

1401 H Street, NW, Washington, DC 20005-2148, USA 202/326-5800 www.ici.org



LETTER OF COMMENT NO. 435

VIA ELECTRONIC DELIVERY

May 4, 2007

Mr. Lawrence W. Smith
Director – Technical Applications and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Dear Larry:

The Investment Company Institute¹ requests that the FASB issue additional implementation guidance relating to FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"). The requested guidance would address some of the unique issues that exist for investment companies ("Funds") as defined under the AICPA Audit and Accounting Guide, Audits of Investment Companies ("Audit Guide") and the proposed Statement of Position, Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies. This request follows three prior submissions made by the ICI to the FASB.²

At the end of last year, the Securities and Exchange Commission's staff ("Staff") responded to some of the issues facing Funds, acknowledging the difficulties FIN 48 raises. The Staff granted a sixmonth delay in the application of FIN 48 to daily net asset value calculations (the "Staff Letter"). The

¹ The Investment Company Institute is the national trade association of the U.S. investment company industry. ICI members include 8,826 open-end investment companies (mutual funds), 666 closed-end investment companies, 398 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$10.634 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 See Letter to Christopher Cox, Chairman, U.S. Securities and Exchange Commission and Robert H. Herz, Chairman, Financial Accounting Standards Board from Paul Schott Stevens, President, Investment Company Institute (December 11, 2006); Letter to Donald B. Thomas, Financial Accounting Standards Board from Gregory M. Smith and Keith Lawson, Investment Company Institute (May 19, 2006); and Letter to FASB Technical Director from Gregory M. Smith and Keith Lawson (September 12, 2005).

³ See Letter to Paul Schott Stevens, President, Investment Company Institute from Conrad Hewitt, Chief Accountant, Office of the Chief Accountant and Barry D. Miller, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission (December 22, 2006). The Staff Letter stated that the Staff would not recommend

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Staff Letter also stated the Staff's expectation "that funds will make good use of this additional time to carefully assess all issues related to the implementation of [FIN] 48." After careful consideration, we believe two issues still must be addressed to prevent adverse and unintended consequences from FIN 48's application to Funds. These issues and our proposed resolutions are described below.

Detail of Guidance Requested

1. Adequate Time to Allow for Accurate FIN 48 Accruals

Funds generally compute their net asset value ("NAV") on a daily basis in accordance with generally accepted accounting principles ("GAAP") and would be required to make FIN 48 determinations every business day. These determinations would then be used to calculate the price at which investors purchase and redeem Fund shares (i.e., NAV), thereby having a direct impact on shareholder value.

Once the FIN 48 extension period for Funds ends, Funds may inadvertently find themselves in a position in which they have no way to assess either the threshold accrual issue or the appropriate amount to accrue. This can occur, for example, when an administrative error is discovered, or when a Fund finds itself holding a particular instrument that gives rise to tax uncertainties based on developments at the issuer level that are beyond the Fund's control (e.g., a corporate action). In such circumstances, a Fund may be unable to make a reasoned assessment of the potential liability within the limited time provided for NAV calculation for one of two reasons.

First, there may be inconsistent or nonexistent authority in a particular area; this lack of authority will typically be accompanied by no audit experience. This fact pattern occurs most frequently with evolving financial instruments, but can occur with many fund tax matters.

enforcement action to the Commission against any Fund based solely on the Fund's implementation of FIN 48 under the timetable set forth in the Staff Letter, which would commence on June 29, 2007.

⁴ This discussion applies primarily to SEC registered open-end Funds. These Funds are required to calculate NAV in accordance with rule 2a-4 of the Investment Company Act of 1940 ("1940 Act"). Rule 2a-4 does not expressly mention GAAP, but refers to items that will be on Funds' financial statements at such times as they are issued. Many closed-end Funds also calculate NAV daily as a matter of practice. Non-registered Funds typically compute a NAV as frequently as investors purchase and redeem their capital.

⁵ At present, tax uncertainties that arise in these circumstances generally need not be reflected immediately in NAV if they are unlikely to result in actual liability or the amount of the tax to be paid can not be reasonably estimated, since they are governed by FAS 5, Accounting for Contingencies.

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To illustrate, assume a Fund investing in credit default swaps ("CDS") values them for tax-diversification test purposes⁶ on a net basis (*i.e.*, based on fair market value). The Fund believes that it is at least more likely than not that CDS can be valued in this manner. Assume that, due to an administrative error, the Fund fails the tax diversification requirements, but would not fail if it were able to value the CDS on a gross basis (*i.e.*, based on notional exposure). Finally, assume that the Fund is reluctant to take the position that valuation on a gross basis meets the more likely than not standard, due to the fact that it had previously taken the position that net valuation meets the more likely than not standard. Under these circumstances, FIN 48 could require the Fund to reduce its NAV immediately because of the potential diversification failure—even though, given a lack of authority and audit experience, it is entirely possible that the IRS, when approached by the Fund, could conclude either that gross valuation of CDS is the correct method or that, in the absence of guidance, a Fund could adopt either a gross or net approach.⁸

Second, even if there is legal authority on a given issue, it may be impossible within the one-day time constraint of NAV calculations to determine how to apply that authority to the existing fact pattern in assessing whether the more likely than not recognition standard has been met. Moreover, if a timely determination is made that the uncertainty does not meet the more likely that not standard, an additional calculation, again based on the facts, must be made under the same time constraint—a determination of the largest amount of tax benefit that is more likely than not to be realized upon ultimate settlement. This determination may take days or even weeks. If FIN 48 is applied to require the NAV reduction before complete information is available and the facts can be fully analyzed, one or more additional adjustments to NAV likely will be necessary as more facts are learned. In the meantime, shareholders will be paying and receiving prices that do not represent the fair value of the Fund's net assets due to inaccurately calculated, and difficult to estimate, tax liabilities.

To avoid this consequence—which uniquely affects Funds—we request that the FASB issue guidance providing Funds with an appropriate period of time to perform a good-faith FIN 48 estimate, during which period the FIN 48 reduction need not be recorded as long as no reduction is required under FAS 5. That is, when a tax uncertainty first is noticed, the Fund must make a FAS 5

⁶ Under section 851(b)(3) of the Internal Revenue Code, among other requirements, at least 50 percent of the value of a Fund's total assets must be represented by (i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and (ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the Fund.

⁷ It is not entirely clear, taking administrative practice into account, that two different positions on a particular tax uncertainty can both meet the more likely than not recognition standard.

⁸ One possible approach would be to reduce the Fund's NAV by 34% of its income for the year in which the failure occurs, since a diversification failure could result in the Fund paying corporate tax. Such an approach, however, would be grossly unfair to the existing shareholders of the Fund.

determination and, if it believes no accrual is required under those standards, it will have until its next financial reporting period-end to resolve the issue prior to applying FIN 48. Alternatively, given that Funds typically issue financial statements on a semi-annual basis, the FASB could consider a model consistent with operating companies, allowing for a period until the end of the fiscal quarter, but in no event less than 45 days, to research and analyze the uncertainty prior to applying FIN 48. Regardless of the approach taken, and of paramount concern, we believe it is necessary for the FASB to clarify that the FIN 48 recognition and measurement model was not designed or intended to be applied as a daily accounting model.

2. <u>Consideration of the Taxing Authority's Administrative Practice of Enabling the Fund's Adviser or Other Party to Settle the Tax Matter on Behalf of the Fund</u>

a. Recognition of Tax Benefit

Funds typically have no employees, and tax determinations are often made on behalf of the Fund by a fiduciary such as its adviser or another third-party. In the rare instances that administrative errors relating to tax matters create uncertain tax positions, the IRS has expressed a willingness to settle these matters with the Fund's adviser or another third-party. These settlements typically involve a negotiated payment by the adviser or another third-party, so as to ensure the Fund is not subjected to tax.

We are concerned that the application of FIN 48 upon the identification of an administrative error as described above could result in a determination that the associated tax position will not meet the more likely than not recognition criterion because the error is evidence of a potential tax liability. We seek clarification that the willingness of the IRS to resolve fund tax matters with the adviser or another third-party, along with the adviser's intent to settle the current matter and history of settling previous similar matters, should be evidence that the recognition criterion has been satisfied. This application of FIN 48 would reflect the economic reality that the likelihood the Fund will ever be required to pay the tax is remote.

b. Indemnification

In the event the Board disagrees with this view and believes a liability should be recognized by the Fund, we seek clarification as to whether and under what circumstances an indemnity relating to the anticipated settlement with the IRS by the Fund's adviser or another third-party may be recognized.

Some interpret FAS 5 to preclude recognition of an indemnity until such time as the benefit is ultimately realized. This view would create a timing mismatch in the recognition of the FIN 48 liability and the offsetting indemnity. The Audit Guide, however, permits recognition of litigation settlements

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prior to realization. Some would apply this treatment to the accounting for indemnifications and recognize the indemnity when it is first established. This apparent conflict in the accounting literature may create a divergence in practice.

Recognition of the indemnity as an asset along with separate recognition of the FIN 48 liability would enable the Fund to avoid any diminution in NAV where the adviser or another third-party has committed to settle the liability on behalf of the Fund. Rather than such arrangements being subject to the gain contingency criteria in FAS 5, we believe they should be analogized to the accounting for insurance recoveries as discussed in Emerging Issues Task Force 01-10, Accounting for the Impact of the Terrorist Attacks of September 11, 2001.

Conclusion

Without additional guidance on these issues, FIN 48 has the potential to create artificial NAV reductions that present arbitrage opportunities for sophisticated investors, to the detriment of long-term shareholders. Such opportunities may result from the mechanical operation of FIN 48, whereby the recognized tax liability will automatically disappear—and, correspondingly, a Fund's NAV will immediately increase—upon ultimate settlement of the tax matter by the fiduciary with the IRS, or expiration of the tax-related statute of limitations. As a result, sophisticated investors who are aware that the application of FIN 48 to a Fund may result in an artificial decrease or increase in the Fund's NAV could redeem or purchase, respectively, shares of the Fund prior to this price movement.

The issues discussed above are complex and may extend beyond the original areas contemplated by the Board for consideration within the scope of FIN 48. We also understand that any additional guidance needs to be considered in the context of other industries that also must apply FIN 48. We remain supportive of the Board's goals of providing a consistent framework for accounting for uncertainties in income taxes and greater transparency of tax risks. Nevertheless, we believe without additional guidance, FIN 48 will result in adverse unintended consequences for Funds and their shareholders. Finally, none of our recommendations for guidance are intended to obviate the need for

⁹ See paragraph 8.26. Before an unusual item is collected, it should be valued by the board of directors, and subsequent changes in the fair value should be recorded (emphasis added).

¹⁰ This movement in a Fund's NAV tied solely to the FIN 48 requirements has the effect of harming Fund shareholders that held shares while the Fund recorded the tax liability and redeemed their shares prior to the expiration of the applicable statute of limitations. These shareholders would be unable to attain the full economic benefit of their investment in the Fund, even where the Fund knew, or had reason to believe, that it would never make a payment in connection with the artificially recorded tax liability. Further, shareholders that entered the Fund after the redeeming shareholders, and that remained in the Fund when the statute of limitations expired, would receive an economic benefit tied to Fund activities that took place prior to their purchase of Fund shares. This economic benefit would effectively accrue at the expense of the redeeming shareholders.

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adequate disclosure to ensure shareholders have appropriate insight into the tax risks and uncertainties of Funds.

Thank you for your consideration of this request for interpretive guidance. If you need additional information, please contact the undersigned at 202/326-5851.

Very truly yours,

/s/

Gregory M. Smith
Director – Fund Accounting

cc: Richard Paul

Fellow

Financial Accounting Standards Board

Conrad Hewitt

Chief Accountant, Office of the Chief Accountant

Barry Miller

Associate Director, Division of Investment Management

Richard F. Sennett

Chief Accountant, Division of Investment Management

U.S. Securities and Exchange Commission