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File Reference 1215-001 - Accounting for Uncertain Tax Positions - an Interpretation of FASB Statement No. 109

I offer the comments below with respect to the Exposure Draft ("ED"). First, the FASB should be commended for taking on this difficult subject. There clearly is diversity in practice with respect to uncertain tax positions, and the readers of financial statements would be well served by attempting to reduce such diversity.

However, there are some serious practical, and possibly conceptual issues with the ED as currently formulated. The most serious issues surround the overall model, and thus, I will comment on those first. Other issues are then addressed, including my views on most of the questions posed in the ED.

Overall Model

In my opinion, the practical consequences of the overall model proposed in the ED will be as follows:

- Systematically overstate tax reserves for substantially all taxpayers that have uncertain tax positions - In many cases, the reserves will be grossly overstated.

- Increased volatility in earnings by virtue of the establishment of greater than needed reserves, and then the subsequent release of such reserves

- Substantially increased effort by taxpayers as they attempt to demonstrate to themselves, their auditors, and ultimately the SEC that they can get over the "probable" recognition threshold required by the ED.

Note 1 – These comments are based upon a combination of my experience as: (i) a Tax Partner in a Big 4 accounting firm with 28 years of hands-on experience reviewing client’s uncertain tax positions; and (ii) as the Senior Accountant Advisor in the US Treasury Department Office of Tax Policy where I participated in drafting and interpreting the US law, including the 1986 Tax Act. However, the views expressed in this comment letter are solely my own views and do not necessarily represent the views of the Big 4 firm I am currently associated.
• Finally, for certain industries (e.g., mutual funds that are traded at net asset value), the overstatement of tax reserves upon adoption, and thereafter, will have an immediate negative impact on shareholders who own the stock at the time such overstated reserve is recorded.

Tax reserves will be overstated for the following reasons:

• **Tax Laws by Their Nature are Very Uncertain:**

  > **US Tax Law** - The US tax law is very complex with many shades of grey and many contradictions. If the law (code, regulations, etc...) is not relatively clear on its face, tax advisors are usually cast into a swamp of uncertainty with many varying views on how an issue should be decided.

  > **Other Tax Jurisdictions** - The tax laws of state and local governments and foreign countries are also very grey, but the reason is often a lack of guidance. For example, issues surrounding nexus and apportionment are particularly difficult in state and local jurisdictions. Similarly, issues surrounding so-called permanent establishments; proper interpretation of treaties; the authority of the EEU Court of Justice, etc... raise many questions in the foreign context.

• **High Threshold Adopted in the ED** - The ED defines "probable" by reference to paragraph 3 of FAS 5. Most accountants in practice view this threshold to be approximately 70-75%.

Based on my experience in attempting to interpret various tax laws, failing to reach a 70-75% level of confidence on uncertain tax positions may be the rule, rather than the exception. If this is the case, 100% reserves will effectively be established for many uncertain tax positions where one might anticipate only conceding say 40% or 50% to a taxing authority. The net result will be the systematic overstatement of tax reserves, and in some cases the overstatement will be (i) very material, and (ii) as discussed later possibly indefinite.

If one accepts the premise the ED will result in (i) reserves for uncertain tax positions being likely overstated, and (ii) business enterprises will spend a substantial amount of effort attempting to comply with the ED, then I think the FASB needs to consider whether the end result of the ED is in conflict with the general requirements of FASB Concept Statement Number 1 ("CON 1"). Specifically, the sections in CON 1 which state that information should be "useful in making business and economic decisions", and that the benefit of providing such information outweighs the cost.

If the FASB agrees there is an issue with the overall model proposed in the ED, then there are several alternatives I believe the FASB could consider. Any of the alternatives would be better than the current proposed model.

• **Liability Model, except for Tax Motivated Transactions** - Although I understand the argument in a self-assessment tax system that filing a tax return with an uncertain tax position could be viewed as creating an asset, I personally believe most uncertain tax positions should be viewed as a contingent liability. The reason for my view is that when filing a tax return, a taxpayer is trying to self-assess its tax liability. Most tax positions are
uncertain because of uncertainties in the tax law, rather than some intent on the part of the taxpayer to create an asset.

From my experience, the one type of uncertain tax position that requires special attention is when a taxpayer is implementing a so-called "Tax Motivated Transaction". This is a transaction or series of steps being taken primarily for tax reasons. In these cases, I believe taxpayers are trying to create assets, and thus an asset recognition model would be appropriate.

One potential criticism of differentiating between certain types of uncertain tax positions above is that it may be difficult to define a Tax Motivated Transaction. If the FASB attempted to provide a detailed "rule" defining Tax Motivated Transactions, I believe such effort would be doomed to failure. Rather, these transactions are sort of like pornography – you should know one when you see it. I would suggest the FASB only describe the "principle", and not much more. Although there could be some uncertainty in practice, I believe the end result would be better than (i) materially overstating tax reserves, and (ii) dealing with the issues created by inappropriately applying an asset recognition model to all uncertain tax positions.

- **Asset Recognition Models with Lower Thresholds for Recognition** - If the FASB decides to retain an asset recognition threshold for uncertain tax positions, then there would seem to be two principle alternatives to the current threshold proposed in the ED. Before describing the alternatives, I want to acknowledge that paragraph 25 of FASB Concept Statement Number 6 ("CON 6") states:

  "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

Thus, CON 6 clearly uses the word "probable". However, it is worth noting that Footnote 18 to CON 6 defines "probable" as follows

"Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (Webster's New World Dictionary of the American Language, 2d college ed. [New York Simon and Schuster 1982], p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

Since the CON 6 definition of "probable" is specifically not tied to FAS 5, paragraph 3, I found it interesting that paragraph 6 of the ED defines "probable" by reference to FAS 5, paragraph 3. The bottom line is that if the FASB wants to define "probable" in a manner different than FAS 5, it would appear they have the ability to do so without being in contradiction of CON 6.

- **More Likely Than Not Threshold** - Given the existence of uncertain tax laws and the resulting practical difficulty of reaching a "probable" threshold, the FASB may want to reduce the asset recognition threshold to more likely than not ("MLTN"). Although tax reserves may still be somewhat overstated, most taxpayers generally require a MLTN confidence level before taking a position on a return. In some cases, the MLTN is the statutory minimum.
required to avoid penalties, and in many other cases, taxpayers' internal policies are that a MLTN position needs to be obtained.

In addition, currently the US tax law does not have any requirement to reach a "probable" or 70-75% threshold. However, MLTN is a threshold that is used for various purposes. For example, the recent Circular 230 rules require that certain tax opinions have no less than a MLTN level of comfort. In addition, the recently finalized PCAOB independence rules on tax services adopt a MLTN standard for purposes of defining permitted tax services.

Thus, a MLTN threshold has the following advantages:

- Relatively well understood by taxpayers and their advisors

- Substantially less work would need to be done by taxpayers implementing a MLTN standard vs. a "probable" standard. However, there would still be some work, especially in making sure outside auditors were in agreement with the taxpayer's conclusion the uncertain tax position is MLTN.

- It would also seem to fit within the general definition of "probable" articulated in CON 6, footnote 18.

> Alternative Threshold Advocated by Two Board Members - Paragraphs B46 and B47 describe an asset recognition standard based upon a minimum standard for avoiding penalties. I believe this is preferable to the model proposed in the ED because (i) it should not result in a material overstatement of tax reserves; (ii) the recognition standards are better understood than a "probable" threshold, and (iii) there should be substantially less work by taxpayers implementing this standard.

However, I do have some concerns that the Recognition threshold will be variable depending upon the tax law of a particular jurisdiction. For the US federal tax law, the levels of comfort required to avoid penalties are relatively well documented. I do not know whether that is the case in other tax jurisdictions.

Of the three overall models articulated above, I would personally prefer the Liability Model (except with respect to Tax Motivated Transactions). I believe such a model is the most conceptually consistent with the nature of the issues surrounding uncertain tax positions, and also will result in tax reserves best approximating reality. Admittedly, there will be some practical definitional issues surrounding Tax Motivated Transactions, but the Liability Model should result in more realistic tax reserves, and avoid the issues surrounding the proper Recognition threshold within the asset recognition model.

Measurement Issues

Regardless of whether the FASB decides to change the overall model proposed in the ED, I urge the FASB to reconsider the measurement criteria proposed (i.e., the Best Estimate as defined in FASB Concepts Statement No. 7 (CON 7)). CON 7 defines Best Estimate to mean the "single most-likely amount in a range of possible estimated amounts". Furthermore, paragraph B28 of the ED states:

"The best estimate is not a probability-weighted or expected-value approach, ...."
I have two concerns with this tentative decision:

- **Conceptual Concern** - Over the past several years, the FASB seems to have a clear preference for using "fair value" or "expected value" as a measurement standard. In paragraph B10 of the ED, the FASB rejects a "fair value" measurement attribute because FAS 109 does allow discounting for deferred taxes. I personally agree the FASB should not re-open the discounting issue at this time and therefore, as a practical matter, cannot adopt a true "fair value" approach for Uncertain Tax Positions. However, I see no reason why the FASB cannot use the "expected value" concepts imbedded in CON 7.

- **Practical Concern** - As illustrated in Tim Lucas's comment letter dated August 10, 2005, the CON 7 definition selects the point estimate with the single greatest probability. I am concerned in practice there will be inconsistent application of this standard. Furthermore, some taxpayers might argue no reserve is needed under this standard when in the real world, a reserve may be appropriate.

In my experience both taxpayers and the IRS start with an "expected value" approach when attempting to reach a settlement, especially on technical issues. For example, if a taxpayer and the IRS both agree an issue is a 70/30 issue in favor of the taxpayer, typically one would expect an agreement to coalesce around a 70/30 settlement. Admittedly, there will be many times when the actual settlement is different than 70/30, but at the time a taxpayer takes the position on a return, an estimate of a 70/30 settlement is probably the most appropriate when they have concluded the technical issue is a 70/30 issue in their favor.

In summary, I believe an "expected value" approach makes the most sense for the Measurement stage of the model. However, if the FASB decides to retain the Best Estimate approach of CON 7, then I suggest they make clear that Best Estimate be determined by reference to the relative weight of the arguments for and against the taxpayer. Said differently, if there is a 70/30 issue, then one would expect the Best Estimate to be approximately a 30% concession by the taxpayer. Otherwise, there will be taxpayers that will argue there are an infinite number of potential settlements between 0 and 100% with a zero settlement being the most likely.

One final recommendation with respect to Measurement is to make clear that one should presume the issue will be audited by the relevant taxing authority. Paragraph 7 of the ED makes this clear for Recognition, but it is not 100% clear in paragraph 11 of the ED.

**Other Issues and Comments**

- **Effective Date** - If the FASB maintains the current model (i.e., "probable" threshold required to avoid a 100% reserve on a tax issue), then I believe taxpayers will require approximately 9-12 months from the date the FASB publishes such final rule to properly implement the guidance. Anything sooner will cause significant issues for taxpayers and their auditors. If the FASB changes its current model, then the amount of time after final adoption will depend on the nature of the model selected.

- **State and Local Tax Nexus/Filing Issue** - Assuming the Recognition threshold is maintained for all uncertain tax issues, there is a distinct possibility many state and local tax reserves will need to be recorded indefinitely. A variation of this issue applies in international taxation as well, and is referred to as the permanent establishment issue.
Because of the tremendous uncertainty surrounding whether taxpayers have created nexus in a particular tax jurisdiction, many taxpayers do not file tax returns in certain jurisdictions. Ultimately some of these states will challenge the taxpayer and some back taxes will likely be paid. Given (i) the language in footnote 2 of the ED; (ii) the statute of limitations does not generally start to run until a tax return is filed; and (iii) the tax law surrounding nexus is so uncertain; it is very possible that many taxpayers will not meet the "probable" threshold and a 100% reserve will be required for nexus issues. As a practical matter, such reserve will never be released unless the taxing authority directly challenges the taxpayer. If the taxing authorities never challenge the taxpayer, the reserves will be recorded forever. Does this make sense?

I don't think so. However, fixing this issue depends upon what overall model is adopted by the FASB. If the FASB adopts a Liability Model, except for Tax Motivated Transactions, then the issue should go away. However, if the FASB adopts any sort of Asset Recognition model, the issue will still exist. Certainly it will be less of an issue with a lower threshold, but given the lack of clear guidance on nexus, it could still be an issue.

As a practical matter when a state and local taxing authority challenges a taxpayer on nexus, they usually have a policy of only going back a certain number of years (e.g., 3 to 10 years). Where such a policy exists, at a minimum, a reserve should only be retained for such period of time.

• **Paragraph 9** - Several questions have been raised with respect to the evidence necessary to meet the Recognition threshold, including:

  > **Taxpayer has Received a Settlement Offer, but is Still Negotiating** - If at time of adoption of the final standard, a taxpayer is addressing transition and has received a settlement offer from the IRS, should they be able to assume they have met the Recognition threshold? I believe if the taxpayer represents they are willing to accept the offer (i.e., if negotiations fail), then they should be able to assume Recognition and go directly to the Measurement stage. However, such a result would not appear to be consistent with the ED, as currently drafted.

  > **Taxpayers may Only be Allowed to Consider their Own Audit History** - Paragraph 9(c) should be broadened to consider other taxpayer's audit histories. Otherwise, taxpayers that are not audited frequently are at a disadvantage.

• **EITF 93-7** - Pursuant to paragraph 4, the ED applies to uncertain tax positions acquired in a business combination. As I read Appendix C, the ED retains the concept in EITF 93-7 that require the effects of all subsequent tax adjustments to generally be recorded to goodwill.

If one agrees the ED will overstate tax reserves, then I urge the FASB to think long and hard before it completely eliminates EITF 93-7. This is especially true if the FASB retains the model proposed in the ED that will result in overstated reserves. The reason is that most tax adjustments take substantially longer than a year to resolve, and thus the net effect of eliminating EITF 93-7 could be to allow companies to recognize such overstated reserves in future operations, rather than goodwill.

Even if the FASB adopts an uncertain tax position model that more fairly estimates tax reserves, my personal view is that EITF 93-7 still makes sense since as mentioned previously, tax issues take an extraordinarily long time to resolve.
• **Enhanced Disclosure Threat** - During FASB's public deliberations leading to the ED, there seemed to be a notion that if the Recognition threshold was reduced below "probable", then it might be necessary to require enhanced disclosure. I found this concept a little curious for the following reasons:

> The current ED will likely overstate tax reserves, and thus, if anything, more disclosure should be required in such case. Possibly this is why paragraph 18 of the ED emphasizes the reference to paragraph 17 of FAS 5 (i.e., gain contingencies).

> If the ED is modified to more appropriately reflect tax reserves, then I would submit no special enhanced disclosure should be required.

• **Should the ED Apply to Non-Income Based Taxes** - Conceptually I believe both income and non-income based taxes should be based on an Expected Value Liability Model. However, if the FASB adopts an overall Asset Recognition model, then I would urge the scope of the ED be limited to income taxes. The reason is that the tax law surrounding non-income based taxes is often more nebulous and undefined than the income tax law. Imposing an Asset Recognition model on such taxes could cause an ever greater overstatement of tax reserves.

• **Presumption of Detection Risk** - I agree detection by the taxing authorities should be presumed (in both the Recognition and Measurement stages of the analysis). Although this in its own right may result in tax reserves being practically overstated, I don't believe it is appropriate to be guessing whether the taxpayer is going to get a thorough agent vs. one that is likely to miss the issue.

• **De-Recognition** - If the FASS maintains the proposed model with a "probable" threshold as defined by FAS 5, and it decides it wants to have de-recognition, then I believe the proposed de-recognition threshold is reasonable. However, if the "probable" threshold is lowered, then the need for a de-recognition threshold would be reduced.

I do not have strong feelings as to whether there should be (i) an "on-off switch" approach, vs. (ii) an approach that only requires passage of the Asset Recognition criteria at the time of filing the return. If I had to pick one, I would lean in the direction of an "on-off switch" so that similar issues for the same taxpayer and across taxpayers would be treated the same, regardless of the time period the position was taken.

• **Interest** - I believe there should be consistency between the amount of tax that will be accrued, and the related interest. Thus, if the ED assumes a $100 tax reserve is required, then interest should be accrued on that amount even though the $100 liability is overstated. Said differently, I do not support a model that applies different standards to tax vs. interest. If there is an issue with the underlying model, then that should be directly addressed rather than trying to partially mitigate the overstatement through adoption of a different rule for interest.

Thank you for the opportunity to provide comments on this important FASB project.

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