Comments by the American Petroleum Institute
To the Financial Accounting Standards Board Regarding
Their Review of FAS 109 on Uncertain Tax Positions

I. Introduction

The American Petroleum Institute (API) represents more than 400 companies involved in all aspects of the petroleum industry, including exploration and production, refining, marketing and transportation. API members are among the leaders in the oil and gas business and conduct operations through a variety of business arrangements and in a number of different countries throughout the world.

We recognize that there has been a significant amount of concern expressed by members of Congress, governmental officials and private individuals on the issue of companies benefiting from aggressive or uncertain tax positions. In the past few years, numerous efforts have focused on limiting the opportunity and situations where these issues can arise. For example, recently the Public Company Accounting Oversight Board issued rules strengthening the objectivity of auditors providing tax work for audit clients. Further, the Internal Revenue Service (“IRS”) issued regulations requiring the disclosure of certain tax advantaged or potentially aggressive positions to the Commissioner. Congress reinforced these rules as part of the American Jobs Creation Act of 2004 by granting the IRS authority to impose penalties on taxpayers that fail to disclose these transactions in their tax returns. Both continue to develop measures to possibly quell such actions or better disclose them to relevant parties.

In a similar vein, the Financial Accounting Standards Board’s (“FASB”) recently released exposure draft on the Proposed Interpretation on Accounting for Uncertain Tax Positions under FAS 109 (the “Interpretation”) appears to be
another step in this process. This project arose from discussions with the Securities and Exchange Commission on the inconsistent use of the existing FAS 109 and FAS 5 accounting rules toward uncertain tax positions on company financial statements.

A. Current Rules

Under the current interpretation of FAS 109, current tax liabilities or assets are recognized for the estimated taxes payable or refundable on tax returns for the current year. Deferred tax assets or liabilities are recognized on temporary differences in the book and tax amounts of reported assets and liabilities. The value of a deferred tax asset is reduced by a valuation allowance if it is determined that it is more likely than not that some portion of the deferred tax asset will not be realized. For positions taken on a return which potentially impact the amount of tax paid, an amount for an additional tax liability must be accrued on a company's current financial statement if it meets the general standards for contingent liabilities under FAS 5: i) if it is probable that a claim will be asserted against the company for taxes otherwise due, ii) it is probable that a tax liability will arise, and iii) the amount of that tax liability can be reasonably estimated.

B. Proposed Interpretation

The FASB's Interpretation would restrict an entity from recognizing the financial benefit of a tax position unless it is probable that the position giving rise to that benefit will be sustained when challenged by taxing authorities. Probable, in this context, would mean that the position is likely to be or "should" be sustained, as the meaning of that term is defined in FAS 5. It also assumes that the issue will be reviewed and questioned by the tax authorities regardless of a company's history or experience with the issue or similar situations. If the position is judged probable of being sustained, the Interpretation would then
require a determination of what is the best estimate of that benefit, presumably again under a FAS 5 analysis. If it were determined that the best estimate analysis reduced the tax benefit an appreciable amount, then the probability analysis would be reassessed. If the company files a tax return based upon a tax position that does not meet the probable level but reduces taxes relative to other contrary positions, the Interpretation would consider that a benefit had been created which, because it does not rise to the probable level, could not be recognized in the company's financial statements.

Therefore, under the Interpretation, a tax position taken on a return could not be recognized for financial statement purposes unless it met a probable threshold. The impact of the position would then be valued and reflected solely under FAS 109 guidance. The difference between what could be claimed as a tax benefit and what was filed would give rise to a tax liability classified according to the expected timing of when the liability would be settled.

II. General Concerns with the Proposed Interpretation

Before making comments on the Interpretation's specifically identified issues or paragraphs, we believe it necessary to make some general statements about the logic upon which the Interpretation bases its conclusions. We will then comment on the specific issues identified in the Notice for Recipients of the exposure draft of the Interpretation.

A. Accounting for Tax Liabilities Not Assets

The Interpretation analyzes tax accounting predominantly in the conceptual framework of recording assets. This approach disregards the fundamental characteristics of tax regimes in most jurisdictions wherein the governing laws create a duty or obligation on the reporting entity to transfer cash to the government at specified or determinable dates, with little discretion to
avoid the payments. The amount due is typically based on transactions or events of the entity which have already occurred. Thus, pursuant to Concepts Statement 6, paragraph 36, these characteristics are consistent with those of a liability, not an asset. Indeed, paragraph 39 provides, “some obligations are imposed on entities by governments...Thus, taxes...commonly require business enterprises...to pay cash...”

Moreover, many tax regimes (including the U.S., for example) are based on a system of self-assessment. Under a self-assessment system, a taxpayer generally files a return reporting its taxes due to the government under the applicable laws. The returns are typically accepted with limited reviews for clerical accuracy. The tax authority typically can assess additional taxes due for the period covered by the return only by making a formal claim against the reporting entity after conducting a substantive examination of the return.

As a factual matter, the amount legally due to the government is the amount required to be shown on the tax return. Any additional taxes sought by the government would require the government to make a claim through a formal process. The filing of a tax return based on a position reducing taxes compared to other positions, which would result in a greater tax, does not create an asset. It creates a contingency that the government will assert a claim against the reporting entity. Only when a tax regime provides for carryforwards of certain attributes (e.g., net operating loss and tax credit carryforwards) or refund claims (e.g., net operating loss carrybacks to claim a refund of prior year taxes) does the concept of an asset arise.

B. Determination of a Tax “Benefit”

The Interpretation provides for recognition of “benefits” from tax positions. This implies that a “benefit” results from the difference in the tax effect of a position taken by the reporting entity and the tax effect of other contrary
positions. The natural extension of this logic implies that a "benefit" could exist even when the reporting entity's position has superior technical merit to competing contrary positions but results in less tax. The Interpretation fails to recognize that certain transactions or events will lend themselves to competing tax positions, all of which could form the basis for a position on a tax return, but none of which might satisfy the "probable" standard as it will be applied. Under the Interpretation, therefore, the result would be to record taxes based on the worst possible outcome to the reporting entity, which may also be the least probable outcome.

C. Consistency in Determining Probable Positions

We readily concede that diverse accounting practices may currently exist among enterprises on the determination of their contingent tax liabilities under FAS 5; but we see this as the result of the misapplication of existing standards rather than the failure of the accounting standard itself. Regardless, the Interpretation assumes that a wholly new methodology is the only way to resolve the current diversity. However, because of the implementation of such a high (but potentially still subjective) standard for the recognition of what is, in actuality a contingent liability, the Interpretation will still lend itself to diversity in accounting practice.

For example, our members have experienced diverse application in how qualified tax experts (e.g., national law and accounting firms) apply the "should prevail" standard in tax opinions. The tax law does not rely upon this level of comfort as it does other standards such as "more likely than not," "substantial authority," and "reasonable basis." These other standards, though, rationally recognize certain ambiguities and risks that are taken into account when interpreting tax law which are not available with a more restrictive "should prevail" level. Hence, no authoritative standard exists by which the "should prevail" standard can be consistently applied and it is highly dependent upon individual
approaches and assessment whether any relevant risks exist. This is especially eviden in foreign jurisdictions where even the concept of a “should” opinion is very uncommon. Attempts to mandate consistent standards do not necessarily solve the inherent issue of subjective consideration needed to interpret tax laws.

In addition, through discussions in various seminars and other forums, our members have serious concerns that the Interpretation will be applied inconsistently. The subjective nature of tax liabilities will always make the area susceptible to inconsistencies in application of whatever standards exist. Perhaps more clarity around existing standards would better serve the interests of those relying on financial statements rather than a fundamental change in the underlying accounting standards.

D. Disconnection from Actual Tax Charge

Many current filing positions taken by companies on their tax returns are the result of an educated and reasoned interpretation of the tax law. However, the tax law is not entirely settled in many instances. Accordingly, it is not clear how the new measurement standard stated in the Interpretation will result in a better reflection of taxes or tax effects to investors. Transactions that do not meet the probable level but are still considered more likely than not to be the state of the law will not be reflected for financial reporting purposes. This will raise the effective tax rate in one year, which will be followed by a subsequent reversal in a later year. We do not believe that the significant accruals and inevitable reversals of these unlikely tax liabilities in later periods will represent an improvement in financial reporting for the investing public.

Additionally, obviously many of our members are large, multinational corporations with operations located throughout the world. Accounting for those operations under various systems gives our members a certain perspective on how the different standards can interact. It is our impression that the
Interpretation, analyzed in a broader context, appears to discount other standards or operating environments by assuming that all tax regimes have a similar level of sophistication and clarity to allow for a clear interpretation of whether a position is probable or not. It is just as likely that the Interpretation could cause a substantial overaccrual in jurisdictions where the audit activity is less known and the law is less developed.

E. Increasing of Accounting Burden

From a practical application standpoint, implementation of the Interpretation would be a significant undertaking, in terms of both time and cost, to companies. In addition to a review of current year events, every return position for every open tax year in every jurisdiction would need to be reviewed internally as to what is considered to rise to the “should” level. In doing so, companies would likely have to redefine their historical return review analysis, as they likely relied only on achieving a more likely than not or substantial authority level of comfort. There has been no real need to conduct additional analysis to reach a “should” level on most items reflected on the return or quarterly financial statements. In addition, given the use of this high standard, each position will need to be reviewed quarterly for changes in fact or law that could topple the earlier analysis and require a derecognition. Needless to say, this has the potential to be a substantial burden on most companies.

In addition, this analysis will need to satisfy a company’s external auditors. Tax opinions will likely need to be re-reviewed and may quite possibly be challenged as to whether they rise to a “should” level. Given the breadth of the Interpretation and the fact that there is no real guidance as to how this should be done, this will present a substantial resource issue for auditing firms.

It should also be noted that taxable temporary differences can also arise from uncertain tax positions. In such situations, though, the current application of
the deferred tax accounting standards effectively eliminates the "benefit" of these positions in a company's financial statement. Regardless, under the Interpretation, taxable temporary differences based upon uncertain tax positions will require reclassification on a company's balance sheet. Additionally, a contingency reserve for interest expense will be required. While the imposition of interest on such positions would represent a new accounting method, the reclassification of taxable temporary differences from deferred taxes to other liabilities will not substantively impact a company's balance sheet, particularly where the resolution of the uncertain position is not anticipated within a year. Consequently, the Interpretation appears to impose a significant accounting burden which may have minimal substantive impact on the balance sheet as it applies to taxable temporary differences.

F. Disconnection from International Accounting Standards

Finally, we wish to highlight that the current system for recording the impact of current tax assets and liabilities is consistent with International Accounting Standards. Under IAS 12 and 37, companies will reflect current tax assets and liabilities as they are taken on the tax return and will then accrue a reserve for potential tax adjustments raised by local taxing authorities. The implementation of a probable standard prior to recognition of a reduced current liability could create a sizable difference between the FASB and IAS methodologies. As the FASB and IAS have been undergoing an extensive exercise to converge accounting standards, it seems counterproductive to have the FASB create a distinction where none had previously existed.

III Specific Concerns with the Application of the Proposed Interpretation

In its Notice for Recipients of the exposure draft, the FASB outlined certain areas where it would like comments on the Interpretation. The following paragraphs are our thoughts and suggestions on some of those specific items.
A. Initial Recognition – Review by Taxing Authorities

As previously stated, the current process of allowing companies to reflect potential exposures as contingent liabilities under FAS 5 is a method that allows entities to consider all relevant information in developing an accurate picture of a company’s actual financial exposure. Given that many of our members are under continuous audit, their assumptions on how to reserve for an issue under FAS 5 is really based on experiences with audits and agreements with the IRS. However, under the Interpretation, companies must disregard this experience and assume that the IRS will review all filing positions on audit.

Not all company tax audits are the same and the IRS has different audit plans for different size companies. Issues of concern are still raised and addressed, but some taxpayers have reached accords with the IRS on how certain areas will be audited or even ranges on how some points of disagreement will be worked. This all goes into the assessment of properly calculating the contingent liability for FAS 5 purposes. While we appreciate this adds a certain subjective aspect to the determination, we believe that disregarding that experience would ignore the company’s best assessment of its potential financial position to investors. Further, this again shows a bias in the Interpretation to treating tax return positions as assets rather than the more proper contingent liability approach.

B. Initial Recognition – Use of “Probable” Standard

API and its member companies consider the use of a probable standard as applied by the FASB in the Interpretation to be problematic for a number of reasons. Our foremost concern is that the proposal can lead to an incongruent result where an entity accrues a liability for a contingency unlikely to occur. For example, a company may consider a legal position taken to determine its current
tax liability as more likely than not to be the proper interpretation of the tax rules, but - for various reasons - not probable. While taking such a position would be perfectly acceptable under the IRS rules, in this situation, the Interpretation essentially considers the taxpayer as availing itself of an uncertain tax benefit. However, this “benefit” is associated with an outcome that is more likely than not to be the proper result. This approach in the Interpretation would then lead to the reflection of an unlikely outcome in the financial statement.

A practical example of this concern could arise in the situation where a company believes it is more likely than not that it has no taxable presence in a state or foreign jurisdiction that would require it to file a return. However, if the law is not entirely clear (for example, no foreign treaty in place), the company cannot develop a “should” position. In this example, a company would be faced with having to record a liability for the “tax benefit” associated with not filing the state or foreign return. However, if there were no statute of limitations on tax years where no return had been filed in the jurisdiction, the recorded liability for the “benefit” could remain on that company’s financial statements, accruing calculated interest, for an indeterminate time.

Second, by supplanting the applicability of FAS 5, the new proposal would represent a different standard for contingent tax liabilities than is used for all other financial contingencies. It is unclear why a potential claim against an uncertain tax position represents an exposure that is different or distinct from any other potential legal challenge or impact on a company’s financial position.

Additionally, as expressed earlier, we are not convinced that the proposed probable standard will reduce confusion and inconsistency with company reporting. Certainly different company or auditor approaches towards the high probability standard will still be at issue. Absent a specific definition, companies will still likely apply different approaches in determining what issues to consider and whether something is probable in the context of determining current tax
expense. Some may consider a tax benefit to be as broad as any book-to-tax difference, such as depreciation; others could take a more limited approach. It is also certainly possible that fact patterns will generate situations where reserves are established just because of a lack of experience.

For example, assume that Company A begins operations in a country and pays taxes to a foreign government on income generated, which is recognized currently for U.S. tax purposes. In general, the tax law allows a company to credit foreign income taxes against the U.S. tax on that foreign income. However, in this example, the issue of whether the foreign taxes constitute income taxes has never been addressed. Based upon an interpretation of tax law in the area, Company A may believe that it is more likely than not that the taxes paid are creditable, but it is a case of first impression. In such a situation it is unclear how Company A might be able to reach a probable standard initially and at what point in the IRS administrative or potential litigation process the determination might be resolved.

IV. Suggested Changes to the Proposed Interpretation

API and its member companies suggest changes to the Interpretation to address two primary points. First, it should refocus from the asset or benefit approach taken in the Interpretation to a more appropriate liability approach. Second, a change should address the development of a threshold that can be applied more consistently and will integrate better with what is required by the tax law for return preparations.

It has been our perception that this effort undertaken by FASB is the result of concerns raised about taxpayers' accounting treatment of aggressive tax transactions. Accordingly, we suggest that the Interpretation focus on activities defined by the IRS as listed transactions or as substantially similar to such transactions. The scope could also encompass tax shelter transactions or other
tax structured schemes that a reasonable tax practitioner would consider as outside the normal course of the company's business. Companies engaging in these transactions are already likely to have disclosure requirements with the IRS, which raises the distinct possibility of audit review. If there still remains a concern about the consistency of recording the tax effects of normal business transactions, we believe that the Public Company Auditing Oversight Board can appropriately direct auditing firms to apply the current standards consistently and correctly with their clients.

Absent this narrowing, we would alternatively suggest that, if an asset approach is still adopted, the probable standard employed by the Interpretation be changed to a standard based upon a more likely than not approach. We consider the use of this approach to be more closely identified with the standard employed by companies in deciding whether they have a position that they can reasonably claim on the tax return in the first place. Following this standard will eliminate the incongruent position found in the Interpretation where a provision that is likely to prevail could still not be included for book purposes. We also believe that reliance upon a different standard would also mitigate other issues such as interpretation of foreign tax law and highly subjective issues such as transfer pricing. Finally, we would suggest that the more likely than not standard also allow some reliance upon a company's audit experience in the area as is currently applied for FAS 5 purposes.

V. Implementation Date

As currently drafted the substantial revisions to the financial handling of uncertain tax positions is scheduled to be effective for years ending after December 15, 2005. For the reasons noted above we disagree with the proposed interpretation and believe the interpretation should be reconsidered and revised. In addition, as part of the reconsideration, we recommend that the Board delay the effective date allowing impacted companies additional time to
consider the changes required and reset controls compatible with the final interpretation. Reviewing all open years and establishing the proper control environment, especially with multinational operations in jurisdictions at differing tax regime evolutionary stages, can be especially troublesome. As seen in the leasing area, late revisions to accounting requirements substantially increase the risk of internal control issues. We ask that changes in this important and complex area not be made with limited time for analysis, review and design. We, therefore, suggest that the effective date for any interpretation of FAS 109 on uncertain tax positions be pushed back to years ending on or after December 31, 2006.

VI Conclusion

We thank the FASB for the opportunity to comment on the Interpretation and raise our concerns with its directions. We understand that there could be situations where companies are not clearly reflecting the risk associated with some tax positions on their books or that the suggested approach on such positions could be inconsistent based upon outside auditor. However, we generally believe that the FASB should consider other avenues or forums to address the issue and reflect further on whether the proposed approach would generate more clarity for investors. In the interim, should the FASB have any questions or wish to discuss the points raised in our comments in any way, please do not hesitate to contact Stephen Comstock at 202-682-8455.