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Technical Director
File Reference No. 1215-001
Financial Accounting Standards Board
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Subject: **Comment Letter Regarding Accounting for Uncertain Tax Positions**

Dear Director:

American Electric Power Company, Inc. (AEP) appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB or the Board) Exposure Draft (ED) of a Proposed Interpretation, *Accounting for Uncertain Tax Positions, an interpretation of FASB Statement No. 109,* dated July 14, 2005. AEP, a Columbus, Ohio based energy company, is one of the largest investor-owned utilities operating in the United States, with revenues of over $14 billion and more than 20,000 employees. We provide energy to approximately 5 million customers in Arkansas, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Tennessee, Texas, Virginia and West Virginia.

While we understand the Board's effort to standardize the accounting practice related to uncertain tax positions in an attempt to eliminate inconsistency, we submit that specific facts and circumstances as well as judgment will be involved in the application of any standard, including the ED's approach of applying a probable threshold for recognition of tax benefits. We believe the ED's application of a probable threshold would result in overstated liabilities and significant variation in income from the reversal of unnecessary tax provisions.

Current practice recognizes tax benefits for positions taken on the tax return, and then looks to whether it is probable that a tax return position will be ultimately disallowed to determine if a loss contingency accrual should be recorded under SFAS 5, *Accounting for Contingencies*. We believe the results of this approach applied consistently come closest to the expected outcome of an uncertain tax position and are more appropriate than the Board's proposed asset approach with a dual threshold for recognition. Once the tax benefit has been recognized, the merits of sustaining the tax return position should be evaluated under the provisions of SFAS 5.

Under the asset approach, each level of higher certainty from *substantial authority*[1] through *more likely than not* to a SFAS 5 level of probable removes management judgment in applying a best estimate. If the Board continues to support the asset approach proposed in the ED, we strongly encourage the Board to adopt a *more likely than not* level of confidence as the tax benefit recognition threshold instead of probable, as discussed in more detail below.

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[1] For federal income tax purposes, the minimum confidence required to avoid penalties on non-tax shelter positions is substantial authority. Substantial authority implies at least a one in three chance of being sustained.

Recognition Threshold

Using a SFAS 5 probable level of confidence for recognition leads to a distortive tax impact on the financial statements. Concepts Statement 6 (CON 6) defines an asset as a probable future economic benefit obtained by an entity as a result of past transactions or events. CON 6 notes that probable is used with its usual general meaning (that which can reasonably be expected on the basis of available evidence but is not certain) rather than in a specific accounting sense, as in SFAS 5. We do not believe that a higher standard of probability should be used for uncertain tax positions than is required by CON 6 and we are concerned that this threshold will be interpreted differently among external auditors, leading to less comparability in financial reporting. We believe a *more likely than not* threshold for recognition better reflects the CON 6 definition of an asset, is more operational and is a more accurate representation of the expected tax benefit.

The proposed approach would effectively require a "should" level of certainty before a tax benefit could be recognized. As an example, if a company believed there was a 65% probability of prevailing on an issue, no tax effect of the deduction could be recorded even when the benefit was realized in cash on the return (subject to the sustainability criterion in audit). Instead, a 100% liability would need to be recorded due to falling below the probable threshold, resulting in a less than accurate financial report. We do not agree that the threshold for recognizing tax benefits should be changed to a probable level of sustaining a tax position. Requiring the equivalent of a "should" opinion to recognize tax benefits for financial purposes is not practical.

If a tax benefit is *more likely than not*, any potential loss should be recorded at management's best estimate. This approach correctly records any estimable loss, while the proposed model would require a 100% liability for any benefit taken that is less certain than 70-90%, and will create out-of-period tax benefits in a later period when the issue is resolved at less than 100%. The proposed approach would result in excess liabilities that would contradict management's best estimate.

Issues

We have attached a response to the eleven specific issues raised in the ED. The more salient points we raise include the need for a definition of uncertain tax positions, the use of a *more likely than not* recognition threshold instead of probable if the proposed asset approach is used, and the need for a delay of the proposed effective date to the beginning of the first fiscal year beginning after December 15, 2006.

Thank you for the opportunity to comment on this proposal.

Sincerely,

Joseph M. Buonaiuto

Attachment

Attachment

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?

> We understand the Board believes that the majority of positions taken on a tax return are not "uncertain tax positions". We believe the Board needs to define uncertain tax positions and clarify that *all* tax positions do not need to be documented, to avoid inconsistency through subjective interpretations by companies' external auditors.
>
> Without a clear definition of an uncertain tax position, any expense, loss, permanent book/tax difference and temporary book/tax difference would be subject to unnecessary external audit scrutiny. When a vast majority of items in a tax return are considered by taxpayers to garner a "should" level of confidence by statute alone, we believe it creates an environment of uncertainty and inconsistency in conflict with the original reason for issuing this Proposed Interpretation.

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?

> For positions taken on filed tax returns, we believe that with the use of a *more likely than not* recognition threshold, it should be presumed that a taxing authority will evaluate the position in determining whether the benefit should be recognized; however, when determining the best estimate to record, all aspects of tax risk should be considered.
>
> If it is *more likely than not* that an entity is not required to file a return in a tax jurisdiction and the entity does not file a tax return (for example, it does not believe it has nexus in a state), we believe any potential liability should be evaluated under paragraph 38 of SFAS 5 related to unasserted claims, and should be accrued only if it is probable a claim will be asserted. If a company does not file a return, but is required under the ED's presumed audit test to establish a liability based on the potential for a taxing authority to assert a claim, the liability would continue to grow and accrue interest and would never reverse since there would be no statute of limitations.

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?

> We do not agree with the dual threshold approach. We believe a single *more likely than not* threshold should be used for recognition and derecognition. SFAS 109, *Accounting for Income Taxes*, paragraph 96, states that the Board selected *more likely than not* as the criterion for measurement of a deferred tax asset because the criterion should be one that produces accounting results that come closest to the expected outcome, that is, realization or nonrealization of the deferred tax asset in future years. We concur that the best measurement approach should be the one that produces accounting

results that come closest to the expected outcome. In that regard, the probable standard misses the mark.

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?

While we do not agree with the probable threshold for recognition, we do agree that a tax position should be recognized in the period in which it meets the appropriate threshold.

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?

We agree that a tax position that no longer meets the *more likely than not* criterion should be derecognized.

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?

We believe that with *a more likely than not* threshold for recognition, the best estimate of the amount that would be sustained on audit should be recognized. We agree that changes in the best estimate should be recognized in the period of change.

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?

We agree with the proposed liability classification.

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?

We agree the impact of a change in judgment should be recognized in the period when the change occurs.

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?

We believe interest and penalties should only be accrued on the amount of payment anticipated to settle the controversy, as considered by the Board in paragraph B39. We believe the use of a *more likely than not* threshold for recognition would achieve this result.

We agree that classification of interest and penalties should not be addressed in this ED.

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 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?

We do not believe any additional disclosures should be required.

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?

We are concerned the final interpretation will not be issued soon enough to complete the required documentation by year-end. We believe the effective date should be the beginning of the first fiscal year beginning after December 15, 2006.

We agree with the proposed transition method.