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Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

File Reference: 1215-001 – Accounting for Uncertain Tax Positions

Dear Members of the Board,

I am writing to urge the Board to vote against adoption of the proposed Interpretation on uncertain tax positions. As revised, the proposed Interpretation still suffers from many of the same problems that were highlighted in comment letters on the Exposure Draft. It raises significant compliance issues and will not improve accounting for uncertain tax positions. I recommend that the accounting for uncertain tax positions be addressed in the context of the Board's broader consideration of assets and liabilities with uncertainties.¹ At a minimum, the proposed Interpretation should be re-exposed for comments on the significant changes from the Exposure Draft and other concerns associated with the proposal.

There are Better Alternatives

The fundamental premise of the proposed Interpretation is that all uncertain tax positions represent contingent claims to assets (tax benefits) rather than an estimate of a liability. This premise is technically unsound and lies at the heart of many of the problems associated with the proposed Interpretation. It conflicts with longstanding and legitimate accounting principles under FAS 5 and IFRS, and has been rejected by the IASB.

The objective of this project - to clarify the criteria for recognition of uncertain tax positions and enhance consistency - can be better achieved by a clear articulation and reinforcement of the existing requirements of FAS 5 as applied to income taxes. By applying a liability recognition model, existing rules achieve reasonable results while avoiding the problems and complexity created by the proposed Interpretation. All the evidence that I have observed suggests that FAS 5 is being properly and consistently applied by the vast majority of reporting entitles, and has provided a reliable means of arriving at a reasonable estimate of a company's expected tax liabilities.² I have not heard any compelling justification for discarding existing

¹ See Selected Issues Relating to Assets and Liabilities with Uncertainty (Sep. 2005), available at http://www.fasb.org/draft/itc assets liabilities with uncertainties.pdf.

² Cf. 84 TAXES at p. 34 (June 2006) (less than 5% of respondents to a survey of Fortune 500 companies reported additional tax expense upon settlement of their most recent federal tax audit). This evidence refutes Sen. Levin's erroneous assertion that FAS 5 "necessarily" causes companies to avoid reporting known tax liabilities and overstate financial earnings.

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rules, or any credible explanation how the proposed rules will improve financial accounting as compared to existing rules.

Alternatively, the stand-by liability model being pursued by the IASB is another rational means of achieving the goal of good consistent accounting. In a rush to bring this project to a close, the Board too hastily dismissed the IASB's proposed approach, and in so doing, discredited the Board's professed commitment to convergence.

The Board has instead decided to adopt entirely new rules that have no precedent in GAAP and lack the support of the IASB. Perhaps this radical departure from precedent and principle could be justified if the proposed new rules were truly an improvement. Unfortunately, the opposite is true.

The Proposed Interpretation Presents Many Problems

The proposed Interpretation provides useful guidance on several issues arising under existing GAAP, such as the classification of accrued liabilities for uncertain tax positions, accounting for changes in judgment, accounting for interest and penalties, and disclosures. But on the central issues of initial recognition and measurement, the proposed Interpretation suffers from many administrative and substantive problems, most of which were highlighted in the comment letters to the Exposure Draft. For example:

- The requirement to establish satisfaction of the recognition and measurement criteria for *all* tax positions is impractical and unduly burdensome.
- The presumption of audit detection does not reflect reality and, when coupled with strict recognition and measurement criteria, will lead to accruals for liabilities that have no realistic possibility of ever being paid.³
- The proposed Interpretation provides no guidance on how to deal with nexus issues and other "perpetual liabilities" that will arise in the absence of an applicable statute of limitations.
- The treatment of tax positions as assets rather than liabilities is unworkable in many circumstances. For example, if an entity takes the position that a transaction does not give rise to taxable income, it might be impossible to determine the amount of "tax benefit" to be "not recognized."

³ The Board justified the presumption of audit detection solely as a "policy matter." It is unclear to me how the intentional assumption of facts that may have no realistic possibility of being true is good accounting policy. It is also unclear to me why it is good policy to create a presumption for unasserted claims related to income taxes that does not apply to unasserted claims related to other similar loss contingencies.

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 The absolute presumption that all positions lacking documented proof of a more likely than not level of technical merit will be 100% disallowed is unrealistic and will inevitably lead to excessive accruals.⁴

- The comment letters on the Exposure Draft raised many questions and concerns about the evidentiary requirements under the initial recognition standard. It appears that most of those questions and concerns will not be addressed in the proposed Interpretation.
- The "unit of account" concept is hopelessly ambiguous and therefore impossible to apply in practice. Inconsistent interpretations will inevitably develop.
- The proposed Interpretation's artificial distinction between the "validity" versus "value" of a tax position is also hopelessly ambiguous.
- The proposed measurement standard unrealistically assumes that tax disputes can be analyzed with statistical precision and specific probabilities assigned to a defined set of outcomes. This will almost never be the case. Consequently, the measurement standard will be inapplicable, or produce illogical results, in most circumstances.
- As previously noted, in many cases the entity will not know the tax authority's position and therefore may be unable to reliably calculate the amount in controversy. Under those circumstances, it may be impossible to measure the liability.
- The decision to accrue interest and penalties based on the full amount of unrecognized tax positions makes sense. But because the proposed Interpretation will cause overstatements of underlying tax liabilities, it will necessarily overstate related interest and penalties. This piling on effect could be avoided by adopting a standard that more rationally estimates the underlying tax liability.

⁴ The proposed "administrative practices and precedents" exception acknowledges this problem, but will apparently solve the problem for only a very narrow set of affected issues.

⁵ See, e.g., American Bar Association, Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (Mar. 2003) ("Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises.").

⁶ Assume an entity believes it has a slightly better than 50% chance of prevailing in litigation on a \$100 tax benefit. The entity has offered to settle for \$50 and would pay up to \$70, but the tax authority is demanding \$80. It is impossible to predict the ultimate outcome of settlement discussions. One might argue that the entity must reserve \$80 on the theory that it is likely the case will be settled and \$80 is the only amount that can be assigned any probability of being realized (100%). However, if the entity maintains that it will not settle for \$80, the entity might reserve \$0 on the theory that the case will not settle and there is, in the entity's opinion, a greater than 50% probability that the entity will prevail in litigation. It is not clear that either of these results was intended.

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• The proposal conflicts with generally applicable international accounting standards, thereby creating implementation issues for entities with significant foreign operations. Moreover, the peculiarities of foreign tax rules and enforcement practices will present additional implementation challenges for such entities.

As a result of these and other issues, the proposed Interpretation will lead to implementation problems and bad accounting. Entities that are unable to meet the strict recognition or measurement requirements may be forced to accrue the worst case scenario (assuming that can even be calculated), including penalties and interest, even if the accrual does not reasonably reflect the expected liability.

Consider, for example, how the proposed Interpretation would have impacted MCI's reserve for state income taxes. At the end of 2004, MCI was facing \$2.75 billion in state tax deficiency claims (which, based on my knowledge of the issues, were likely correct as a purely technical matter). In 2005, MCI settled those claims for far less than the asserted deficiencies (approximately \$450 million). MCI's 2005 third quarter report discloses that MCI had reserved all but \$99 million of the ultimate liability. In contrast, under the proposed Interpretation, MCI might have been required to reserve the full \$2.75 billion deficiency. Instead of a \$99 million understatement, MCI would have accrued a \$2.3 billion overstatement.

MCI is not an isolated example. Consider DHL Corp.'s litigation with the IRS regarding the issue whether DHL should have charged trademark royalties to its foreign affiliate. The IRS issued a deficiency assessment of \$195 million. Due to the inherent ambiguity of the applicable tax rules and the significantly heightened burden of proof DHL faced, it is doubtful that DHL would have been able to establish that it had a more likely than not chance of prevailing in the litigation. After losing the substantive issue at the trial court level, DHL ultimately prevailed on substantially all of the amount in issue. The \$195 million accrual apparently required under the proposed Interpretation would have significantly overstated the company's ultimate liability.

GlaxoSmithKline has a similar tax dispute right now. It faces an estimated \$13 billion in proposed tax deficiencies in highly contentious litigation proceedings involving some of the same issues raised in the DHL case. Under the circumstances, GSK might have a difficult time establishing that it has a more likely than not chance of prevailing in the litigation. Nevertheless, GSK has apparently estimated that the case can be settled for \$1.5 billion (it has an unreserved exposure of \$11.5 billion). In contrast, under the proposed Interpretation GSK might be required to accrue the entire \$13 billion potential deficiency, plus staggering amounts of interest going forward, not because that represents a reasonable estimate of the expected liability, but simply because the matter is so highly uncertain as a purely technical matter that GSK can't get past the initial recognition threshold.

These are just three examples that highlight how the proposed Interpretation might force entities to materially overstate their expected tax liabilities.

⁷ DHL Corp. v. Commissioner, 285 F.3d 1210 (9th Cir. 2002).

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Unintended Collateral Consequences

In addition to causing implementation problems and bad accounting, the proposed Interpretation could have the deleterious effect of impairing the legal rights of affected entities.

Under existing accounting rules, the tax return is presumptively correct. To comply with FAS 5 and related documentation requirements, a company need only analyze and document those tax positions that are being challenged or are probable of being challenged. For those tax positions that must be analyzed, the workpapers generally only document the reasonably estimated settlement amount and any realistic possibility of exposure to additional loss.

In contrast, the proposed Interpretation would reverse the presumption of correctness and, read literally, would require an entity to affirmatively establish its entitlement to every material tax position reported (or not reported) in every tax return filed (or not filed) in every jurisdiction that could possibly impose an income tax on the entity for every year that could conceivably be open under any potentially applicable statute of limitations. The entity must have in place an effective system of internal controls to identify and analyze every such tax position. The entity's accounting workpapers must document each of the tax positions identified, categorize the positions as either fully recognized, fully reserved, or partially reserved, and explain the basis for the categorization in every case. In addition, the entity may also have to document reconciliations of its tax accruals for uncertain tax positions under GAAP to its tax accruals under IFRS. The financial auditor will then test the entity's controls and documentation to ensure no material items are undocumented or treated incorrectly, and will create additional workpapers documenting the financial auditor's analysis.

This added level of documentation will almost certainly draw the attention of tax authorities and amplify their ongoing efforts seek discovery of tax accrual workpapers as a tool in conducing audits. Information required to be maintained in the entity's workpapers could significantly compromise the entity's ability to defend its tax positions.

Even when the company's workpapers are not disclosed or do not compromise its litigating positions, the requirement to fully reserve highly uncertain tax positions could force companies to settle those issues at excessive amounts just to avoid intolerable financial reporting effects. If GlaxoSmithKline is required to accrue a \$13 billion liability, plus ongoing interest, for its pending dispute with the IRS simply because of the inherent legal ambiguities and presumptions, that could well force the company to succumb to excessive IRS settlement demands rather than pursue its appeal rights.

While one might argue that these outcomes are desirable as a matter of social policy and efficient tax enforcement, they do not serve the interests of shareholders and other persons to whom the Board owes its principal responsibility. By requiring an entity to affirmatively prove with statistical precision its entitlement to the tax benefits of all reported (and unreported) tax positions, the proposed Interpretation goes far beyond the legitimate goal of faithfully reporting the entity's estimated tax liabilities. It infringes on the entity's essential legal rights and directly influences the amount of the underlying liability.

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Conclusion and Recommendations

The proposed Interpretation continues to be unworkable and will not improve financial accounting for income taxes. The IASB agrees.

Therefore, I recommend that the proposed Interpretation be withdrawn. Accounting for uncertain tax positions should be addressed in the context of the Board's and IASB's broader consideration of assets and liabilities with uncertainties. There is no justification for rushing to implement new rules for uncertain tax positions that differ so radically from all existing and proposed rules for other types of loss contingencies. Moreover, a more careful consideration of uncertain tax positions in the context of a broader reconsideration of FAS 5 could provide the opportunity to craft rules that improve financial accounting, reduce complexity, and achieve convergence with IASB rules on uncertain tax positions.

At a minimum, the proposed Interpretation now varies so significantly from the Exposure Draft that the Board should re-expose it. There has never been a meaningful opportunity for broad public comment on the proposed new "cumulative probability" measurement standard, the "administrative practices and precedents" exception, the proposed disclosure rules, or other important aspects of the proposed Interpretation. I also believe that a more careful analysis of the costs of implementation relative to the benefits to be achieved (particularly as compared to simply clarifying and reinforcing existing rules) should be provided and exposed to public comment. Finally, I believe the Board should solicit public comments on the divergence of the proposed Interpretation from the IASB's proposed rules, and the proposed Interpretation's lack of consistency with existing and proposed rules for other types of loss contingencies (especially loss contingencies related to taxes other than income taxes).

Respectfully submitted,9

James R. Sionne

⁸ Last spring, the Board refused to open a project on accounting for environmental liabilities on the ground that the matter should be addressed in the broader context of revisiting FAS 5 generally. See Minutes of FASB Board Meeting of March 9, 2005. The same logic compels the conclusion that uncertain tax positions should be addressed in the broader context of revisiting FAS 5 generally rather than as an isolated topic.

⁹ The views expressed in this letter are my own and are not necessarily shared by any former or current employer, firm, or client.