INVESTMENT COMPANY INSTITUTE

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The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

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LETTER OF COMMENT NO. 1

Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Post Office Box 5116
Norwalk, Connecticut 06856

Re: Effect of FASB's FIN 48 on Mutual Funds

Dear Chairman Cox and Chairman Herz:

I am writing regarding the application to mutual funds of the Financial Accounting Standards Board's ("FASB's") Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"). This FASB pronouncement raises unique issues for the fund industry. For the reasons discussed below, the Investment Company Institute[1] (the "Institute") requests that the FASB (or the Commission, if necessary[2]) delay the effective date of FIN 48 for investment companies until supplemental written guidance is provided.

FIN 48 uniquely affects the mutual fund industry because the price at which fund shares are purchased and sold (the "net asset value" or "NAV") is calculated each business day in accordance with Investment Company Act Rule 2a-4. Commission staff traditionally has viewed the daily NAV

[1] ICI members include 8,792 open-end investment companies (mutual funds), 662 closed-end investment companies, 269 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $9.898 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

[2] Under section 13(b)(1) of the Securities Exchange Act of 1934, the Commission has the authority to prescribe the methods to be followed in the preparation of financial statements. The Commission recently used this authority to delay implementation of FAS 123(R), *Share-Based Payments*. *See* SEC Release No. 33-8568, April 15, 2005. Further, Investment Company Act section 38(a) authorizes the Commission to issue, amend, and rescind rules and regulations as necessary and appropriate in the exercise of its powers, including rules and regulations defining accounting, technical, and trade terms.

calculation as subject to Generally Accepted Accounting Principles (GAAP). Thus, unlike other corporate registrants that are required to apply FIN 48 only to their periodic financial statements, mutual funds must apply the interpretation on a daily basis.

Fund share prices will be inaccurate whenever FIN 48 requires a fund to recognize tax liabilities that the fund will not be required to pay. There are three scenarios in which a literal application of FIN 48 could require funds to reduce inappropriately their NAVs:

- Issues for which tax is not paid because of IRS administrative practices. Tax benefits may be recognized under FIN 48 only when a position is more likely than not to prevail based upon specified authorities and, in limited circumstances, administrative practices and precedents. Funds could have significant difficulties meeting this standard in certain cases because the general tax rules applicable to funds or their investments are unclear or because the guidance that exists cannot be applied confidently to specific fact patterns.

  For example, the treatment of mutual funds' investments in credit default swaps is unclear. There are three potentially applicable methodologies (*i.e.*, treatment as insurance, a guarantee, or a swap) that may be used to determine the tax treatment. Until the Internal Revenue Service ("IRS") issues guidance, it is possible to conclude that none of the alternatives is more likely than not to prevail.

  When funds face these uncertainties, they rely upon less formal IRS guidance and practices that may not be considered in applying FIN 48. The IRS is aware that funds face these tax uncertainties and that fund shareholders ultimately bear the burden of any fund-level tax. Thus, the IRS typically addresses fund industry issues by providing guidance that is prospective only. FIN 48, however, would not allow funds to consider such less formal guidance and administrative practices when determining whether a position satisfies the more-likely-than-not standard.

- Issues for which tax is paid by another party. Mistakes occasionally are made that cause a tax liability to arise. For example, a derivative instrument may generate more income than the fund anticipated, thus subjecting the fund to an excise tax for under-distributing its income. Under FIN 48, these types of mistakes would require an immediate adjustment to the fund's NAV, even if it were expected that another party (*e.g.*, the investment adviser) would pay the tax liability on behalf of the fund. Before the application of FIN 48, funds did not recognize tax liabilities until the payment of tax was both probable and estimable.

- Tax positions taken in fiscal years beginning before December 16, 2006. Under the Internal Revenue Code, the reporting standard for tax returns is one of "substantial

> authority," which is lower than the "more-likely-than-not" standard required by FIN 48. Funds that filed tax returns for prior years under the substantial authority standard will be required to reduce their NAVs on the first business day that FIN 48 applies if those positions do not also satisfy the more-likely-than-not standard. This is true even though the funds' positions likely will not be challenged by the IRS.

The harm caused by inappropriate NAV reductions will fall directly on fund shareholders. This is distinct from the application of FIN 48 to other corporate registrants, where such tax liabilities are not reflected directly in the corporations' stock prices.

Given the potential impact of these issues, the FASB or the Commission should issue additional written guidance. This is particularly true in light of the departures of several key staff members involved in discussions on these issues at both the Commission and the FASB.

The Institute has advanced several significant proposals to address the unique concerns arising from FIN 48. The most comprehensive solution would be to allow mutual funds to disclose potential tax liabilities under FIN 48 in footnotes to their financial statements in lieu of recognition in the financial statements and daily NAV calculations. Alternatively, written guidance should be issued to address three areas of concern. First, the guidance should expand those factors that may be considered by mutual funds in determining whether a tax benefit may be recognized. Second, the guidance should provide relief for situations in which a mistake is made, giving rise to a potential tax liability, but for which another party is expected with reasonable certainty to pay the tax. Finally, the guidance should not apply FIN 48 to positions taken on tax returns under the lower "substantial authority" standard prior to the effective date of the interpretation, unless it is probable that the fund will pay the tax.

In addition, FASB staff has raised another solution that is worth considering. This alternative would permit mutual funds to recognize and measure potential tax liabilities at their fair value. A fair value measurement model would allow funds to consider the low probability that the tax liability will be realized. It would be consistent with current practices because mutual funds value their securities holdings under this method.

Implementation of FIN 48 should be delayed to give the FASB and the industry sufficient time to resolve these issues. Unlike other corporate registrants, mutual funds must begin recognizing tax liabilities in their NAVs as early as January 2, 2007. Other corporate registrants will not be required to recognize tax liabilities under FIN 48 until, at the earliest, March 31, 2007. Therefore, we request that the FASB or the Commission announce promptly that FIN 48 will not be applied to investment companies until additional written guidance is provided.

We appreciate the time and energy that the Commission and FASB staffs have given to assisting us on this matter. Quick resolution of the issues raised by FIN 48 will ensure that our joint goal of protecting shareholders is achieved. I will call you shortly to arrange a meeting to discuss these issues further.

Sincerely,

Paul Schott Stevens
President

cc: Mark W. Olson
Chairman
Public Company Accounting Oversight Board

Andrew Donohue
Director, Division of Investment Management
Securities and Exchange Commission

Scott Taub
Deputy Chief Accountant, Office of the Chief Accountant
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