in which it is not clear at all what the rule is.<sup>2</sup> Anecdotal evidence from presentations by many representatives of the Big Four auditing firms points to the conclusion that reaching a more likely than not determination on nexus will be doubtful in many situations. Numerous taxpayers will be required to reserve the full 100% of the “potential” tax liability in locations where they do not currently believe they have nexus, but might in the future depending on how the law shakes out over the coming years (decades).<sup>3</sup> As noted, this reserve is indefinite with interest and penalties accruing each year. Many of these taxpayers will never actually be subject to a tax payment by the jurisdiction because the law might be resolved in the taxpayer’s favor (or the tax authority tacitly accepts the taxpayer’s position by never assessing the position) but the lack of a real tax liability will not only never be reflected in the financial statements, the erroneous position of an unpaid liability will continue to accumulate and compound over the years. Thus, we know right now under existing FIN 48 rules that many businesses with nexus issues will carry financial statements that do not reflect reality and over time will not reflect reality in ever increasing amounts.

Unfortunately, the problem with FIN 48 and nexus is so great that at least one accounting firm has publicly suggested that businesses should consider filing and paying taxes in jurisdictions where they may not have nexus because the alternative under FIN 48 (indefinite reserves, interest, and penalties) is too large a dollar figure for the financial statement to bear. Thus, the regrettable result of FIN 48 – a rule created under a regime to protect shareholders and the financial markets, will actually make shareholders of companies with nexus questions financially worse off because the company will be compelled to pay a tax that it never actually owes.

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<sup>1</sup> The issue of nexus is neither a hypothetical question nor an obscure issue. In a recent survey of COST members regarding issue priorities unrelated to FIN 48, 80% of COST members listed nexus as either their first or second priority.

<sup>2</sup> Even if the most aggressive legal position of some of the states were to prevail – that only an economic presence is sufficient to create nexus – this answers only a subset of the problem. If an economic presence is the rule, what is a sufficient economic presence -- one customer, ten customers buying \$4000 of goods, two customers buying \$1,000,000 every two years? There must be some limit on nexus since the United States Supreme Court requires that the nexus between the taxpayer (and the taxed activities) and the taxing jurisdiction be substantial.

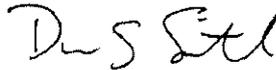
<sup>3</sup> An additional perversity is that to determine the proper reserves, a business that does not file in a jurisdiction because it does not believe it has nexus, will nevertheless have to go through all of the effort of determining its potential tax in such a jurisdiction for which it might constitutionally never have any tax liability, including a FIN 48 review of all of the potential uncertain tax positions within that jurisdiction’s law.

## **Conclusion**

FASB should delay the implementation deadline for FIN 48 to allow time for a measured and reflective compliance period and for additional opportunities to resolve the confusing and conflicting results of the current FIN 48 principles to certain common state and local tax issues. Rules should explain or constrain reality; not create a fictionalized reality.

State and local tax compliance requires unique and difficult issues not typically found in other fields of tax law. COST is available to discuss these issues with representatives from the FASB. Please contact me at [202-484-5215](tel:202-484-5215)/[dsmith@statetax.org](mailto:dsmith@statetax.org) with any questions or thoughts regarding COST's request for a delay of the implementation date for FIN 48. After attending and sponsoring scores of meetings over the last five months, COST staff and its members believe that such a delay can only benefit the financial reporting systems and the financial marketplace.

Sincerely,



Diann L. Smith  
General Counsel

cc: COST Board of Directors  
Douglas L. Lindholm, COST President & Executive Director  
Timothy J. McCormally, Executive Director, Tax Executives Institute