

Committee on Private Companies

December 5, 2008

Mr. Russell G. Golden **Technical Director** Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

LETTER OF COMMENT NO. 1.5

File Reference: Proposed FSP FIN 48-c

Dear Mr. Golden:

The Committee on Private Companies ("CPC") Standards Subcommittee of Financial Executives International ("FEI") wishes to express its support for Proposed FSP FIN 48-c, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises (the proposed FSP).

FEI is the leading advocate for the views of corporate financial management in the United States. It is a professional association of more than 15,000 CFOs, treasurers, controllers and other senior financial managers. With approximately 7,500 members from private companies, FEI has a strong base of knowledge to draw upon with regard to the financial reporting needs and requirements of the private sector. The CPC is a technical committee of FEI, which formulates private company positions for FEI in line with the views of the membership. This letter represents the views of the Committee on Private Companies Standards Subcommittee and not necessarily the views of FEI.

Support for delay

FEI CPC strongly supports the proposed delay in the effective date for private companies set forth in the proposed FSP, and we appreciate FASB taking into consideration practical issues for private companies in implementing FIN 48, as well as conceptual issues relating to the usefulness of applying FIN 48 to private companies including pass-through entities.

We believe FASB's chosen approach of delaying FIN 48 for all private companies, not only pass-through entities, is a helpful decision which will remove uncertainty and undue complexity for this year-end, while FASB continues to address the needs of its constituents, including users of private company financial statements as well as implications for preparers and auditors of those statements.

Private companies are different

FIN 48 is complex, for both public companies and private entities. However, one key point which differentiates private company financial reporting, as recognized by FASB and the AICPA in forming a Private Company Financial Reporting Committee (PCFRC), is that the users of private company financial reporting are fundamentally different from users of public company financial reporting. We refer you to our August 12, 2008 comment letter (attached) which provides some demographic and background information on private company structure, particularly with respect to taxation.

In response to the request in the FSP for examples of issues that pass-through entities will encounter when applying FIN 48, we provided some examples in Attachment 1. Although we have attempted to keep the examples brief, the issues are complex.

During the deferral period, in looking at these and other examples, we ask FASB to consider the costbenefit equation in light of private company concerns and the needs of users of private company financial statements. We also suggest that FASB aim to simplify guidance where possible, while still considering user needs.

It is not uncommon for private entities to have an exemption from their lenders with respect to distributions for taxes. Thus, taxes are treated as a cash flow item. Therefore we believe it may add an unnecessary layer of burden for pass-through entities to have to account for taxes under FIN 48, with no attendant benefit for users (in this case, the bank lender, or similarly, for the primary owners of the company) or the company itself.

The owner will have incurred an unnecessary cost in going through this exercise purely for FIN 48 compliance purposes if there is no ultimate economic or transparency benefit to the company or its users.

For a further exploration of these issues, we recommend that FASB board and staff members seek further guidance on the practical issues involved with private and particularly pass through entities, including with respect to S Corp taxation and international taxation.

One way to accomplish this could be through an educational session. We would be happy to provide you with some names of experts in this field. Additionally, CPC members have appreciated the opportunity to meet with members of the board and staff in the past, and would be happy to meet with you again to discuss these issues in further depth.

Thank you for considering our comments. If you have any questions or wish to discuss this issue please feel free to contact me at 412/257-3885 or Bill.Koch@ddiworld.com, or Edith Orenstein at FEI 973/765-1046 or eorenstein@financialexecutives.org.

Sincerely,

William Koch

Chair, Standards Subcommittee Committee on Private Companies Financial Executives International

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ATTACHMENTS (2):

Examples

FEI CPC August 12, 2008 comment letter

FEI Committee on Private Companies – Standards Subcommittee Letter to FASB on Proposed FSP FIN 48-c ATTACHMENT 1

Examples of implementation complexities and potential issues for pass-throughs in applying FIN 48:

1. Branches/subsidiaries.

a. A typical example is a US company with a subsidiary that has a branch in a foreign country. Costs are allocated from the parent company to the branch. The issue is whether the enterprise has complied sufficiently with transfer pricing rules. If allocated expenses are disallowed, the branch will have higher taxable income, but at the owner level, the tax is a credit and can be used as a tax against foreign source income so that the owner has no net tax impact. The auditor would have to consider all this. Even if he/she were to find out that there is a potential exposure at the corporate level, it will likely be offset at the personal level, so the net impact to the owner(s) is nil. (Again, you have to remember that profit remittances are provided to pay taxes. If more taxes are paid at the corporate level, then a smaller amount is remitted. The cash impact is a wash.)

2. Withholdings on foreign remittances, such as royalties and dividends.

a. When a subsidiary remits a royalty there is often a withholding tax. With respect to Canada, when the royalty is paid, the tax is due; it is then an income tax and is creditable on the owner's return. If foreign source income is such that there is excess foreign tax credit limitation position, then the owner just pays a lower US tax. On the other hand, if the owner has excess foreign tax credits, then he can carry these backward/forward to recover income tax paid. The uncertain issue is what to do when you are close to the 'line' for having excess foreign tax credit limitation position vs. having excess foreign tax credits when the tax year is not the same as the fiscal year. The remittance of a dividend or royalty can easily tilt the calculation between the two outcomes. Having a tax year end different than the financial year end is common, particularly in countries that mandate a particular year end date, such as India and Mexico.

3. State taxation/multi-state taxation:

- a. nexus issues: States are getting aggressive on 'economic nexus' theories as opposed to the physical presence/assets tests. What should be done when new theories of law create an uncertain position?
- **b.** allocation of income between states. There can be choices on how to allocate income. Suppose that there are grey areas in the allocation. Does this create an uncertain position? What determines the 'base' from which the uncertain position is calculated?
- c. determination of income to allocate. Some states want to tax worldwide income at some corporate level. What if they claim that a related company income should be brought into the worldwide calculation, even though the related company has different owners. Again, remember that in some states, S income tax is payable by the owners, in some states, it is paid by the corporation, and in some states, the company can file an election, which may be useful in reducing tax filing complexity at the shareholder level. (This is not an issue for the C; it is for an S.) When the law is ambiguous, what is the obligation under Fin 48? The public corporation typically has stockholders who receive economic benefit AFTER federal tax is paid by a single group taxpayer. This is not the case for private companies, wherein the owners are typically accountable for the tax in these complicated structures. This is particularly true when there is real estate involved which gets consolidated under 46R, wherein the owners may be extended family or past shareholders. Because 'S' shareholders are limited, it is more likely that a shareholder could be management, or involved with a special purpose enterprise.

4. Royalties.

- a. Some jurisdictions (India, Russia) take aggressive positions on royalty rates. Consider a firm that has a 10% standard rate. In India, anything over 5% must be petitioned. Until that agreement is reached, the company has an uncertain tax position. Again if the payor is a branch, then there may be similar issues as described under Branches, above, except that royalties are foreign source income and help with foreign tax credit limitation position. This may / may not affect state income tax. Since the petition may be approved or denied, an uncertain position can exist for an extended period.
- b. Assume there is an 'S' corporation in the US which is a cash basis taxpayer and is the parent. (NB: S and LLC's can be cash basis taxpayers, which is never the case for public companies, another

key difference.) Assume that there is a royalty from a foreign subsidiary whose amount is under question by some foreign authority so that the tax owed locally could be questioned. (5% vs 10% for India for example).

- i. What would be the uncertainty on taxation for local income tax, particularly in the case where the tax and fiscal year ends are different or when the Indian company is an accrual tax payer and the parent is a cash basis tax payer?
- ii. Assume that there is withholding tax payable when the royalty is <u>booked</u>. The withholding tax is a tax on income. The 'income' using the higher royalty would be lower with lower tax, but given that the royalty withholding would be larger, then that tax would offset. Would it make a difference if the withholding tax were payable when the royalty were paid?
- iii. How would one determine the uncertainty
 - i. For the subsidiary corporation. Difference if it is a 'c' vs an 's' taxpayer. Further, consider the differences if the subsidiary were a 's' accrual taxpayer.
 - ii. For the 'S' taxpayer/owner

5. Transfer pricing:

- a. For a service company, there may be issues involved with allocation of common expense to foreign operations. For example, the foreign operation could be a branch of a U.S. S corp, and there may be an uncertain tax position at the branch, but the company may have an excess foreign tax credit limitation position which makes it a wash for the owner. There may be federal and state tax considerations in this scenario as well.
- **b.** Assume there is an 'S' corporation in the U.S. which is a cash basis taxpayer who is the parent. (NB: S and LLC's can be cash basis taxpayers.) Assume that the parent has expenses to charge out which lead to a question on transfer pricing which leads to a potential tax uncertainty. Similar questions would exist as noted in the discussion of Royalties, above.

6. Carry forward / carry backwards.

a. If a branch of an 'S' were to have an adverse ruling, the company can carry forward/backward the 'new' tax credit. It may result in no tax impact at the corporate level, may result in a tax impact at the corporate level, may result in a tax impact only at the individual level, or may result in a tax asset.

7. Exchange rates:

a. Exchange rates can impact the calculations in complex ways.. Taxes are generally a local currency impact, in a currency other than the consolidated currency.

8. Consolidation, including consolidation of FIN46 R arrangements:

- a. One example is consolidation of FIN 46R arrangements, including consolidation of an unaudited 'C' company into an 'S' Corp'.
- b. If the company must be consolidated, but if the tax status of the taxpayers are different, which might be the case of a family owned building being leased to another family member's company, there may be issues of getting access to the data. With an S corp, the company has to give a K1, so the data becomes available. Not true with a C corp. What if the tax year ends are different?

9. Federal vs. State:

a. An issue to consider is the handling of taxes when the company is an 'S' for federal taxes, but a 'C' for state taxes. Personal rates may be lower than corporate rates. Suppose a small compliance error is made which, if the tax authorities were to apply the letter of the regulations might lead to a 'C' classification for a year. Is this an uncertain position?

10. Receipts for foreign taxes.

a. There are timing issues in that receipts for foreign taxes withheld may not be available when the audited financial statements are filed for one of several reasons. This can raise questions about whether tax credits are uncertain.



Committee on Private Companies

August 12, 2008

Mr. Robert Herz Chairman Financial Accounting Standards Board 401 Merritt 7 Norwalk, CT 06856

RE: FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes

Dear Mr. Herz:

The Standards Subcommittee of the Committee on Private Companies (CPC) of Financial Executives International (FEI) wishes to share its views on FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FEI is the leading advocate for the views of corporate financial management in the United States. It is a professional association of more than 15,000 CFOs, treasurers, controllers, and other senior financial executives. With approximately 7,500 members from private companies, FEI has a strong base of knowledge to draw upon with regard to the financial reporting needs and requirements of the private sector.

The Committee on Private Companies is a technical committee of FEI which formulates private company positions for FEI, considering the views of its membership. This letter represents the views of the Committee on Private Companies, Standards Subcommittee, as a whole, and not necessarily the views of FEI. The size of our private companies range upward to in excess of \$1 billion in revenue. The respondents to a recent survey of FEI private company members indicate that 51% of their companies have revenues above \$100 million, and about 10% have revenues above \$1 billion.

We have been provided a copy of the letter addressed to you dated May 30, 2008 from Judith H. O'Dell of the Private Company Financial Reporting Committee regarding FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. For the record, we wish to support the position that her committee has taken to "exempt private companies from all the requirements of FIN 48".

The purpose of this letter is to point out that there is a very salient and relevant argument that was not mentioned in Ms. O'Dell's letter. We wish to emphasize that the vast majority of private companies are pass through organizations, and as such, the bulk of the income tax attributable to the income of the firm is paid by the owner and not by the firm. Therefore, we believe that the requirement to spend accounting and

auditing effort on the minor portion of tax that is paid by the firm on behalf of the owner is requiring the firm to spend limited resources on an issue that should not be given such a level of importance.

You may recall that on March 29, 2007, several of our committee members met with you and other FASB members and staff wherein we presented some data on the nature of private companies. In that presentation, we shared some data that showed that 62% of all corporate tax returns filed in 2003 were for 'Sub S' corporations. Further, the data showed that there were some 10,000 'Sub S' corporations that had \$50mm or more revenue. The IRS data said that 99.4% of the 'S' corporations had 10 or fewer owners. Our committee's observation is that financial statement audits generally start when the firm is somewhere in the \$5 or \$10 mm revenue range. The implication is that FIN 48 will require thousands of pass through firms to prepare calculations and have them audited to book an entry that will be immaterial. The fact that the accounting standard exists requires the firm to demonstrate that the rule does not apply or that the amount is immaterial.

How is taxation different between private and public companies? Private companies tend to be pass through organizations. This is the case because the ownership is generally limited, and the owners can take advantage of single step taxation, which is the major driver. Single step taxation means that dividends are not taxed a second time. Further, in a number of states, such as Pennsylvania, personal state income tax rates are less than corporate state rates. Therefore, single step taxation means that the owner receives a lower individual rate tax instead of the individual tax *and* the higher corporate rate of tax. An 'S' or LLC saves a lot of tax, both at the federal and state levels. This is a very significant difference between public and private pass-through companies.

Another common taxation difference between private and public companies is that private company owners usually receive a dividend to pay their tax obligations. The money required to pay the income tax obligation arising from the firm's operations is typically sent out as a dividend or profit remittance, which is shown as a balance sheet, not an income statement transaction. Therefore, the vast majority of tax arising from the firm's economic activity is not an income statement item. If so, then we ask why should the firm spend money to compile the FIN 48 disclosures on the small portion of tax that is paid by the firm, and spend even more money having them audited, when the bulk of the cash flow remitted for taxes is a balance sheet transaction? As practitioners and owners, we find this wasteful.

Some may argue that excluding private companies from FIN 48 provides for two standards - one for public companies and one for private companies. As was true for FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, there are differences in the two sets of companies. The tax code limits the number of shareholders that a firm may have to elect 'S' status. If the user and owner needs are different, it seems reasonable to us that the standards need not be the same.

Therefore, for the above reasons, we support the PCFRC's position to exempt private companies from all the requirements of FIN 48. It is our belief that the arguments for exemption from FIN 48 by private pass-through companies are extremely strong, and we encourage the Board to act quickly so that the 2008 audit cycle is not impacted.

If you have any questions or wish to discuss our specific concerns, please feel free to contact me at 412-257-3885 or Bill.Koch@ddiworld.com or Serena Dávila at FEI's Washington, DC office at 202-626-7809 or sdavila@financialexecutives.org.

Very truly yours,

William Koch

Chair, Standards Subcommittee Committee on Private Companies Financial Executives International

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cc: Paul Glotzer Judy O'Dell