September 12, 2005

Technical Director
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File Reference: 1215-001 - Accounting for Uncertain Tax Positions

This letter is submitted in response to the Board’s invitation for comments on an exposure draft of a proposed interpretation titled “Accounting for Uncertain Tax Positions, an Interpretation of FASB Statement No. 109” (the “Proposed Interpretation”). My comments are based on my more than 24 years of experience representing primarily very large multinational publicly traded corporations in various roles: as a tax lawyer in private practice, as a certified public accountant and partner in a Big 4 accounting firm, and as a chief tax executive for three such corporations. While my comments are based on my experience representing affected entities, the views expressed in this letter are my own and are not necessarily shared by any former or current employer, firm, or client.

Summary

I oppose adoption of the Proposed Interpretation in its current form. The Proposed Interpretation deals constructively with certain issues related to accounting for uncertain tax positions, and I support those aspects of the Proposed Interpretation. However, the fundamental premise of the Proposed Interpretation – that a tax position cannot be recognized in an entity’s financial statements unless it is probable that the position will be sustained – is unworkable and will lead to material misstatements of tax items in financial statements. I oppose that aspect of the Proposed Interpretation, and recommend that the Proposed Interpretation be withdrawn in its entirety pending further consideration.

I believe that existing accounting principles appropriately account for uncertain tax positions and should be retained. I recommend that the Board issue an interpretation of FAS 1091 and FAS 522 affirming and clarifying the application of existing accounting principles to uncertain tax positions as described below. Such an interpretation would be sufficient to address any concerns regarding inconsistency in the application of existing accounting principles and any perceived deficiencies in existing accounting principles.

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2 FASB Statement No. 5, Accounting for Contingencies (1975).
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My comments are divided into three main sections. In the first section, I provide responses to the issues presented in the exposure draft. This discussion endorses many of the proposed clarifications of existing accounting principles, but points out other significant weaknesses in the treatment of the issues in the exposure draft. The second section provides additional comments on the approach of the Proposed Interpretation and recommends, in lieu of the Proposed Interpretation, that the Board issue guidance affirming and clarifying existing accounting principles. The final section analyzes the examples listed in Appendix A comparing the results under the Proposed Interpretation to the results under existing accounting principles. This comparative analysis demonstrates that the approach of the existing rules is superior to the Proposed Interpretation.

Responses to Issues Raised in the Exposure Draft

1. Issue 1: Scope

1.1 I do not agree that the Proposed Interpretation should apply to “all tax positions accounted for in accordance with Statement 109.” This expansive scope would apparently require affected entities to affirmatively document that each of its tax positions is supported by a probable level of confidence as prescribed in paragraph 6 of the Proposed Interpretation. This would create a significant and unwarranted compliance burden. If, contrary to the recommendations below, the Board adopts an asset recognition model for uncertain tax positions, I recommend that the scope of the guidance be limited in some manner so it applies only to those tax positions that are truly uncertain. Uncertain tax positions could be defined as those material tax positions as to which there is evidence that there is a reasonable possibility of challenge by the applicable tax authority. Absent evidence of a reasonable possibility that a tax position will be challenged, the tax position would be presumed to be valid in accordance with its treatment in the tax returns filed (or to be filed) by the entity. Under this approach, the tax returns would generally be adequate substantiation for all tax positions other uncertain tax positions.

1.2 I agree that the accounting for uncertain tax positions that pertain to assets and liabilities acquired in a business combination should be consistent with the accounting for uncertain tax positions that result from an entity’s other operations. I believe that this is the treatment under existing (and proposed) accounting principles.

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3 Proposed Interpretation, ¶ 4.

4 This approach is consistent with the Board’s prior acknowledgment that “The tax basis of most assets and liabilities is not subject to dispute and can be determined from initial filings with the tax authority.” See FASB Special Report, A Guide to Implementation of Statement 109 on Accounting for Income Taxes: Questions and Answers (1992), Q&A 17.

1.3 I agree that the Proposed Interpretation should apply to recognition of income tax assets and liabilities that relate to tax positions to be reported in future tax returns.

1.4 I do not agree that the initial recognition standard in the Proposed Interpretation should apply to claims for refunds or credits that are subject to substantive review and are likely to be challenged by the applicable tax authority. In cases where there is material uncertainty regarding whether a claim for refund or credit will be granted, I believe it is generally more appropriate to account for the claim as a gain contingency under FAS 5. The tax benefit would be recognized only when there is no material uncertainty regarding the ability to collect the refund or regarding the amount of the refund to be obtained.\(^6\)

2. Issue 2: Initial Recognition – Audit Detection Risk

2.1 I do not agree that it is appropriate to presume that a tax authority will examine all tax positions taken by an entity. Such a blanket presumption will be invalid under some common circumstances, and in those cases the presumption will result in overstatement of tax liabilities. In extreme cases, the presumption could require a perpetual accrual for tax liabilities that have no reasonable prospect of ever being paid.\(^7\)

2.2 Under current accounting principles, the risk that a tax authority will challenge a position taken on a tax return is generally treated as an unasserted claim under FAS 5 paragraphs 10 and 38.\(^8\) The entity must first determine whether the assertion of a claim (i.e., proposed disallowance) is probable. If it is not probable that the tax authority will propose to disallow the tax position, then there is no accrual or disclosure for the potential disallowance.

2.3 In practice, larger entities (those that are regularly audited) generally assume that all material tax positions presented in the returns will be examined by the tax authorities and

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\(^6\) Certain federal tax refunds are granted without substantive review. For example, I.R.C. § 6411 allows under certain circumstances a “quickie refund” of tax for prior years based on a carryback of a current year net operating loss. Similarly, I.R.C. § 6425 allows for a refund of estimated taxes for the current year under certain circumstances. Neither of these refund applications is subject to substantive review, and the receipt of such refunds is not generally subject to any material uncertainty. Therefore, an entity would be entitled to record the tax benefit of such refunds at the time the entity determines that it is eligible for the refund. Similarly, if a claim for refund is based on an item that is not expected to be disputed by the tax authority (e.g., correction of an error in the calculation of a tax deduction), it would generally be appropriate to treat the refund as an asset rather than a gain contingency. But a claim for refund that is likely to be disputed by the tax authority (such as a claim that is based on a theory that the tax authority is challenging in pending litigation) should be treated as a gain contingency.

\(^7\) For example, if the tax position is that the entity is not subject to a particular tax, it may not file a tax return. In such cases, there is generally no period of limitations for assessment of tax on the entity. Accordingly, even if it is highly unlikely as a practical matter that the tax authority would assert a tax deficiency, under the approach of the Proposed Interpretation, the entity would be required to accrue the tax and applicable interest and penalties literally forever.

\(^8\) The Board’s assertion in paragraph B14 of the exposure draft that FAS 5 paragraph 38 does not apply to income tax liabilities is incorrect. See paragraph 14.2 below and pages 14-15 of the attached paper.
challenged if there is a reasonable basis for a proposed disallowance. This assumption is increasingly appropriate in the face of significantly expanded reporting obligations under the Internal Revenue Code and comparable provisions of state and foreign tax laws. However, there are circumstances where it is reasonable to conclude that a material tax position will either not be examined by the tax authority, or will not be challenged even though there might be a reasonable legal or factual basis for doing so. For example, if a tax position is not examined during an audit and the audit is closed, it will generally be reasonable to assume that the tax position for that year will not thereafter be reviewed by the tax authority, even though a subsequent review is not legally foreclosed. The accounting rules should not presume that an examination will occur when the evidence establishes that the presumption is unfounded under the circumstances.

2.4 If the Board is concerned that paragraph 38 of FAS 5 provides an inappropriately high threshold for the recognition of unasserted claims related to income taxes, I would not be opposed to issuance of guidance clarifying how an entity should account for unasserted claims related to income taxes. A recommended approach is discussed at paragraph 14.5 below (presumption of detection for material items reported on a return).

3. Issue 3: Initial Recognition – Dual Threshold Approach

3.1 I do not agree with the proposed probable threshold for initial recognition of tax benefits. The proposed level of confidence for initial recognition of tax benefits is too restrictive and will systematically overstate tax expense and tax liabilities (or understate tax assets) in current periods, resulting in large gains in future periods that have no relationship to operations in those future periods. It is difficult to see how financial statements will be improved if tax benefits that are likely to be realized (e.g., more likely than not level of confidence) are recorded at zero simply because the entity cannot satisfy an arbitrarily restrictive standard for initial recognition.

3.2 For a more detailed critical analysis of the proposed probable threshold for initial recognition of tax benefits, please refer to the attached paper.9

3.3 If, despite my objections, the proposed probable threshold for initial recognition of tax benefits is adopted, then I agree that a lower threshold for derecognition of previously recognized tax benefits is appropriate. The dual threshold approach helps to minimize situations in which minor changes in subjective evaluations of highly technical tax issues can have material impacts on an entity’s financial statements. I note however that this dual threshold approach is inconsistent with the Board's stated goal of achieving greater comparability of financial statements,10 and is additional evidence that the Proposed

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9 The attached paper is a revised version of a paper I submitted to the Board last November. See http://72.3.243.42/ocl/1203-UTU/32125.pdf.

10 For example, assume one entity enters into a transaction at a time when it is probable that the tax benefits will be sustained, and the confidence level thereafter slips to merely more likely than not. Another entity entering into the identical transaction after that time will report zero tax benefit from the transaction whereas the first entity will (footnote continued)
Interpretation is flawed. I support the lower threshold for derecognition only because I so strongly disagree with the proposed probable threshold for initial recognition.

3.4 If the Board determines that the threshold for initial recognition should be reduced to a "more likely than not" or lower level of confidence, I do not believe that a different threshold for derecognition of the tax benefit is appropriate.  

3.5 See the discussion in paragraphs 23.3 and 24.2 below regarding the difficulty in determining the amount of tax benefit that should be "not recognized" under the asset recognition model adopted in the Proposed Interpretation.

3.6 See the comment in paragraph 5.2 below regarding the problems with "not recognizing" the tax benefit claimed in the tax return, as opposed to separately recording an asset impairment or liability for the potential disallowance of the benefit.

4. Issue 4: Subsequent Recognition

4.1 If, contrary to my recommendations, the Board adopts a probable (or other) threshold for initial recognition of tax benefits, I agree that a position that did not meet the initial recognition threshold in any prior period should be recognized in any subsequent period in which the entity concludes that the initial recognition threshold has been met.

5. Issue 5: Derecognition

5.1 I agree that a tax position should not be derecognized through a valuation allowance or valuation account.

5.2 I do not agree that the potential disallowance of a tax position should be accounted for as if the tax position were never claimed, as is apparently required under the "derecognition" approach of the Proposed Interpretation. Rather, I believe that the financial statements should reflect the tax positions as reported on the tax return, and should account for the potential disallowance of those positions on audit as a separate item (either as an asset impairment or as a liability). This accounting preserves the "audit trail" from the tax return to the financial statements and allows the entity and its auditor to separately track and reconcile tax return and tax exposure items, while still accomplishing on a net basis the objective of eliminating the tax benefit from the financial statements pending resolution of the underlying tax issues.

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Note that I do not support adoption of a lower standard for initial recognition of tax benefits. See discussion at paragraph 13 below.

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Report the best estimate of the expected settlement of the issue. Even a single taxpayer can experience this inconsistency if it has recurring transactions.

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6. Issue 6: Measurement

6.1 If, contrary to my recommendations, the Board adopts the probable standard for initial recognition of tax benefits, I agree that it is appropriate to then measure the tax benefit that should be recognized taking into account the expected resolution of the issue. However, I believe that the best estimate of probable benefit measurement standard in paragraph 11 of the exposure draft is not well defined and should be replaced with the reasonable estimate of loss standard found in FAS 5.

6.2 It is unclear under the best estimate of probable benefit measurement standard how an entity determines the amount of benefit that is “probable of being sustained on audit,” and whether the definition of probable in this context is the same as the definition of probable for purposes of the initial recognition standard in paragraph 6 of the exposure draft.

6.2.1 It is not always possible to determine the amount of benefit that is to be sustained on audit. For example, if a taxpayer takes the position that a transaction does not give rise to taxable income, it will be impossible to determine the benefit of the position without knowing the amount of taxable income the tax authority will assert should have been reported on the transaction. Likewise, it will be impossible to determine the benefit of a deduction without knowing the amount of deduction the tax authority will assert should be allowed.

6.2.2 The reference to the amount of benefit to be sustained is potentially confusing. A tax position is fundamentally a matter of calculating the proper liability owed to the tax authority, and except in the case of refund claims, the tax audit will determine the amount of liability owed by the entity, not the amount of benefit to be conferred on the taxpayer. For these reasons, the best estimate standard should be restated in terms of accruing the best estimate of the loss to be incurred to resolve any challenge to the position (consistent with the existing guidance for loss contingencies in FAS 5). And guidance may need to be provided as to how entities should determine the estimated liability when the position of the tax authority is not known.

6.2.3 Even when an entity knows the potential loss amount, it is unclear how the entity should determine the best estimate of the amount that is “probable of being sustained.” If the entity concludes that a tax position has a 75% chance of success in litigation, must the entity have a probable level of confidence (however that might be defined) that the tax authority will capitulate in order to avoid accruing a loss (i.e., a reduction in the reported tax benefit)? If the entity cannot satisfy this requirement, how does it determine the amount of loss (reduction in benefit) to be accrued? Should it determine the amount of loss (reduction in benefit) that has a probable likelihood of being accepted by the tax authority to resolve the issue? The Board’s deliberations on this issue suggest that the entity must consider the amount

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12 See discussion at paragraph 23.3 below.
that it would be willing to pay to settle the issue and avoid the expense, inconvenience, and uncertainty of litigation.13 Does the best estimate standard require that an entity determine the maximum amount that it would be willing to pay to avoid litigation?

6.2.4 If the "probable of being sustained" qualification is retained (which I oppose), the Board should indicate how probable is defined for this purpose. Presumably, probable is defined for this purpose in the same manner as it is defined for purposes of the initial recognition standard in paragraph 6, but this should be made clear.

6.3 Another potential problem with the best estimate measurement rule is the requirement to determine "the single most likely amount in a range of possible estimated amounts." In many cases it may be impossible to determine a single amount that is the best estimate. FAS 5 currently accounts for this circumstance by requiring an accrual at the low end of the range of loss, and disclosure of the range. See FIN 14.14 Similar guidance should be provided for the definition of best estimate in the Proposed Interpretation.

6.3.1 Under the approach most consistent with the proposed asset recognition model of the Proposed Interpretation (which I oppose), when no amount within the range is a better estimate than any other amount, the entity would apparently be required to record the benefit of the position at the minimum amount of the estimated range of potential benefit (i.e., accrue a loss for the maximum amount of potential tax liability in the range).

6.3.2 For example, assume the tax authority proposes a tax deficiency of 10 based on a challenge to the valuation of a tax deduction (the validity of the deduction is not in issue). No amount within the range of zero to 10 is a better estimate of the expected outcome than any other amount. The entity is unable to conclude with a probable level of confidence that the proposed deficiency of 10 will not be sustained. Under the approach of the Proposed Interpretation, the entity apparently would recognize a tax liability of 10. It would apparently also disclose the possibility of incurring a liability of less than 10 if disclosure is required to keep the financial statements from being misleading and provided care is exercised to avoid misleading implications as to the likelihood of realization.15

6.3.3 Assume that in the example in the previous paragraph the entity could establish with a probable level of confidence that the matter will be resolved for a tax

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13 Minutes of November 17, 2004 Board Meeting at p. 3, reprinted at http://72.3.243.42/board_meeting_minutes/11-17-04_UTP.pdf.


15 Paragraph 18 of the Proposed Interpretation does not require gain contingency disclosure for tax positions that are partially recognized in the financial statements. However, see the discussion in paragraphs 10.3.3 and 10.3.4 below questioning that exclusion.
liability of not more than 6, but is unable to conclude with a probable level of confidence that the matter will be resolved for a liability of less than 6. No amount within the range of zero to 6 is a better estimate than any other amount. In this case, it appears that the entity would recognize a tax liability of 6. It would disclose the possibility of incurring a liability of less than 6 as noted in the previous paragraph, but would not be required to disclose the possibility that it might incur a liability of more than 6 because the risk of loss in excess of 6 is implicitly not reasonably possible.16

6.4 An alternative approach, suggested by CON 7,17 would be to require the entity to record the benefit of the position based on the sum of the probability weighted amounts within the range of possible estimated amounts; i.e., based on the expected value of the possible estimated amounts. I do not favor this approach. A probability weighted analysis would be enormously complex and would demand and imply a level of precision that rarely, if ever, exists in the settlement of tax disputes. Requiring an accrual for the probability weighted amount of tax benefit could also have the undesirable effect of requiring the entity to reveal its settlement assessment to its adversary.

6.5 Overall, I believe that the best estimate of probable benefit standard in paragraph 11 should be replaced with the reasonable estimate of loss standard in FAS 5. In other words, once a tax position satisfies the probable standard for initial recognition, the “benefit” of that position should be recorded in accordance with the tax return. The position would then be evaluated to determine if loss should be accrued under the existing standards of FAS 5. Under those standards, if the entity believed it was probable that the matter would be challenged on audit and a loss would be confirmed, it would accrue the reasonable estimate of the loss either as an asset impairment or as a liability depending on the nature of the tax position.

6.6 The examples in Appendix A of the Proposed Interpretation all assume that it is possible to derive a single best estimate of the amount of tax benefit to be sustained. Whatever measurement standard is adopted, it would be helpful if one or more of the examples could give guidance on how to deal with situations in which the amount of “benefit” associated with a tax position is uncertain, and situations in which it is not possible to derive a single best estimate of the tax benefit that is expected to be sustained.

6.7 I agree that any subsequent changes in the amount of recognized tax benefit should be made using a best estimate methodology (modified as suggested above) and recognized in the period of the change. See paragraph 15 below.

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16 FAS 5 paragraph 9 requires the disclosure of exposure to loss in excess of the amount accrued where there is a reasonable possibility of such loss. Because the entity has concluded it is probable that it will sustain a liability of no more than 6, this implies that the exposure to additional loss (in excess of 6) is not reasonably possible (i.e., is remote).

6.8 The complexity and ambiguity involved in the application of the best estimate of probable benefit measurement standard is additional evidence that the asset recognition model proposed by the Board is inferior to the impairment approach of existing accounting principles.

7. **Issue 7: Classification**

7.1 I support the proposed clarification that the accrued liability for potential disallowance of tax positions should be classified as current or non-current based on the period in which the liability is expected to be paid.

8. **Issue 8: Change in Judgment**

8.1 I agree that any change in the recognition, derecognition, or measurement of a tax position taken in a prior *annual* period should be reported as a discrete item in the period in which the change in judgment occurs, and should not be allocated to interim periods as part of the effective tax rate. I do not agree that a position taken in a prior *interim* period should necessarily be accorded the same treatment. When the change in judgment occurs within the same annual accounting period as the initial determination, and if the initial determination is included in the determination of the effective tax rate for the annual period, a change in judgment occurring in the same annual period would also be taken into account through the effective tax rate for the current and remaining interim periods as provided in APB 28\(^{18}\) and FIN 18\(^{19}\).

8.2 One commentator on the Proposed Interpretation has argued that changes in judgment regarding the recognition, derecognition, or measurement of a tax position should not be recognized on a discrete basis, but should instead be spread over the current year’s interim periods under the integral method of APB 28\(^{20}\).

8.3 I agree that under existing guidance in APB 28, FIN 18, and FAS 109, a strong argument can be made that changes in judgment regarding uncertain tax positions should be accounted for through the effective rate. Paragraph 8 of FIN 18 provides that an enterprise’s effective tax rate may be computed by reference to the total tax (or benefit) provided for the year divided by ordinary income (i.e., income excluding extraordinary items). There is no explicit indication that current year tax expense (or benefit) related to changes in judgment regarding prior period tax positions should be excluded from this calculation.

8.4 Nevertheless, I believe that it is appropriate and preferable to account for changes in judgment regarding uncertain tax positions (as well as other changes in estimates regarding

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\(^{20}\) See comments of CSC dated September 1, 2005 (comment letter #7).
prior years’ tax expense) “outside the rate” as discrete items in the interim period in which the change in estimate occurs.

8.4.1 The objective of APB 28 and FIN 18 is to compute the tax expense “related to” ordinary income for the fiscal year. See FIN 18, paragraph 6. Including tax expense related to prior years in the calculation of the effective tax rate for the current year arguably overstates the true tax expense “related to” current year ordinary income.

8.4.2 The treatment of changes in judgments regarding valuation allowances is strong support for treating changes in judgment regarding uncertain tax positions as discrete items. The two types of estimates are logically similar in that both can involve current year tax expense (or benefit) related to items arising outside the current year.

8.4.3 Treating changes in judgment regarding uncertain tax positions as discrete items can help investors gain a better picture of an entity’s “structural effective tax rate” (the tax rate that the entity is likely to incur on continuing operations in future periods). While changes in estimates for uncertain tax positions are in some sense a normal and recurring part of continuing operations, the adjustments are too uncertain in timing and amount to provide meaningful information to investors and others trying to forecast the tax effects of future operations. It is therefore preferable that the effective tax rate be calculated by excluding material changes in estimates related to prior years’ taxes (with appropriate disclosure for interim period impacts of discrete items related to prior years’ taxes).

8.4.4 I believe that many entities currently report the results of audit settlements and other changes in estimates relating to prior years’ taxes as discrete items in the quarter in which they occur. While this practice is probably no more common than the integral approach, it at least provides some support for adopting the discrete method in the Proposed Interpretation.

9. Issue 9: Interest and Penalties

9.1 Recognition and Measurement

9.1.1 I do not agree with the requirement to recognize interest and penalties on unrecognized tax positions based on the tax benefit recognized in the financial statements as compared to the tax benefit claimed or to be claimed in the tax returns. Rather, I believe that interest and penalties should be recognized for any tax position that is not fully recognized in the financial statements based on the

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21 See, e.g., BMC Software Inc. Form 10Q for the quarterly period ended June 30, 2004 at p. 20 (six month results include $11.1 million provision recorded for potential income tax assessments and increase in valuation allowance; no mention of effect on three month results).
difference between the reasonably estimated outcome of the tax positions (including any expected settlement) as compared to the amounts claimed or to be claimed in the tax returns. Otherwise, in addition to significantly overstating the expected underlying tax liability, the Proposed Interpretation will also significantly overstate the expected interest and penalties, thereby compounding one problem with another.

9.1.2 If the threshold for recognition of tax positions is reduced to a penalty avoidance standard, it might be appropriate to require recognition and measurement based on the benefit recognized in the financial statements. However, I would still favor measuring interest and penalties based on the reasonably estimated outcome because I believe that the potential for overstatement of the underlying tax liability exists under any initial recognition approach.

9.2 Classification

9.2.1 I agree with the Board’s decision to make no changes in existing rules for classification of interest and penalties related to potential tax deficiencies.

9.2.2 I note, however, that it is incorrect to say that this issue was not considered when FAS 109 was issued. Paragraph 148 of FAS 109 notes that Board had proposed to require that interest and penalties be reported separate from income tax expense. That requirement was rejected based on objections from affected entities; objections that are still valid today. As a result of the objections, the Board gave entities the option whether to report interest and penalties as part of income tax expense.

9.2.3 I believe that the preferred treatment of interest and penalties related to income tax deficiencies is to include such amounts in income tax expense.

(a) Interest on tax deficiencies is unlike interest on other borrowings in that there is no consensual debtor-creditor relationship. Including interest on tax deficiencies in the calculation of pre-tax income as part of interest expense would not give investors a true picture of an entity’s borrowing costs.

(b) Although penalties imposed for errors or omissions in reporting and paying taxes are arguably properly reported as part of other penalties and fines taken into account in computing pre-tax income, determining whether a particular tax assessment should be classified as a penalty can be problematic. For example, certain amounts commonly thought of as penalties are referred to as “additions to the tax” or “additional amounts” under Chapter 68 of the Internal Revenue Code. One such “addition to tax” is the addition for underpayment of estimated

22 On page iii, the exposure draft states: “Because the 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.”
9.2.4 I recommend that the Board specifically confirm that, until other guidance is issued as part of the income tax convergence project or otherwise, in accordance with paragraph 148 of FAS 109 an entity may report interest and penalties with respect to income taxes payable as components of income tax expense and income taxes payable, or as components of pre-tax income and interest and other payables (i.e., no change in existing accounting principles). An entity's classification of interest and penalties related to income taxes should be disclosed in the footnotes to the financial statements (if material) and should be consistent from period to period and across all income taxes.

10. Issue 10: Disclosures

10.1 If the probable standard for initial recognition of tax benefits is retained, more detailed guidance is required with respect to required disclosures. Paragraph 18 of the Proposed Interpretation (relating to disclosures) is vague with respect to loss contingencies, and overbroad with respect to gain contingencies. I recommend that specific disclosure rules should be adopted for uncertain tax positions, with examples illustrating the operation of the rules, in lieu of trying to incorporate the FAS 5 disclosure rules by reference.

10.2 Loss Contingencies

10.2.1 The Proposed Interpretation provides that loss contingencies related to previously recognized tax positions shall be disclosed in accordance with paragraphs 9 through 12 of FAS 5. It is unclear how the FAS 5 disclosure rules are to be applied in the context of the proposed asset recognition model of the Proposed Interpretation.

10.2.2 Paragraph 9 of FAS 5 deals with disclosures related to amounts accrued as a loss contingency. As I understand the Proposed Interpretation, there could never be an accrual for a loss contingency related to income taxes under FAS 5. Accordingly, I don't believe that paragraph 9 of FAS 5 could ever be applicable under the approach of the Proposed Interpretation. The reference in Paragraph 18 of the

23 If an entity must have a probable level of confidence that a tax position will be sustained before any benefit can be recognized in the financial statements, and can only recognize the benefit that is probable of being sustained upon audit, by definition it could never be probable that the entity has incurred a loss in excess of the amount accrued (i.e., realize a tax benefit less than the amount recognized).
Proposed Interpretation to paragraph 9 of FAS 5 should either be eliminated or explained.

10.2.3 Paragraph 10 of FAS 5 requires disclosures for situations in which there is a *reasonable possibility* of a loss in excess of the loss accrued in the financial statements. Again, I’m not sure that this situation could ever exist under the approach of the Proposed Interpretation. If it is probable that a tax position will be sustained and the best estimate of the amount that is *probable* of being sustained upon audit is, say, 90% of the tax benefit, could there ever be a *reasonable possibility* that a tax benefit of less than 90% will be sustained? Doesn’t the probable standard embedded in the best estimate requirement (paragraph 11 of the exposure draft) imply that the chances of recognizing any benefit less than the best estimate is remote?\(^{24}\) This issue needs to be clarified in the Proposed Interpretation.

10.2.4 If in the circumstances described in the preceding paragraph the tax position has not been challenged by the relevant tax authority and such a challenge is not probable, FAS 5 paragraph 10 literally states disclosure is not required. Although I support non-disclosure in such circumstances (see comments elsewhere regarding audit detection risk), this seems clearly contrary to the intent of the Proposed Interpretation and should be clarified.

10.2.5 Paragraph 11 of FAS 5 deals with information that becomes available after the date of financial statements but before their issuance date, where such information indicates that a loss was incurred, or indicates that a there was a reasonable possibility that a loss was incurred, after the date of the financial statements. FAS 5 paragraph 11 states that it would not be proper to accrue a loss in the financial statements, but that it may be necessary to disclose the loss or possible loss to keep the financial statements from being misleading, and pro-forma information may be required under certain circumstances.\(^{25}\) It is not clear how this guidance applies to loss contingencies related to income taxes. Presumably it would apply if, for example, there is an adverse legal development after the financial statement date and before the issuance date indicating that a tax benefit recognized in the financial statements will have to be derecognized, or indicating that there was a reasonable possibility that a tax benefit less than the amount recognized in the financial statements would be realized. The application of FAS 5 paragraph 11 should be clarified.

10.2.6 Paragraph 12 of FAS 5 (relating to guarantees) does not appear to have any application to loss contingencies related to income taxes. The reference in

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\(^{24}\) See the example in paragraph 6.3.3 above.

\(^{25}\) I have not researched whether this guidance may have been superseded by more recent guidance regarding post-closing, pre-issuance events.
paragraph 18 of the Proposed Interpretation to FAS 5 paragraph 12 should either be eliminated or explained.  

10.2.7 See the discussion in paragraph 6.3 above for potential disclosure issues when it is not possible to arrive at a single best estimate of the tax benefit to be realized with respect to a recognized tax position.

10.3 Gain Contingencies

10.3.1 The Proposed Interpretation provides that an enterprise “shall disclose” all tax positions that have not been partially or fully recognized in the financial statements. This approach is overbroad in some respects, and potentially underinclusive in other respects.

10.3.2 If a tax position is more likely than not correct, but does not meet the probable recognition threshold such that zero tax benefit is reflected in the financial statements, it probably makes sense that the entity should disclose the potential future recognition of a benefit with respect to the position. But what about a tax position having only a substantial authority (or lower) level of confidence? Any disclosure would have to heavily discount the likelihood of realizing a benefit, making the disclosure somewhat pointless.

10.3.3 Also, it is unclear why the Board chose to exclude partially recognized tax benefits from the gain contingency disclosure requirement. If a tax position that has a probable level of confidence has not been fully recognized in the financial statements, there will often be a good chance that the entity will sustain the full benefit. Shouldn’t disclosure of the potential future benefit be required in those cases?

10.3.4 I recommend that the Proposed Interpretation be modified to provide that disclosure is required for both unrecognized and partially recognized tax positions, but only where there is at least a reasonable possibility that a tax benefit will be realized in excess of the tax benefit recognized in the financial statements, and only to the extent that the disclosure is required to keep the financial statements from being misleading. In all cases, care should be exercised to avoid misleading implications as to the likelihood of realization.

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26 It is possible that the reference to paragraph 12 of FAS 5 was intended to address an entity’s obligations under a tax indemnity agreement. On the other hand, it seems more likely that the treatment of an entity’s liabilities under a tax indemnity agreement is beyond the intended scope of the Proposed Interpretation.

27 Some will counter that disclosure of the potential additional benefit for a partially recognized tax benefit will unreasonably compromise the entity’s negotiating position with the tax authority. The disclosure will signal to the tax authority that the entity expects to compromise the position on audit. I believe that this concern can be addressed through a clearer statement of the disclosure requirements (as proposed in paragraph 10.3.4) that would allow a disclosure statement that alerts users of the financial statements to the potential future benefit without providing the tax authority with detailed settlement analysis information with respect to specific issues.
10.4 I also recommend that the examples in Appendix A be supplemented in each case to address the disclosure requirements under the facts of the examples. The disclosure issues can be at least as important and as complex as the asset or liability recognition issues, and those disclosure issues need more comprehensive consideration and explanation in the Proposed Interpretation.

11. **Issue 11: Effective Date and Transition**

11.1 If, contrary to my recommendations, the Proposed Interpretation is adopted without significant modification, I generally agree with the transition rules for the Proposed Interpretation. However, I do not agree that the probable threshold for initial recognition should be applied to tax positions reflected in the financial statements as of the effective date. Rather, I recommend that those positions be subject to derecognition only in accordance with paragraph 10 of the Proposed Interpretation (i.e., the position is derecognized only if it fails to meet the more likely than not level of confidence). Previously recognized positions would be adjusted as necessary to conform to the best estimate of probable benefit measurement rule of the Proposed Interpretation (if it is retained).x

11.2 The Proposed Interpretation should make clear that if as a result of the adoption of the Proposed Interpretation an entity is required to make any adjustments to its best estimate of the tax basis of assets, liabilities, and carryforwards acquired in a business combination, or to its best estimate of loss contingencies related to the acquired entity’s prior tax returns, those adjustments should be accounted for in accordance with EITF 93-728 (i.e., any reduction in recognized tax benefits would be recorded as an increase to goodwill).

11.3 I believe that the effective date for the Proposed Interpretation should be delayed. I expect that the Proposed Interpretation will create significant implementation issues for entities having previously recorded tax benefits that may be subject to derecognition under the Proposed Interpretation. I recommend that the effective date be not earlier than the end of two full calendar quarters following the date final guidance is issued. Affected entities might persuasively argue that a longer implementation period is required, or that implementation should not be required as of calendar year end. In this regard, in view of the significant problems associated with the guidance in the exposure draft, I believe that final guidance should not be adopted until a revised exposure draft is issued and an additional opportunity for comments is granted.

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Additional Comments and Recommendations

12. Retain and Affirm Existing Accounting Principles

12.1 I believe that existing accounting principles provide the most appropriate accounting for uncertain tax positions. They are straightforward and properly balance the potential for understatement or overstatement of tax items in the financial statements. Nothing in the exposure draft or the Board's deliberations on the matter contains any convincing evidence that the existing rules are defective and need to be abandoned.\(^2\) In contrast, as discussed elsewhere in this letter and in the attached paper, the Proposed Interpretation is unnecessarily complex and leads to inappropriate accounting results in many circumstances. It does not represent an improvement to existing accounting principles. For this reason, I oppose adoption of the Proposed Interpretation and favor retention of existing accounting principles.

12.2 Due to the confusion regarding the application of existing accounting principles to uncertain tax positions that is evident from the Board's deliberations of the Proposed Interpretation and that could result from the issuance of the exposure draft, I support issuance of an interpretation of FAS 109 and FAS 5 that affirms the following general principles under existing guidance:

12.2.1 Tax assets and liabilities must initially be recorded in accordance with the tax positions taken or to be taken by the entity.

12.2.2 FAS 109 requires a valuation allowance for any resulting deferred tax asset if it is "more likely than not" that the asset will not be "realized." Whether a valuation allowance is required is determined by evaluating whether there will be sufficient taxable income of the appropriate character, or other applicable tax attributes, to realize the deferred tax assets in future periods. The risk that the tax position giving rise to the deferred tax asset will be disallowed is generally not considered in evaluating whether the deferred tax benefits flowing from that tax position will be "realized."

12.2.3 FAS 5 requires a charge to income (and a related impairment of an asset or accrual of a liability) with respect to the potential disallowance of a tax position if:

(1) it is probable that the tax position will be challenged on audit;

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\(^2\) The contention that the rules are unclear and have been applied inconsistently is debatable, but even if true, does not justify abandonment of the rules. The rules can be clarified (as proposed in this letter) and in so doing the application of them should become more consistent.
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(2) it is probable that the future resolution of the challenge will confirm that a loss has been incurred; and
(3) the amount of the loss can be reasonably estimated.

12.2.4 FAS 5 requires that a claim for refund or credit be accounted for as a gain contingency if the realization of the refund or credit is subject to material uncertainty.

12.3 An analysis of the technical foundation for the foregoing interpretation of existing GAAP is set forth in the attached paper.

12.4 The proposed guidance should declare Q&A 17 of the FAS 109 Implementation Guide obsolete to make clear that the accounting for income tax assets and liabilities acquired in a business acquisition is consistent with the accounting for such items generally. See FAS 141, paragraphs 35 and 46. While the “best estimate” requirement in Q&A 17 is arguably consistent with the principles articulated in paragraph 12.2 above, the difference in terminology could be confusing.

13. Recognition Threshold

13.1 I anticipate that some comment letters objecting to the proposed probable standard for initial recognition of tax benefits will recommend as an alternative a “more likely than not” standard, a “penalty avoidance” standard such as the standard discussed in paragraph B47 of the Proposed Interpretation, or some other standard for initial recognition of tax benefits in the financial statements.

13.2 I do not support adoption of any initial recognition threshold. Such an approach is at odds with the self-assessment nature of income taxes, is inconsistent with the rules applicable to other types of taxes and other similar self-assessment items, and could lead to material differences in financial statement effects based on immaterial differences in judgments on technical merits or other considerations. I believe that the approach of current rules – which recognize tax benefits in accordance with the reasonable estimate of the taxes payable – is preferable.

30 The “loss” may be in the form of a tax deficiency for underpayment of current or prior taxes payable, or it may be an impairment of a deferred tax asset or increase in a deferred tax liability based on the potential disallowance of tax positions to be claimed in the future.


32 In addition to the general deficiencies inherent in any initial recognition standard, the penalty avoidance standard suffers from some unique problems. While the standards for avoiding penalties under U.S. federal income tax rules are fairly well defined, that is not true under all income tax laws. The penalty avoidance requirements in some jurisdictions may be unclear, and some jurisdictions may impose penalties on any underpayment of tax without regard to the technical merits of the taxpayer’s position or the taxpayer’s exercise of reasonable care and (footnote continued)
13.3 If the Board believes that existing accounting guidance may lead entities to recognize the tax benefits of positions that have an insufficiently high level of confidence of being sustained on audit, the Board could adopt a rule that, in the case of a tax position that has been challenged or is likely to be challenged, unless an entity can establish that it is more likely than not that the tax position will be sustained if the matter were litigated to a final decision, the entity must presume that the tax position will be disallowed under the theory or theories most likely to be asserted by the tax authority, and recognize a loss contingency accrual for the resulting loss. In effect, the entity in those circumstances must presume under FAS 5 that it is probable that a loss has been incurred and that the reasonably estimated amount of the loss is the amount of loss expected to be asserted by the tax authority. This presumption could be overcome if, based on all available evidence, (a) the entity can establish that it is probable (as defined in FAS 5) that the matter will be resolved (e.g., through settlement) for some amount less than the loss expected to be asserted by the tax authority, and (b) the entity can reasonably estimate the loss that will be incurred to resolve the matter. In such circumstances, the entity should accrue the reasonably estimated loss amount.

13.4 I believe the rebuttable presumption proposed in the preceding paragraph is more faithful to existing accounting rules than any initial recognition standard. The presumption follows the liability or impairment approach of FAS 5, whereas an initial recognition approach creates an entirely new accounting concept applicable only to income taxes. The more likely than not standard is an easier standard to apply than a probable standard, it is consistent with the standard for valuation allowances, and it appropriately targets only those positions that an entity is likely to lose if the issue were litigated. A key benefit of the proposed rebuttable presumption as compared to any initial recognition standard is that the rebuttable presumption allows for management judgment based on particular facts and circumstances in those cases where an inflexible initial recognition standard might produce inappropriate results.

13.5 Note that simply because a tax position satisfies the more likely than not threshold would not necessarily mean that the tax benefit of the position should be recognized in whole or in part. The tax position must still be evaluated under the principles of FAS 5, and a loss contingency accrual recorded if it is probable that the position will be challenged on audit, if it is probable that the resolution of the challenge will confirm that a loss has been incurred, and if the amount of loss can be reasonably estimated.

good faith (i.e., strict liability). In those cases, it is unclear how one would demonstrate that a tax position has met “the threshold under applicable tax law to avoid statutory penalties for underpayment of taxes ... .”

33 See discussion in paragraph 14 below.

34 Note that there may be situations where the amount of potential loss cannot be reasonably estimated. See paragraph 6.2.1 above. In those situations, an accrual would not be required, but the nature of the loss contingency would be required to be disclosed together with a statement regarding the inability to reasonably estimate the amount of loss. Also, the entity would not have to take into account any potential theories for assessment that do not have at least a reasonably possibility of being sustained.
14. Audit Detection Risk

14.1 I recommend that the Board confirm that in applying FAS 5, an entity need not accrue a liability for the potential disallowance of a tax position (regardless of the level of confidence that the position would be sustained if challenged) unless it is first probable that the position will be challenged by the relevant tax authority. See FAS 5 paragraph 38. This position reflects the view that loss contingencies related to income taxes are subject to the same rules as are applicable to loss contingencies related to other potential disputes, and the probability that a counterparty will assert a claim must in all cases be assessed as described in FAS 5 paragraph 38.

14.2 In this regard, I disagree with the Board’s statement that FAS 5 paragraph 38 does not apply to income tax contingencies simply because a tax return is required to be filed. Many other types of loss contingencies involve potential liabilities that are subject to extensive reporting (e.g., liabilities for taxes other than income taxes, environmental liabilities, potential claims under government contracts, potential claims for underpayment of pension benefits, etc.). The fact that a tax return is filed is not a valid basis for treating income tax contingencies different from other loss contingencies.

14.3 Based on the Board’s discussions of the Proposed Interpretation, it appears that the Board and the staff are concerned that FAS 5 paragraph 38 could lead to overstatements of tax benefits based on unreasonable assumptions regarding audit detection risk. There appears to be a concern that entities will use the “audit lottery” as cover for inflating financial statement earnings based on questionable tax shelter transactions.

14.4 I do not believe that the Board has established that there is sufficiently widespread abuse of audit detection risk to justify the proposed unrealistic presumption, particularly in light of recent tax law changes expanding disclosure and reporting requirements and related penalties. But more important, I do not believe that it is appropriate for the Board to use the accounting rules to address perceived deficiencies in the tax authorities’ disclosure requirements and examination resources. The objective of the accounting rules is to faithfully report the facts regarding a company’s financial position, not to influence behavior or protect the tax system from abuse. If the facts are that a tax position will be sustained for whatever reason — be it the merits of the position or the fact that the position will not be challenged — the financial statements should reflect the effects of that position. By ignoring the position based on fictitious assumption that it will be examined, the integrity of the financial statements is compromised. Liabilities will be recorded that have no reasonable prospect of ever being paid.

14.5 If the Board feels that guidance is required to avoid abuse, it should consider guidance under FAS 5 providing that, in applying FAS 5 paragraphs 10 and 38 to loss contingencies related to uncertain tax positions, if the tax position relates to the determination of an income tax liability reported on a tax return or information return filed with the relevant tax authority, or if the tax position is otherwise required to be disclosed to the relevant tax authority, then the entity must presume that it is probable that the position will be examined by the relevant tax authority, and must presume that the position will be challenged if there
is a reasonable basis for such a challenge. The presumption could be overcome if, based on all available evidence, the entity can establish that the risk of such a challenge is remote. For example, if a tax return containing an uncertain tax position has been examined and the tax position was not challenged, and if the risk that the relevant tax issue will be reexamined in the future is remote, then as of the period in which the risk of challenge becomes remote the entity need not presume that it is probable that the position will be challenged.

14.6 Note that with respect to those tax positions that are not reflected on a tax return or information return or otherwise disclosed to the tax authority (e.g., a position that a return is not required because the entity is not subject to tax in a particular jurisdiction), the presumption does not apply and those matters are evaluated under the general standard (i.e., whether it is probable that a claim will be asserted).

15. Subsequent Adjustments and Interim Period Reporting

15.1 FAS 5 does not specifically address subsequent adjustments to a loss contingency accrual. Accordingly, the Board should clarify that once the initial determination is made with respect to the proper loss contingency accrual with respect to an uncertain tax position (including a determination that no loss contingency accrual is required), the accrual should be adjusted thereafter if there is a change in circumstances that causes a material change in management’s judgment regarding:

(a) whether it is probable that the tax position will be challenged,

(b) whether it is probable that resolution of the challenge will confirm that a loss has been incurred, or

(c) the reasonable estimate of the amount of loss.

15.2 Any change in judgment that results in a subsequent adjustment to a loss contingency accrual should generally be accounted for as a discrete item in the interim period in which the change in judgment occurs and should not be allocated to other interim periods through the effective tax rate. However, if an initial determination with respect to a loss contingency accrual is taken into account in the determination of the effective tax rate for a year and is thereafter adjusted in an interim period within the same annual period, the effective tax rate for the year would be recalculated in accordance with APB 28 and FIN 18.

16. Classification

16.1 Liabilities or asset impairments arising from a loss contingency accrual related to income taxes should be classified in accordance with principles stated in paragraphs 14 and 15 of the Proposed Interpretation.
17. Interest and Penalties

17.1 As noted in paragraph 9.2 above, I recommend that the Board confirm that, until other guidance is issued as part of the income tax convergence project or otherwise, in accordance with paragraph 148 of FAS 109 an entity may report interest and penalties with respect to any income tax loss contingency as components of income tax expense and income taxes payable, or as components of pre-tax income and interest and other payables (i.e., no change in existing accounting principles). An entity's classification of interest and penalties related to income taxes should be disclosed in the footnotes to the financial statements (if material) and should be consistent from period to period and across all income taxes.

18. Disclosure

18.1 If existing rules for accounting for uncertain tax positions are retained, I do not believe that any changes are required to existing disclosure rules for loss contingencies.

18.2 It is unclear under current rules whether disclosure is required with respect to the possibility that a tax position will be resolved in a manner that produces a loss amount less than the loss contingency accrual. I believe that general rules regarding disclosure are adequate to compel disclosure in appropriate circumstances. However, if the Board feels that explicit guidance is required, it could require disclosure in accordance with the proposed standards in paragraph 10.3.4 above (i.e., adequate disclosure is required where there is at least a reasonable possibility of realizing the additional benefit, the disclosure is necessary to keep the financial statements from being misleading, and care is exercised to avoid misleading implications as to the likelihood of realization).

19. Valuation Allowance and Tax Planning Strategies

19.1 I do not agree with the implication in paragraphs A24 through A26 of the exposure draft that a tax planning strategy should not be taken into consideration under paragraph 22 of FAS 109 in determining the amount of a valuation allowance unless it is first established that the tax benefits of the tax planning strategy meet the threshold for initial recognition in the financial statements. While this might be an appropriate requirement if an asset recognition model is adopted, it is not consistent with existing accounting principles.

19.2 If the Board adopts my recommendation to retain and affirm existing accounting principles related to uncertain tax positions, I recommend that the Board also clarify how tax planning strategies are taken into account in cases where there is a realistic possibility that the tax planning strategy will not be sustained if challenged by the tax authority. That guidance should provide:

19.2.1 Under paragraph 22 of FAS 109, a tax planning strategy will be taken into consideration in determining the amount of any valuation allowance only if management can demonstrate that the strategy is prudent and feasible, that
management intends to implement the strategy to preserve the deferred tax asset, and that the strategy will result in realization of the tax asset (on an as filed basis).

19.2.2 The likelihood that a tax planning strategy will be challenged on audit should be taken into account in considering whether management would implement the strategy. If management has an established practice of not taking positions that lack a more likely than not level of confidence, that would generally be evidence that management does not intend to implement a tax planning strategy that does not have a more likely than not level of confidence.

19.2.3 If a tax planning strategy is taken into account under paragraph 22 of FAS 109, the likelihood that the tax planning strategy would be challenged on audit must be taken into account in considering whether a loss contingency accrual or disclosures are required under FAS 5 with respect to the tax effects of the tax planning strategy.

20. Effective Date and Transition

20.1 Because the guidance I have proposed does not reflect a change in accounting principles or a material departure from existing practice, it should be possible to have the guidance take effect upon adoption. However, the Board should allow a reasonable implementation period subsequent to release of the final guidance so that entities can reassess their accounting for uncertain tax positions under the new guidance.

20.2 Because the guidance I have proposed would not be a change in accounting principles, any adjustments to an entity's accounting for uncertain tax positions would be recorded as a current period adjustment (i.e., a change in an accounting estimate). No restatement of prior periods would be required.

20.3 Any required adjustments to loss contingency accruals for acquired entities should be accounted for in accordance with EITF 93-7 as described in paragraph 11.2 above.

Comparison of Effects under Existing Principles and the Proposed Interpretation

I believe that accounting results with respect to the examples in Appendix A of the exposure draft are generally the same under the approach of the Proposed Interpretation as under the approach of existing accounting principles. However, existing accounting principles reach those results with significantly less complication and confusion. Moreover, under some common variations of the fact patterns in the examples, existing accounting principles would lead to results that are far superior to the results that would be achieved under the Proposed Interpretation.

21. Example of R&E Credit Dispute

21.1 The accounting result under the circumstances discussed in paragraphs A2 through A11 of the exposure draft would generally be the same under either existing accounting principles
or the Proposed Interpretation. Under existing accounting principles, management could reasonably conclude that:

- it is probable that the reported R&E credit will be challenged on audit;

- it is probable that the resolution of the challenge will confirm that a loss has been incurred; and

- the amount of the loss can be reasonably estimated at $5.5 million (generally on the basis of the reasoning in paragraph A9, and assuming that no benefit will be sustained with respect to the projects having only 10% settlement value).

21.2 Although the result is the same as under the Proposed Interpretation, existing accounting principles reach this result through a much more straightforward analysis of the expected outcome of the potential challenge. There is no need for a determination of the proper “unit of account,” and no need to engage in a complicated multi-step analysis of the technical merits of the position and the estimated settlement results. Management simply determines the reasonable estimate of the amount of loss incurred with respect to the position.

21.3 Moreover, it is arguable that existing accounting principles would allow management the flexibility to arrive at a more appropriate accounting result than under the Proposed Interpretation. If management was truly confident that the two questionable projects could be settled for 10% of the amount of benefit claimed, and could produce credible evidence of that determination, under existing accounting principles the entity could record a loss contingency accrual of only $5 million. In this respect, existing accounting principles facilitate a more accurate measurement of tax liabilities than under the Proposed Interpretation. The Proposed Interpretation would force an entity to recognize a liability of $5.5 million even when management’s best estimate of the liability is only $5 million.

22. Example of Charitable Contribution Deduction Dispute

22.1 The accounting result under the circumstances discussed in paragraphs A12 through A15 of the exposure draft would generally be the same under either existing accounting principles or the Proposed Interpretation. Under existing accounting principles, management could reasonably conclude that:

- it is probable that the reported charitable contribution deduction will be challenged on audit;

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35 The “unit of account” is a potential source of considerable confusion. The concept is undefined in the Proposed Interpretation. And there is no indication in the R&E credit example why each research project constituted a separate unit of account or exactly how the entity went about determining the proper unit of account. It is unclear why, for example, separate categories of research expenditures were not considered the proper unit of account. The unit of account concept could lead to significant interpretational disputes that will not contribute to better financial accounting, and which are avoided under existing rules.
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• it is probable that the resolution of the challenge will confirm that a loss has been incurred; and

• the amount of the loss can be reasonably estimated at the tax effect of the $400,000 portion of the deduction that is likely to be disallowed to settle the audit.

22.2 Although the result is the same as under the Proposed Interpretation, existing accounting principles reach this result without artificial distinctions between the validity versus value of a tax position.

22.3 The Proposed Interpretation’s reliance on the distinction between the validity versus value of a tax position is another significant problem with the Proposed Interpretation.

22.3.1 The distinction between validity and value will not always be clear. Evidence of this ambiguity is presented in the timing differences example in paragraphs A22 - A23 of the exposure draft. The example implicitly concludes that the question whether the item is deductible or amortizable is a question of validity and not a question of value. But is that clear? Isn’t it arguable that the deduction is clearly valid, and the only question is when the deduction should be allowed (immediately rather than over 15 years)? That seems to me like a question of valuation (present value versus future value), not a question of validity.

22.3.2 As another example, assume a tax authority claims that an entity was not entitled to include certain tax items in the calculation of the base amount for a particular tax credit. Does the exclusion of those tax items from the base raise a question as to the validity of the credit on those specific tax items, or is the dispute simply a question of the value of the credit that is allowable overall? Is the entity required to first determine whether the additional tax items are a separate “unit of account” before analyzing the validity versus value issue? If so, how is that determination to be made?

22.3.3 In other cases both validity and value may be in dispute. The tax authority might argue that the deduction was not valid, and, in the alternative, even if the deduction is valid, it is overstated. It is not clear how this situation would be handled under the Proposed Interpretation.

22.3.4 The proper application of the Proposed Interpretation in these relatively common situations is highly uncertain, underscoring the inferiority of the Proposed Interpretation relative to existing accounting principles.

23. Example of Transfer Pricing Dispute

23.1 The accounting result under the circumstances discussed in paragraphs A16 through A21 of the exposure draft would generally be the same under either existing accounting principles or the Proposed Interpretation. Under existing accounting principles, management could reasonably conclude that:
• it is probable that the reported transfer prices will be challenged on audit, but

• it is not probable that the resolution of the challenge will confirm that a loss has been incurred, and therefore

• no loss contingency accrual is appropriate.

23.2 This is the same result as under the Proposed Interpretation, but the result is more easily explained under the approach of existing accounting principles.

23.3 In more complicated fact patterns common in actual practice, the approach of the Proposed Interpretation can be more problematic. If the issue is whether a transfer of property between related parties gives rise to taxable income, the taxpayer may not be able to conclude with a probable level of confidence that the income exclusion will be sustained. In such a case, how does the taxpayer “not recognize” the tax benefit of the income exclusion? Must the entity estimate the maximum possible value that the IRS could reasonably assign to the transaction and accrue a liability based on that amount, or can some lesser amount be accrued, and if so, how should it be determined? These issues are avoided under the current rules, which simply require that the entity reasonably estimate the loss that is expected to be incurred to resolve the potential dispute.36

24. Example of Timing Item Dispute

24.1 The example discussed in paragraphs A22 through A23 of the exposure draft is one situation where the accounting results under the Proposed Interpretation would likely not be the same as under existing accounting principles. Under existing accounting principles, management could reasonably conclude that:

• it is probable that the reported deduction will be challenged on audit; and

• it is probable that the resolution of the challenge will confirm that a loss has been incurred.

However, it would be unusual for management conclude that the reasonably estimated amount of loss is the entire tax benefit of the immediate deduction. It is more likely that management would conclude that the matter will be settled, and would accrue the reasonable estimate of the expected settlement amount.

24.2 The example in the Proposed Interpretation assumes that 15-year amortization is the treatment that is probable of being sustained. It is not clear how this determination was made. What if there was a 65% probability of sustaining an immediate deduction, and only

36 If the amount of loss is a range and no one amount within the range is a better estimate than any other amount, under existing rules the entity would accrue the minimum amount of loss within the range and disclose the exposure to an additional loss.
a 35% probability that 15-year amortization would be sustained? What if 15-year amortization had a greater than 50% but less than 70% probability of being sustained? What if there were multiple other potential outcomes (e.g., shorter or longer amortization periods, or lesser or greater amounts that might be reclassified from deductible to amortizable), such any one potential outcome had no more than a 25% chance of being sustained? In those circumstances, is it accurate to say that 15-year amortization is the treatment that is “probable” of being sustained? How does the entity “not recognize” the reported tax benefit in circumstances where the probable outcome is not known?

24.3 Existing accounting principles avoid these issues by allowing management the flexibility to exercise its judgment in reasonably estimating the loss that will be confirmed when a tax controversy is resolved. Multiple possible outcomes with varying and uncertain levels of relative likelihood are all accounted for as part of the evaluation of the reasonable estimate of the expected loss or the range of potential loss. This process of evaluation is complicated and involves subjective judgments, but it is easily understood and applied.

25. Implications of Comparative Analysis

The foregoing comparative analysis demonstrates that, in the context of the fairly simple fact patterns presented in the examples, the Proposed Interpretation generally does not produce accounting results that are different from the results under current accounting principles. This alone causes one to question why the Board is proposing to depart so significantly from existing accounting principles. Moreover, in at least one of the examples presented in the exposure draft, and in more complicated fact patterns common in actual practice, the results are not necessarily the same. The analysis of these fact patterns makes clear that the approach of the Proposed Interpretation is riddled with potential problems and will likely produce accounting results that are inferior to the results obtained under existing accounting principles.

Conclusion

As discussed in this letter and in the attached paper, the Proposed Interpretation suffers from many infirmities and does not represent an improvement to existing accounting principles. I recommend therefore that the Proposed Interpretation be withdrawn in its entirety so that the Board and its staff can more carefully consider the need for the issuance of a proposed interpretation and the proper approach to accounting for uncertain tax positions. The notice of withdrawal should make clear that the Board does not intend to adopt the Proposed Interpretation in its current form, and that any future guidance on accounting for uncertain tax positions will not be effective prior to the issuance of a new exposure draft, completion of an appropriate comment and review period, and allowance of a sufficient implementation period following adoption of any final guidance.
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I would welcome the opportunity to meet with the Board or the staff to provide additional information or to discuss the comments set forth in this letter.

Sincerely,

James R. Boomer
FINANCIAL REPORTING FOR UNCERTAIN TAX POSITIONS

BY

JAMES R. BROWNE*
DALLAS, TEXAS

Introduction

On July 14, 2005, after more than a year of deliberations, the Financial Accounting Standards Board ("FASB") issued an exposure draft of a proposed interpretation of FASB Statement No. 109, Accounting for Income Taxes ("FAS 109") addressing the accounting for uncertain tax positions (the "Proposed Interpretation").

The Proposed Interpretation provides, among other things, that it must be "probable" that a tax position will be sustained before the tax benefit of the position can be recognized in the financial statements. For this purpose the term "probable" is meant to have the same meaning as used in FASB Statement No. 5, Accounting for Contingencies ("FAS 5"), which means a level of confidence less than virtually certain but higher than more likely than not. In applying this new standard, audit detection risk must not be considered.

The FASB's action follows the cue of the SEC Chief Accountant's office. In a December 2003 speech, Randolph Green, a staff member of the SEC Chief Accountant's office, expressed his view that a company should not record in its financial statements the tax benefit of positions claimed on the company's tax returns unless it is at least "probable" that those tax benefits will be sustained on audit.

Mr. Green did not cite any authority for his position, and none has been offered by the FASB.

The standard expressed by Mr. Green and the FASB looks to whether it is probable that a reported tax position will be sustained, and thereby adopts an "affirmative judgment" standard. In contrast, existing accounting principles look to whether it is probable that a reported tax position will be disallowed, which is an "impairment" standard. These are obviously directly opposite approaches.

It is the contention of this article that the affirmative judgment standard proposed by the FASB is unworkable and will lead to material misstatements in financial statements. The existing impairment standard reasonably balances competing policy issues and should be retained.

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2 The Proposed Interpretation addresses not only the issue of the proper standard for initial recognition of tax benefits, but also several collateral issues involving subsequent recognition and derecognition, measurement, classification, changes in judgment, interest and penalties, and disclosure. These collateral issues are beyond the scope of this article.

3 See FASB Special Report, Application of FASB Statements 5 and 114 to a Loan Portfolio (1993), Q. 8.

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In my view, the recognition of the gross amount of a contingent tax asset... should be evaluated for initial recognition like any other asset. That is, the company and auditor should conclude that it is at least probable the deduction will be sustained and the temporary difference will truly exist before that asset is recognized in the company's financial statements. Statement 109 is then used to evaluate any deferred tax asset for impairment.

For example, assume a company enters into a tax-advantaged transaction that results in a $100 permanent difference. Further, the tax opinion received by the company states that the deduction is probable of being sustained. In that situation, it is likely that the company would conclude that the $100 deduction is probable and a reduction in the current payable would be appropriate. In contrast, if the tax opinion received by the company indicated that it was something less than probable that the benefit would be sustained, absent other evidence, I do not understand why it would be appropriate to recognize the benefit as a reduction in income tax expense.

5 I have borrowed the "impairment" and "affirmative judgment" terminology from FAS 109, ¶ 95. Although the terms are used in that context in a slightly different manner, they provide good descriptive references for the alternative positions discussed in this article.
Commonly Expressed Levels of Confidence for Tax Positions

Before turning to a discussion of applicable accounting principles, it is helpful to have a general understanding of the commonly expressed levels of confidence with respect to the question whether a particular tax position will be sustained if challenged by the Internal Revenue Service ("IRS").

In general, a taxpayer will not take a position on a tax return unless there is at least a "reasonable basis" for the position. That is the minimum level of support necessary to avoid a penalty for negligence. In other cases, penalty avoidance may require that there be at least "substantial authority" for the return position, or that the return position have at least a "realistic possibility" of being sustained on the merits. The latter standard implies at least a one in three chance of being sustained, and substantial authority is generally interpreted to require approximately the same level of confidence.

In cases involving tax shelters (broadly defined as any arrangement having a significant purpose of reducing taxes), the taxpayer will want to conclude that the return position is at least "more likely than not" the proper tax treatment, reflecting a more than 50% likelihood that the position will be sustained on the merits. This is the highest level of confidence required under the Code. In fact, the tax law does not explicitly recognize any expression of confidence higher than more likely than not, and opinions that do not use these "magic words" run the risk of failing to satisfy the penalty avoidance standards, even when the intent is to express an even higher level of confidence.

Even though more likely than not is the maximum level of confidence required or recognized under the tax law, it is relatively common practice for tax counsel to opine that a position "should" be sustained when the likelihood of the position being sustained is greater than merely more likely than not. Practice varies with respect to "should" level opinions, but it is generally understood that a "should" level opinion implies a likelihood of success of greater than 70%.

The highest level of confidence is reached when counsel concludes that there is no reasonable basis for the IRS to challenge the reported tax treatment. If the IRS has issued clear guidelines for a given tax treatment and the taxpayer has clearly complied with those guidelines, in common practice tax counsel will conclude that the position "will" be sustained. This level of opinion essentially implies 100% certainty that the reported tax position will be sustained.

In summary, "more likely than not" is the highest level of confidence required or recognized for federal income tax purposes. Although higher levels of confidence are often expressed in tax opinions, they have no recognized effect under the tax law.

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"It is assumed for purposes of this article that other tax authorities generally adopt similar standards as those applicable under the Internal Revenue Code, if they have any such standards at all. Accordingly, the discussion in text addresses only the standards under the Internal Revenue Code.

7 Treas. Reg. § 1.6662-3(b)(1). The reasonable basis standard also applies to avoidance of the substantial understatement penalty in non-tax shelter cases where the issue is adequately disclosed. I.R.C. § 6662(d)(2)(B)(ii).

8 I.R.C. § 6662(d)(2)(B)(i) (applicable in the case of non-tax shelter items that are not adequately disclosed). "The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in § 1.6662-3(b)(1). ... There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." Treas. Reg. § 1.6662-4(d).

9 A taxpayer can avoid the I.R.C. § 6662(b)(1) negligence penalty with respect to a position that is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking), provided the position has a realistic possibility of being sustained on its merits. The realistic possibility standard also applies to tax return preparers under I.R.C. § 6694, and is the standard applicable to return positions under ABA Formal Opinion 85-352.

10 Treas. Reg. § 1.6694-2(b)(2).


12 A taxpayer can avoid the I.R.C. § 6662(b)(2) substantial underpayment penalty for the tax treatment of a tax shelter item only if (1) there is or was substantial authority for such treatment, and (2) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. I.R.C. § 6662(d)(2)(C) (applicable to individuals), and Treas. Reg. § 1.6664-4(e) (applicable to corporations). More likely than not means a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS. Treas. Reg. § 1.6662-4(g)(4).

13 Treas. Reg. § 1.6664-4(d)(2)(i)(B)(2) (reliance on opinion of counsel is warranted only if the opinion "unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.").

14 Although "should" is the term commonly used among tax professionals, the term "should" is a poor choice because it could imply that a result is desirable or equitable but not legally justified.

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Note that the opinions discussed above are generally issued for purpose of defending against challenges by the taxing authorities, and not for the purpose of supporting the financial reporting of the tax positions. Although a should level opinion issued for tax reporting purposes is generally regarded as being sufficient to conclude for financial reporting purposes that it is "probable" under FAS 5 that the return position will be sustained on the merits,16 that is not necessarily a valid assumption. See discussion below.

Existing GAAP

This section reviews existing rules relevant to accounting for uncertain tax positions in order to provide context for the discussion of the Proposed Interpretation.

FAS 5 — Accounting for Contingencies

Under existing GAAP, an estimated loss from a loss contingency must be accrued in the financial statements if the following conditions are met:

- Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

- The amount of loss can be reasonably estimated.17

In the case of an unasserted claim or assessment, a judgment must first be made whether assertion of a claim is probable. If the judgment is that assertion is not probable, then no accrual or disclosure is required under FAS 5. If the judgment is that assertion is probable, then accrual and disclosure is handled in the same manner as an asserted claim.18

Disclosure is required with respect to any loss contingency where it is probable that a material claim will be asserted, and it is reasonably possible that there will be an unfavorable outcome with respect to the claim. If it is not probable that the claim will be asserted, or if the possible claim is not material, or if the chances of an unfavorable outcome are remote, then no disclosure is required.19

For purposes of FAS 5, the following definitions are adopted.

Probable. The future event or events are likely to occur. In this context, the term "probable" means a level of likelihood that is less than virtually certain but higher than more likely than not.20

Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

Remote. The chance of the future event or events occurring is slight.

Based on the foregoing, FAS 5 imposes a three part test for impairment of an asset or accrual of a liability with respect to a loss contingency involving the potential disallowance of a tax return position:

1. it must be probable that the reported tax treatment will be challenged on audit;
2. it must be probable that the future resolution of the challenge will confirm that a loss has been incurred; and
3. the amount of the loss must be reasonably estimable.

Only if all of these three conditions are present is it appropriate to record an asset impairment or liability under FAS 5. Even where an asset impairment or liability is not recorded, the entity may be required to disclose the loss contingency.21

FAS 109 — Accounting for Income Taxes

Applicable accounting rules require the recognition of current and deferred tax assets and liabilities generally as follows:22

- A current tax liability is recognized for the income taxes payable with respect to current or prior periods.23

16 Id at n. 75. See also Minutes of FASB Meeting on July 27, 2004 at p. 4 reprinted at http://www.fasb.org/board_meeting _minutes/07-27-04_interpts109.pdf (it is the staff’s understanding that a “should” level tax opinion and “probable” level of GAAP approximate one another); FASB Staff, Uncertain Tax Positions, memorandum to Financial Accounting Standards Advisory Council (Sep. 23, 2004), p. 4, reprinted at www.fasb.org/project/- 09.2004 uncertain tax.pdf (“probable as it is used in Statement 5 is believed to be a threshold which is consistent with a ‘Should’ level tax opinion”).

17 FAS 5, ¶ 8. If the reasonable estimate of the loss is a range, and some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount should be accrued. When no amount within the range appears at the time to be a better estimate than any other amount within the range, the minimum amount should be accrued. FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, an Interpretation of FASB Statement No. 5 (1976).

18 FAS 5, ¶ 38.

19 FAS 5, ¶ 10, 38.


21 FAS 5, ¶¶ 10-12.

22 See FAS 109, ¶¶ 8, 10, 17.
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A current tax asset is recognized for taxes to be refunded or credited with respect to the current or prior periods, provided there is no material uncertainty regarding the realization of the refund or credit. If there is material uncertainty, the item should be treated as a gain contingency and recognition is deferred until the uncertainty is resolved.24

- A deferred tax asset or deferred tax liability is recognized for the estimated future tax effects attributable to temporary differences and carryforwards. Temporary differences relate to differences in the timing of recognition of income and expenses for financial reporting purposes as compared to recognition of such items for tax purposes. Deferred tax assets and liabilities are not discounted to account for the time value of money.

- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50%) that some portion or all of the deferred tax assets will not be realized (a “valuation allowance”).

In determining the realizability of a deferred tax asset, primary consideration is given to evidence of the future existence of sufficient taxable income of the appropriate character and other applicable tax attributes.25 The likelihood of disallowance of the reported tax position is not mentioned as a factor in considering whether a valuation allowance is required.26 The potential disallowance of a reported tax position appears to be dealt with exclusively by FAS 5.

This reading makes sense. Assuming it is more likely than not that there will be future taxable income of the appropriate character, it may generally be assumed that the company will realize the future tax benefits of the deferred tax asset. The company generally expects that it will claim the loss carryforwards, tax basis, or other deferred tax assets on future tax returns, and will realize reductions in otherwise payable taxes. Any risk that the tax benefit claimed in future tax periods will be challenged on audit is more properly analyzed in terms of whether a liability for repayment of the tax benefits should be accrued as prescribed in FAS 5.27

CON 6 – Elements of Financial Statements

“Assets” are generally defined as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”28 For this purpose, the term “probable” is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FAS 5), 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.29

CON 6 has been cited as authority for the proposition that a tax benefit may not be recognized unless it is first concluded that it is probable that the tax position giving rise to the tax benefit will be sustained on audit. Only after this threshold test is satisfied is the deferred tax asset then tested for a valuation allowance under FAS 109 or a loss contingency accrual under FAS 5.30 This is an incorrect reading of CON 6.

In the case of a tax return position that results in a current tax benefit through the reduction in otherwise payable taxes, there is generally no issue about whether the “asset” or “future economic benefit” will be realized. Under the self assessment regime applicable to U.S. federal income taxes and most other income taxes, the tax due and payable is the amount reported by the taxpayer on the tax return. This amount is assessed by the tax authority with only a limited review (e.g., review for math errors and missing information). The tax authority’s substantive review is generally performed only after the tax return has been processed, and the tax authority is generally restricted from assessing and collecting any claimed deficiency until after it has notified the taxpayer of the amount and basis for

23 FAS 109 refers to the liability as “income taxes currently payable.” The tax liability is classified as a current liability if it is expected to be paid within one year (or within the current operating cycle, if longer). See ARB No. 43, Restatement and Revision of Accounting Research Bulletins (1953), ¶ 7. Otherwise, the liability is classified as a non-current liability.

24 Cf. FAS 5, ¶¶ 1, 17.

25 FAS 109, ¶¶ 21, 92-98.

26 Although this proposition is not specifically expressed in FAS 109, it is apparently accepted by the FASB staff. See FASB Staff memorandum to Financial Accounting Standards Advisory Council (Sept. 23, 2004), reprinted at www.fasb.org/project-09_2004uncertaintax.pdf (“Additionally, the deferred tax valuation allowance only relates to the availability of future taxable income to realize a previously recognized deferred tax asset. The valuation allowance is not meant for adjustments to the amount of the calculated deferred tax asset for sustainability uncertainty.”).

27 If the position giving rise to the deferred tax asset is likely to be challenged and disallowed (in full or in part) prior to the realization of the deferred tax asset on future tax returns, it may be appropriate to recognize the potential disallowance as an asset impairment rather than as a liability.


29 CON 6, ¶ 25 n. 18.

30 See Proposed Interpretation at p. v; Batson Report, supra at n.15, p. 17 and n. 71.
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the deficiency and provided the taxpayer with certain pre-payment appeal rights.\textsuperscript{31} Accordingly, the issue is not whether an asset should be recognized, but whether a liability should be recorded for the potential deficiency that might result from the post-filing audit process. FAS 5 directly governs that issue, not CON 6.\textsuperscript{32}

Similarly, if a tax return position results in a deferred tax benefit (e.g., a net operating loss carryforward, or tax basis in depreciable assets that creates a deductible temporary difference), assuming there is clear evidence of sufficient future taxable income of the appropriate character to realize the benefit such that no FAS 109 valuation allowance is required, there is generally no issue regarding the realizability of the deferred tax asset. In most cases, the deferred tax benefit will be claimed on future tax returns, and a reduction in taxes payable will be realized. Thus, the requirements for asset recognition under CON 6 are clearly satisfied. The question is whether a liability (or asset impairment) should be recorded to reflect the potential disallowance of the future tax benefits. Again, that question is governed by FAS 5, not CON 6.

The CON 6 asset recognition standard arguably does apply with respect to claims for tax refunds. The refund amount represents an asset (receivable) that not be recognized unless it is probable, in the usual general meaning, that the refund will be realized (i.e., granted by the taxing authority, even if only conditionally). In cases where the taxing authority is likely to dispute the taxpayer's right to the refund prior to granting the refund, it may be appropriate to treat the claim as a gain contingency in accordance with FAS 5 paragraph 17.

\textsuperscript{31} The FASB Minutes, supra n. 1, contain a statement that the potential disallowance of a tax benefit should be characterized as a "payable on demand." This characterization is not consistent with the general procedure for assessment and collection of income taxes.

\textsuperscript{32} If the company has intentionally understated its tax liability, it is arguable that the understatement represents an accrued liability governed by CON 6, and not a loss contingency governed by FAS 5. This might imply that a liability should be accrued if it is more likely than not that the IRS will successfully assert a deficiency. CON 6, ¶35 ("Liabilities are probable future sacrifices of economic benefits arising from present obligations . . . "). In practice, the two standards should not lead to different results. If a tax return position has no reasonable possibility of being sustained, both standards will require an accrual for the expected deficiency. If the tax return position has a reasonable possibility of being sustained, the liability should be viewed as contingent and tested under FAS 5 (which will generally require an accrual for the entire deficiency if it is more likely than not that the IRS would prevail if the matter were litigated).

\textbf{Summary of Existing GAAP}

The applicable accounting rules discussed above lead to the following general conclusions for most income taxes:\textsuperscript{33}

- Tax assets and liabilities must initially be recorded in accordance with the tax returns filed or to be filed by the enterprise.
- FAS 109 requires a valuation allowance for any deferred tax asset if it is "more likely than not" that any recorded tax assets will not be "realized." If a tax position results in an immediate (current) tax benefit (e.g., reduction in taxes otherwise currently payable, or a refund), it is deemed to be realized. If a tax position will result in a deferred tax asset, the valuation allowance analysis looks to whether there will be sufficient taxable income of the appropriate character, or other tax attributes, to utilize the carryforwards or other deferred tax effects. The risk that the underlying tax position will be disallowed is generally not considered in evaluating whether the deferred tax benefits flowing from that tax position will be "realized."
- FAS 5 requires that a charge to income (and a related impairment of an asset or accrual of a liability) with respect to the potential disallowance of a tax position if
  1. it is probable that the tax position will be challenged on audit;
  2. it is probable that the future resolution of the challenge will confirm that a loss has been incurred; and
  3. the amount of the loss can be reasonably estimated.
- FAS 5 requires that a claim for refund or credit be accounted for as a gain contingency if the realization of the refund or credit is subject to material uncertainty.

In short, under the impairment standard applied under existing GAAP, tax benefits (other than claims for refund) are recognized in the financial statements in accordance with the reported tax positions. A tax benefit is not offset by any valuation allowance unless it is more likely than not that the benefit will not be realized, and is not offset by any loss contingency accrual unless it is probable that the tax benefit will be challenged and disallowed by the tax authority.

\textsuperscript{33} These observations apply to income taxes imposed under the United States Internal Revenue Code, and other income taxes imposed under a self assessment system whereby original tax returns filed by the entity are not subject to substantive review prior to acceptance by the tax authority.
The Proposed Interpretation's "Affirmative Judgment" Standard

The FASB's Proposed Interpretation turns existing GAAP on its head and suggests that an enterprise should not record in its financial statements the tax benefit of a position reported in its tax return unless it is probable that the reported tax position will be sustained. And for this purpose, the Proposed Interpretation requires the enterprise to assume that the position will be challenged and litigated to a final decision. This threshold inquiry applies to first determine whether a tax benefit can be recognized. Once the tax benefit meets this "initial recognition" test, the entity must then proceed to the second step of the analysis and "measure" the amount of benefit to record in the financial statements. The measurement is based on management's best estimate of the amount of benefit that will be sustained taking into account any potential settlement with the taxing authority. FAS 109 would presumably still apply to determine whether a valuation allowance is required with respect to any recognized deferred tax asset. FAS 5 would appear to have no continuing role with respect to income tax loss contingency accruals.

In applying the initial recognition test, the Proposed Interpretation introduces two new and highly confusing concepts. First, the Proposed Interpretation requires a determination of the proper "unit of account" to be analyzed for initial recognition and measurement. Although the term "unit of account" is undefined, an illustration is given using four research projects. The illustration states that each research project is a "unit of account" for purposes of determining whether the research credit claimed by the company is "valid" (i.e., probable of being sustained). There is no guidance provided as to why each research project was a proper unit of account (as opposed to different categories of expenditures, for example), and the illustration cautions that "the appropriate unit of account may be different based on facts and circumstances."

Second, the Proposed Interpretation draws a distinction between the "validity" of a tax position versus the "valuation" of items associated with the position. An illustration is given of a charitable contribution of intangible property where the deduction for the contribution is clearly proper, but the value assigned by the taxpayer to the intangible property is unlikely to be sustained.

As noted above, audit detection risk is not taken into account in determining the initial recognition or measurement of a tax benefit.

As discussed below, the proposed standard cannot be justified on either technical or policy grounds, and will lead to significant implementation problems.

Evaluation of the Technical and Policy Foundations for the Proposed Interpretation

No Technical Foundation

Neither the Proposed Interpretation nor the publicly available documents related to the FASB deliberations on the Proposed Interpretation provide any indication of the technical basis for the proposed affirmative judgment standard, other than the cryptic reference to CON 6 in the Summary of the Proposed Interpretation. However, the FASB staff and others have indicated informally that, in addition to CON 6, existing guidance under questions 4 and 17 of the FASB Implementation Guide to FAS 109 also support the proposed standard, and that the approach to recognition of regulatory assets under FAS 71 (as amended by FAS 90) provides precedent for the proposed approach to recognition of tax benefits. As discussed below, none of this prior guidance provides support for the proposed standard for recognition of tax benefits.

CON 6 Asset Recognition Standard

Although the summary of the Proposed Interpretation implies that the probable standard for initial recognition of tax benefits as set forth in paragraph 6 of the Proposed Interpretation is consistent with the general requirements for recognition of assets in CON 6, that is a dubious proposition for several reasons.

First, the definition of probable in CON 6 is different from the definition of probable in FAS 5. CON 6 footnote 18 provides:

Provable 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 ...

The FASB has clarified that the term probable as used in FAS 5 "does not mean virtually certain [but] is a higher

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34 See discussion at footnote 77.
35 If management cannot recognize more than its best estimate of the benefit that is "probable of being sustained upon audit" (paragraph 11 of the Proposed Interpretation), there could be no circumstances under which it would be probable that an additional loss (i.e., lower tax benefit) would be incurred.
36 Proposed Interpretation, ¶ 9, A2.
37 Id., n. 6.
38 Id., ¶ A13.
level of likelihood than 'more likely than not'. One might reasonably infer from this guidance that probable in the “usual general” meaning under CON 6 is a lower level of confidence than required under FAS 5, and is only a more likely than not level of confidence.

Second, even if the definition of probable in CON 6 is the same as the definition of probable in FAS 5 and is therefore an appropriate standard under the proposed affirmative judgment approach, the Proposed Interpretation changes the definition by restricting the assessment of probability to a consideration that is “based solely on the technical merits of the position.” Neither CON 6 nor FAS 5 contains any such limitation. Considerations other than solely technical merits can have a significant bearing on the expected outcome of a tax controversy, and it is unclear why the FASB would exclude those considerations from management’s evaluation of the sustainability of a tax position.

Third, as previously discussed, it is generally inappropriate to regard income tax benefits (other than claims for refunds and credits) as assets under CON 6. The recognition of a tax benefit through the reduction of current taxes payable is indisputably a question of the proper measure of a liability. Moreover, because income taxes are generally determined through self assessment, there is generally no uncertainty whether the economic benefit of a deferred tax asset will be realized in future periods (assuming sufficient future tax attributes to avoid a valuation allowance). The only uncertainty is whether the taxing authority will assert, post-filing, that the enterprise has an additional liability.

For all of these reasons, CON 6 does not provide a valid technical foundation for the proposed initial recognition standard or for the FASB’s proposed affirmative judgment approach.

FAS 109 Implementation Guide – Question 4

Question 4 of the FAS 109 Implementation Guide provides as follows:

Q--An enterprise may have a basis under the tax law for claiming certain deductions, such as repair expenses on its income tax returns. However, the enterprise may have recognized a liability (including interest) for the probable disallowance of those tax deductions that, if disallowed, would be capitalized for tax purposes and then would be deductible in later years. How should these items be considered if scheduling of future taxable or deductible differences is necessary? [17, 21]

A--Accrual of a liability for probable disallowance of expenses, such as repairs, has the effect of implicitly capitalizing those expenses for tax purposes. Those capitalized expenses are considered to result in deductible amounts in the later years in which allowable deductions (such as depreciation expense) are expected for tax purposes. If the liability for probable disallowance is based on an overall evaluation of various exposure areas, scheduling should reflect the evaluations made in determining the liability for probable disallowance that was recognized.

Upon disallowance of those expenses, taxable income of the year for which the expenses are disallowed is higher. That increase provides a source of taxable income (paragraph 21(c)) for purposes of assessing the need for a valuation allowance for deductible temporary differences. Similarly, taxable income for years after the disallowance will be lower because of annual deductions attributable to those capitalized amounts.

A deductible amount for the accrued interest is scheduled for the future year in which that interest is expected to become deductible as a result of settling the underlying issue(s) with the tax authority.

Question 4 deals with a situation in which it was probable that a FAS 5 loss contingency had occurred, requiring that a liability be recorded for the expected tax deficiency. The question addressed is whether the corollary effects of the probable deficiency (i.e., additional income in
the year to which the deficiency relates and additional expense in subsequent years) can be taken into account in assessing whether a valuation allowance is required for a net operating loss carryforward.

Question 4 does not stand for the proposition that a current tax benefit cannot be recorded unless it is probable that the tax position will be sustained on audit. Rather, Question 4 implies the opposite: that current taxes are recorded based on the positions reported on the tax return, and that the question is then whether there is a FAS 5 loss contingency reserve required.

FAS 109 Implementation Guide – Question 17

Question 17 of the FAS 109 Implementation Guide provides, in part, as follows:

17. Q--In a taxable purchase business combination, an enterprise allocates for tax purposes the purchase price to the assets acquired and liabilities assumed so as to maximize the potential income tax benefits from the combination. Although the enterprise has a basis under the tax law for the allocations claimed in initial filings with the tax authority, that enterprise believes that portions of the allocation will be denied by the tax authority and the amount assigned to goodwill will be increased. Should deferred income taxes at the date of the business combination be based on (a) the tax basis of acquired assets and liabilities as claimed in initial filings or (b) the best estimate of the tax basis that will ultimately be accepted by the tax authority? What is the appropriate accounting in periods subsequent to the business combination for changes in the purchase price allocation for tax purposes? [30]

A. The tax basis of an asset or liability is a question of fact under the tax law. The tax basis of most assets and liabilities is not subject to dispute and can be determined from initial filings with the tax authority. However, the tax basis of some assets and liabilities is unclear and will be determined by tax regulations, negotiations with the tax authority, appeals procedures, or, in some cases, litigation. The tax basis of those assets and liabilities may not be appropriately determined from initial filings with the tax authority because those filings are only the first step in the process to establish the tax basis. Deferred tax assets and liabilities at the date of a business combination should be based on management's best estimate of the tax basis of acquired assets and liabilities that will ultimately be accepted by the tax authority.

By its terms, the "best estimate" standard established in Question 17 applies only in the context of business combinations. Therefore, it is questionable whether it provides reliable support for determining the proper standard for recognition of tax benefits in other contexts.

Moreover, the "best estimate" standard used in Question 17 is a much less restrictive standard than the "probable" standard proposed by the FASB. The "best estimate" standard prescribed in Question 17 will typically produce the same results as under the FAS 5 impairment standard. When management evaluates reported tax positions under FAS 5, it looks at those positions that are likely to be challenged on audit and determines a reasonable estimate of the liability to be incurred to resolve the challenge. I submit that this analysis is the same analysis that management will undertake to arrive at its best estimate of the tax basis of assets and liabilities that will ultimately be accepted by the tax authority. Accordingly, Question 17 is fully consistent with the impairment standard of FAS 5 and lends no support to the "probable" standard proposed by the FASB.

FAS 71/FAS 90 Recognition of Regulatory Assets

Paragraph 9 of FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation, deals with the ability of a regulated enterprise to record an asset for all or part of an incurred cost that would otherwise be charged to expense (commonly referred to as a "regulatory asset"). A regulatory asset can be recorded if, among other requirements, "It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes." For this purpose, the term "probable" was originally defined in accordance "with its usual general meaning, rather than in a specific technical sense."

In contrast, paragraph 11 of FAS 71 provides, in the case of refunds to customers ordered by the regulator, that the criteria of paragraph 8 of FAS 5 be applied in determining whether a liability for the regulatory refund ("regulatory liability") is required.

Subsequently, in FAS 90, Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs; an amendment of FASB Statement No. 71, the FASB changed the definition of "probable" as used in FAS 71 paragraph 9 (relating to regulatory assets) to mean probable as defined for purposes of FASB Statement No. 5. The change was made primarily to have a single standard for the recognition of regulatory assets and regulatory liabilities.44

The strict standard for recognition of regulatory assets provided in FAS 71/90 makes sense in the context in which it applies, and does not provide a proper standard for recognition of tax benefits. In the regulatory context, the enterprise has no right to collect the regulatory asset

44 FAS 90, ¶ 69-71.
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without the prior approval of the regulator. In contrast, under the self-assessment system generally applicable to income taxes, the enterprise has full authority to reduce its taxes due without prior approval of the tax administrator. Accordingly, the accounting considerations for the two types of assets are not comparable, and FAS 71/90 does not provide reasonable guidance for the recognition of tax benefits. As noted in FAS 90, “much of the accounting specified by Statement 71 is itself a departure from the accounting framework applied by nonregulated enterprises generally.”

No Policy Foundation

Lack of Consistency

The stated impetus for the FASB’s proposed standard is a lack of consistency in the application of existing accounting standards. The alleged lack of consistency is arguably overstated, and in any event is not a sufficient justification for replacing the existing rules with entirely new rules.

While practitioners have adopted different approaches to determining the reasonable estimate of probable loss under FAS 5, and while some have characterized their approaches as asset recognition models, I believe that these different approaches have the consistent objective and effect of recording a reasonable estimate, in accordance with FAS 5, of the loss that will be confirmed when an uncertain tax position is resolved. In cases where a tax position is not supported by a sufficient level of confidence to support a conclusion that the tax position will be sustained on audit, practitioners are reasonably consistent in accruing for the potential disallowance of the position on audit. The required level of confidence may vary depending on the nature of the position and other applicable facts and circumstances, and this variation is an appropriate exercise of judgment in view of the complexities of the tax system.

Admittedly, the current rules permit enterprises to exercise judgment about its expected tax liabilities and thus may result in inconsistencies between reporting enterprises. That inconsistency is a reflection of the inherent complexity of the tax laws. It is not evidence that the rules affording an enterprise the discretion to exercise judgment about the settlement of tax liabilities are invalid and should be replaced with ambiguous, arbitrary, and inflexible rules that will lead to systematic overstatement of tax liabilities.

Moreover, even if there is inconsistency in the application of existing rules to uncertain tax positions, that does not justify the Proposed Interpretation. The solution to consistency is not to change the standards, but rather to clarify and enforce the existing standards.

Deficiencies in Existing GAAP

Regardless of one’s views on the consistency issue, it is appropriate to ask whether there is a legitimate policy reason to impose a heightened standard for recognition of tax benefits. Has the existing standard led to undesirable consequences, and will the Proposed Interpretation fix the problem?

It is tempting to assume that there is a problem with the existing rules based on the highly publicized reports that some companies were improperly overstating earnings based on aggressive tax positions. The SEC and the FASB are acutely aware of these problems, and the FASB’s proposed standard seems clearly motivated by a view that by tightening the standards for recognition of tax benefits, it can reduce the opportunity for overstatements of earnings.

The problem is that the FASB’s proposed standard is neither necessary nor sufficient to address the problem that existed in Enron and other similar cases. Recall that Enron and its auditor (Arthur Andersen), on their own initiative, applied a “should” opinion standard for the recognition of tax benefits related to the transactions in controversy. Enron concluded that it had a should level of confidence that all of the tax benefits it claimed in its financial statements would be sustained on audit, and in most cases it had should level tax opinions from top tier law firms to support its conclusions. Accordingly, the FASB’s proposed standard would not have changed Enron’s financial reporting. Moreover, while the examiner questioned the legitimacy of some (but not all) of the positions taken by Enron and its counsel, the financial reporting of those positions was primarily challenged on more fundamental

45 FAS 90, ¶ 37.

46 Proposed Interpretation, ¶ 2, B2, B45.

47 For example, depending on the circumstances, it may be quite appropriate to (i) defer recognition of a tax position relating to a “listed transaction,” and essentially treat the item as a gain contingency, even though the company has a “should prevail” opinion supporting its tax treatment of the transaction, (ii) fully or partially reserve a tax position related to a material tax shelter item where the enterprise is unable to reach a should level of confidence that the position will prevail, and (iii) fully recognize a tax position having only a more likely than not level of confidence where the item arises from a company’s normal operations and is not expected to draw special scrutiny from the IRS. While these different situations appear to use inconsistent standards, the consistent objective is to provide a reasonable estimate of the expected liability.
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grounds, including failure to properly apply the existing rules for valuation allowances and loss contingency reserves under FAS 109 and FAS 5. 99

The conclusion is that Enron violated existing accounting rules. 50 The solution is not adoption of new rules; it is more rigorous enforcement of existing rules. The PCAOB is actively pursuing the necessary enforcement actions, and FASB’s proposed Interpretation is neither necessary nor helpful to the PCAOB’s work. The FASB is seeking to fix something that isn’t broken, and in the process is only creating new problems (as discussed below).

Encourage Tax Compliance

Some have suggested that the Proposed Interpretation serves an important public policy of encouraging compliance with existing tax laws. The argument is that “If companies knew they were required to meet a ‘probable’ standard before they could incorporate a tax position into their financial statements, it would ... reduce the incentive to buy a risky tax shelter for the purpose of reporting more favorable financial results.” 51

As just noted with respect to the Enron situation, the probable standard proposed by the FASB will not necessarily stop tax shelters. Even in the case of the transactions that the IRS considers most abusive (so-called “listed transactions”), many of the tax positions underlying those transactions are supported by should level tax opinions. The accounting for those transactions would not be impacted by the Proposed Interpretation. Moreover, most tax shelters are promoted on the basis of the tax benefits of the transaction, not on the financial accounting benefits. Even where accounting benefits are important, existing accounting rules already provide that an entity cannot recognize in its financial statements the tax benefits of tax shelter transactions that are likely to be disallowed on audit. Accordingly, all the Proposed Interpretation will do is ensure that many legitimate but uncertain tax positions are derecognized in the same manner as illegitimate tax positions, creating no greater disincentive for one than the other. For all these reasons, the Proposed Interpretation is unlikely to accomplish the desired policy objective of promoting compliance with the tax laws.

But more important, those who support the Proposed Interpretation out of outrage over the tax shelter scandals should critically examine whether it is the proper role of the FASB and the accounting rules to fix the problems of the tax laws. I submit that the objective of the accounting rules is to faithfully report the facts regarding a company’s financial position, not to influence behavior or protect the tax system from abuse. Those who want to address the tax shelter problem should focus on fixing the tax laws and the tax enforcement mechanisms, and should not use the accounting rules as a crude proxy for tax reform. The accounting rules are intended to be agnostic, and when they are stretched beyond their purpose, the integrity of the financial statements will be compromised. 52 As discussed below, that is exactly what will happen under the Proposed Interpretation.

Problems with the Proposed Affirmative Judgment Standard

In addition the fact that there is no authoritative technical guidance or compelling policy argument to support the proposed affirmative judgment standard, there are also many practical problems associated with the proposed standard. By comparison, the existing impairment standard is a more workable approach that provides more meaningful financial statement information.

Some of the problems with the proposed affirmative judgment standard are:

Misstatement of Assets and Liabilities

The FASB’s proposed affirmative judgment standard will lead to misstatements of an enterprise’s assets and liabilities. In the case of a current tax benefit that does not meet the probable standard for recognition, the proposed

99 See, e.g., Baision Report at pp. 37, 68, 88, 101. In addition to failing to properly value allowances and loss contingency reserves, the examiner found that Enron’s accounting for certain transactions rested on an improper application of business combination accounting rules. In other cases, Enron recorded deferred tax assets in circumstances where the book/tax basis differential did not qualify as a temporary difference (e.g., investment in a partnership). Id. at p. 65.

50 Two of Enron’s transactions provide evidence that the real source of the problems in the Enron case was its failure to record a valuation allowance or loss contingency accrual in accordance with FAS 109 and FAS 5. The two transactions, each involving a contingent liability tax shelter identified as a listed transaction in Notice 2001-17, 2001-9 I.R.B. 730, were supported only by “more likely than not” opinions, and therefore arguably did not meet Enron’s and Arthur Andersen’s internal standard for recognition of a tax benefit. Nevertheless, the examiner concluded that Enron’s accounting for the tax benefits of the transactions “arguably complies with GAAP” apparently because these were the only two transactions as to which Enron recorded a “tax cushion.”


52 The Senate Permanent Committee on Investigations has issued recommendations on the tax shelter industry. Although the committee had evidence that tax shelters were sometimes used to generate financial statement earnings, it (appropriately) made no recommendation to address the problem through changes to the accounting rules. See Senate Permanent Subcommittee on Investigations, The Role Of Professional Firms In The U.S. Tax Shelter Industry (Feb. 2005) reprinted at http://levin.senate.gov/newsroom/supporting/2005/pstaxshelterreport021005.pdf.
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standard requires the enterprise to accrue a liability for the potential disallowance of tax benefit, even if the enterprise reasonably believes that it is more likely than not that the tax benefit (or some significant portion of it) will be sustained on audit. Similarly, in the case of a deferred tax benefit (e.g., stepped up tax basis in depreciable assets) that does not meet the probable standard, the proposed standard would prevent recognition of the deferred tax asset even if it is more likely than not that the tax basis will be sustained on audit.

It is statistically and logically impossible that all tax positions with a less than probable level of confidence will all be resolved at zero benefit. Therefore, it is statistically and logically certain that the Proposed Interpretation will misstate tax assets and liabilities. Two of the FASB members acknowledged this fact, and opposed the proposed standard.54

Existing accounting principles carefully avoid the risk of overstating tax liabilities or understating assets by requiring that a higher threshold be met before a liability is accrued or an asset is impaired, and by requiring that only the amount reasonably estimated to be paid be taken into account. It is unclear why the FASB staff and a majority of the FASB decided that the deliberate overstatement of income tax liabilities or understatement of income tax assets will lead to more meaningful information for users of financial statements. It is submitted that the existing FAS 5 standard leads to a more appropriate and meaningful presentation of a company's financial condition.55

53 There is no corresponding risk that tax liabilities might be understated. If an entity believes it is probable that a tax benefit will be sustained if challenged on audit (e.g., 70% level of confidence), but also believes it is probable that some liability will be incurred to resolve the issue without litigation (e.g., the entity reasonably estimates that it will pay 30% of the tax benefit as a settlement), then the entity is required to reduce the recognized benefit by the amount of the expected settlement payment.

54 Proposed Interpretation, ¶ B46.

55 It is arguable that FAS 5 leads to an overstatement of assets or understatement of liabilities because it imposes too high a threshold for recognition of loss contingencies. This issue, which is not unique to tax loss contingencies, was considered when FAS 5 was adopted. The restrictive standard for recognition of loss contingencies can be justified on the ground that excessive loss reserves are a fertile source for future earnings manipulation. This concern was a prominent consideration in guidance issued regarding the accrual of restructuring reserves. See EITF 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring). In any event, any concern that FAS 5 provides too lax a standard for recognition of liabilities is a matter that is not unique to income taxes and is better dealt with as part of a project on loss contingencies generally. In this regard, the FASB recently declined to deal with alleged deficiencies in the application of FAS 5 to environmental liabilities on the

Mismatching of Income and Expense

Under the proposed standard for initial recognition of tax benefits, the tax effects of many transactions that occur in period 1 will not be recorded in period 1. Rather they will be reported potentially many years later when the tax effects are settled through administrative and judicial proceedings or expiration of the period of limitations on assessments.56 This will cause a severe mismatching in the timing of recognition of income and related tax benefits.

It can easily take 10 years or more to resolve a company's tax returns for a given period. Under the Proposed Interpretation, during this extended resolution period the company may be carrying liabilities that it has no expectation of ever having to pay. Tax deficiency interest will accrue and compound, creating a fictional drag on a company's reported earnings and constantly adding to what is already an illusory liability. How does this provide meaningful financial information to investors who trade in the company's stock during the period prior to the resolution of the tax matter?

The better approach (which is reflected in FAS 5) is to initially record the income and related tax benefits in period 1, and, if it is probable that those tax benefits will be challenged on audit, adjust the period 1 tax effects based on the reasonably estimated tax benefits that will be sustained. Although there may need to be further adjustments in subsequent periods, the period 1 accounting achieves the best possible matching of income and tax expense, and gives investors the best possible picture of the results of current operations and financial condition.57

Inconsistent Standards for Loss Contingencies

Under the proposed standard, loss contingencies related to income taxes are evaluated under an affirmative judgment standard, while other contingencies continue to be evaluated under the traditional FAS 5 impairment standard.

56 Indeed, in some cases the tax benefit might never be recorded, even though there is no realistic possibility that it will ever be disallowed. For example, if a return position is not challenged on audit, but under local rules the period of limitations for challenging the item never closes, and if audit detection risk is not a factor to be considered under the proposed standard, does the enterprise have to leave on its books forever the liability for potential disallowance of the return position?

57 In addition, the financial statement accruals are supported by additional disclosures where there is a reasonable possibility of a loss in excess of the loss accrued. See FAS 5, ¶ 10. This seems to be a more sensible approach than the approach of recognizing no benefit and providing no disclosure as implied by the Proposed Interpretation.
It is not clear why loss contingencies related to income taxes should be subjected to a different standard.\textsuperscript{58} The differing standards are likely to confuse users of financial statements by adding complexity to the evaluation of an entity's assets, liabilities, and loss contingencies.

The FASB recently recognized the imprudence of proposing specific rules for specific types of loss contingencies. It rejected a request to add to its agenda a project dealing with accrual of loss contingencies related to environmental liabilities, primarily on the basis that "if the Board decides to reconsider Statement 5, the Board should reconsider all of Statement 5, not just this specific issue."\textsuperscript{59} In effect, the FASB acts contrary to this belief when it proposes to adopt special rules dealing with the recognition of loss contingencies related to income taxes.

**Excessively Restrictive Standard**

As a practical matter, it may be difficult or impossible to satisfy the proposed "probable" standard because companies may be unable to obtain legal opinions or other evidence to establish that it is probable that a tax position will be sustained on audit. As discussed below, existing American Bar Association ("ABA") guidelines for issuance of opinions regarding loss contingencies are extremely restrictive. Moreover, there may be other reasons why a lawyer would be unwilling or unable to provide a supporting opinion. Under these circumstances, the proposed affirmative judgment standard could lead to substantiation requirements that cannot be met as a practical matter, further exacerbating the potential misstatement of assets and liabilities under the FASB's proposed standard.

**ABA Policy Statement Regarding Opinions on Financial Reporting for Loss Contingencies**

In assessing a company's financial accounting for loss contingencies, the independent auditor generally will have the company send a letter of inquiry to its lawyers requesting that the lawyer furnish information to the auditor regarding pending or threatened litigation, and regarding certain unasserted claims or assessments, that the lawyer is handling for the client.\textsuperscript{60} The standard letter of inquiry asks the lawyer to provide, in addition to other matters, "an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss."\textsuperscript{61} This information is obviously tied directly to the standards for reporting loss contingencies under FAS 5.

The American Bar Association, in consultation with the American Institute of Certified Public Accountants, adopted a policy of generally refraining from providing auditors an evaluation of the likelihood of an unfavorable outcome with respect to loss contingencies "except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote' ..."\textsuperscript{62} For these purposes, an unfavorable outcome is "probable" if the outcome is "reasonably certain" (i.e., the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful).

The commentary on the ABA Policy notes that lawyers generally cannot provide any statement about the probability of outcome of litigation in any measurable sense. Accordingly, it is a rare case in which a lawyer could give an opinion a favorable outcome was "probable." "Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law."\textsuperscript{63}

Thus, the ABA Policy explicitly disclaims statements of probability in any numerical sense, and seems to use the term "probable" to indicate a level of confidence closely approaching absolute certainty. If this interpretation is applied in the context of the FASB's proposed standard for recognition of tax benefits, there will be far more instances where tax benefits are not recorded (or reserved) that the FASB seems to be contemplating.

**The "Should Prevail" Opinion Safe Harbor**

In an apparent attempt to avoid the ABA's restrictive interpretation of the term probable as used in FAS 5 in the context of loss contingencies generally, the Proposed Interpretation provides a several examples of the type of evidence that "may" in the absence of opposing evidence demonstrate a probable level of confidence. One example is "An unqualified should prevail tax opinion from a qualified expert for which all conditions are objectively verifiable." Although this appears to get around the ABA's restrictive interpretation of "probable" as used in FAS 5, there are several problems with this provision.

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\textsuperscript{58} There are other types of loss contingencies that are similar to income tax loss contingencies insofar as the contingent liability arises from the potential adjustment of a self-assessed liability. The most obvious comparable contingent liability is the liability for audit adjustments related to transactional taxes and excise taxes.

\textsuperscript{59} See http://www.fasb.org/board_meeting_minutes/03-09-05_fas5.pdf, at p. 5.

\textsuperscript{60} AICPA, U.S. Auditing Standards, AU Section 337.08.

\textsuperscript{61} AICPA, U.S. Auditing Standards, AU Section 337A.

\textsuperscript{62} ABA, Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, ¶ 5 (2003) (hereinafter "ABA Policy").

\textsuperscript{63} ABA Policy, p. 16.
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As noted above, the specific requirements for a “should” level tax opinion are not well defined, and are not necessarily consistent among tax practitioners. Accordingly, the adoption of this ambiguous standard is somewhat at odds with the stated objective of consistency. It is clearly at odds with any objective of simplicity and administrability.

More important, the qualification that “all conditions are objectively verifiable” could invalidate an enterprise’s reliance on many common types of tax opinions. Critical issues underlying many tax opinions – such as business purpose, or the absence of any “plan or intent” with respect to future actions – are often based on factual representations from the client that may not be objectively verifiable.

Also, the requirement to establish the required level of confidence “based solely on the technical merits of the position” could further limit the utility of the safe harbor. There could be cases in which non-technical considerations – such as informal agency guidance or administrative practice, the lack of tax avoidance motives for a transaction, or tax policy considerations – are important factors in reaching a probable level of confidence. Is the opinion invalid if the advisor is unable to say whether a probable level of confidence would be reached in the absence of those non-technical considerations? What alternative facts are to be assumed for purposes of this hypothetical purely technical analysis?

Other Limitations

There are many issues as to which the law is sufficiently uncertain (or lacking) to permit the taxpayer or its counsel to render any conclusion regarding the likely outcome of an issue if it were challenged on audit. There may be no reason to believe that the position will be challenged on audit or that any such challenge will be sustained, but there may also be insufficient legal authority to reach a conclusion that the taxpayer “should prevail” on the position if the matter were challenged and litigated to a final decision. According to the proposed standard, the company might be required to reserve the entire benefit of the reported tax position until the matter is resolved on audit, potentially many years later.

Privilege and “Roadmap” Issues

In cases where a should prevail opinion can be obtained, the opinion might not be privileged. If privilege does not apply, tax authorities will have ready access to such opinions. Because the analysis supporting the opinion will necessarily detail potential challenges to the company’s reported tax position, the opinion will provide a “roadmap” to tax authorities of the arguments they can raise. While the opinion may conclude that those challenges should not be sustained by a court, the opinion’s conclusions are not binding on the tax authority or a court, and therefore will not preclude the tax authority from taking a contrary position.

The roadmap issue will arise even in cases where an opinion cannot be obtained and the entity is unable to recognize in the financial statements a tax benefit claimed in the tax return. In those cases, the unrecognized tax benefit may evident from the financial statements and footnotes, or from supporting workpapers. Tax authorities will be encouraged to challenge all such positions.

While there are admittedly privilege and roadmap issues present under the current rules, they are less pervasive than would be the case under the Proposed Interpretation. In general, the higher the threshold for recognition of tax benefits, the greater the number of tax positions that will be not recognized in the financial statements, the greater the level of documentation that will be required to support the tax positions that are recognized in the tax return, and the greater the risk of companies involuntarily providing tax authorities ammunition for disputes.

Unasserted Claims and the “Audit Lottery”

A particularly troublesome change that would be effected by the Proposed Interpretation is the elimination of audit detection risk as a consideration in determining tax reserves. Under existing GAAP, a contingent liability related to an unasserted claim is recognized only if it is probable that that liability will be asserted, and the other requirements of FAS 5 are met. In contrast, the Proposed Standard states: “In assessing the probability [that a tax position will be sustained], it shall be presumed that the tax position will be examined by the relevant taxing authority.” This presumption is unrealistic and will

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64 One need not venture to third world countries to find such examples. In the state income tax arena, the unitary business principle, the non-business income concept, and nexus determinations are so ambiguous as to defy, in many situations, any reliable forecasts as to the probable outcome of litigation on such issues.


66 While tax accrual workpapers are not routinely requested by the IRS, there are no legal limitations on a tax authority’s right to request and receive the workpapers. See, e.g., Announcement 2002-63, 2002-27 I.R.B. 72 (June 17, 2002) (IRS will request tax accrual workpapers only in unusual circumstances, except in cases involving tax shelter transactions).

67 FAS 5, ¶ 10, 38.

68 Proposed Interpretation, ¶ 7.
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significantly exacerbate the misstatement of a company's expected tax liabilities.

There may be tax positions in an entity's tax return as to which the entity is unable to conclude that it is probable that the position will be sustained if challenged on audit, but as to which the entity has a fairly high level of confidence will never be challenged on audit, either because the issue will not be detected, or because the taxing authority is unlikely as a matter of administrative practice to challenge the entity's tax position even if the tax position is detected on audit. The entity should not be required to accrue a liability for those contingencies because there is no reasonable expectation that the entity will ever suffer a reduction in assets with respect to the contingency. That is the obvious and logical conclusion of FAS 5, but is not the result under the Proposed Interpretation.

This problem is particularly acute as applied to tax positions as to which there is no applicable statute of limitations. Normally, a tax benefit that has not been recognized initially and which is not detected on audit will be recognized when the period of limitations for challenging the position lapses. However, if the position relates to an issue whether the entity has tax "nexus" in a particular taxing jurisdiction, the entity may not have filed a return with the applicable taxing authority and therefore the period of limitations may never lapse. At some point it will become clear that the issue will never be raised by the taxing authority and that the potential liability is zero, but if audit detection risk is not a relevant consideration for recognition of a tax benefit, then the entity would apparently be required to maintain a perpetual liability for the potential disallowance of the tax benefit, including unending quarterly accruals for associated interest and penalties. It is not clear how this provides more meaningful financial information to users of financial statements.

This problem exists even where the contingency is not tied to audit detection risk. Certain tax accounting conventions are routinely sustained on audit as a matter of administrative convenience or materiality even though it might be impossible to conclude that it is probable that the reported tax treatment will be sustained if the matter were litigated. In such cases, the proposed FASB standard would require the accrual of a liability even though it is highly unlikely that the liability will ever be paid.

In explaining the basis for treating income tax contingencies different from other loss contingencies, one FASB member noted in the discussion at the Feb. 15, 2005 meeting that an income tax liability is not like a patent infringement claim (the example used in paragraph 38 of FAS 5) because income tax liabilities must be reported on a tax return. There are several reasons why that distinction is invalid.

First, it is not clear that the entity in the patent infringement example didn't report its patent usage to the U.S. patent office or in some other public forum. So it is questionable whether one can reliably conclude that the treatment under FAS 5 is conditioned on the potential liability not being reported.

Second, there are numerous other categories of contingent liabilities that are reported in some manner to the persons that may be in a position to assert a claim against the company, yet there is no indication that those situations require special treatment under FAS 5. An obvious and directly analogous example is sales taxes and other transaction taxes. Similarly, government contracts frequently require extensive reporting and are subject to audit. Employee benefit plans also involve extensive reporting to employees which can lead to claims against the plan sponsor. Must entities now assume that in all cases

the financial statements, and the administrative inconvenience and cost associated with capitalizing and depreciating the assets outweigh the benefits. The entity may follow the book expensing convention in filing tax returns, and as a matter of administrative practice, the taxing authority may have informally agreed that it will not challenge the entity's tax treatment of such costs. Notwithstanding the taxing authority's administrative practice, the entity may not be able to conclude that it is probable that it would prevail in its tax treatment of the costs if the matter were litigated.

Other examples might include tax positions based on informal agreements with the IRS, such as carryforward effects of audit settlements, rollbacks of advance pricing agreements. Competent authority relief would be another example of tax benefit that might be undisputed and reasonably expected, but clearly not probable as a purely technical matter.

This discussion is apparently the basis for the statement in paragraph B14 that "the Board does not believe that guidance is applicable to tax positions because a tax return is generally required to be filed."

For example, see Citigroup Faces Lawsuit Over Its Pension Plan, Wall St. J. Online, Feb. 7, 2005, reporting on a lawsuit filed against Citigroup alleging an illegal benefit formula under Citigroup's cash balance pension plan, and noting "roughly 20 or so lawsuits against cash balance pension plans." Citigroup's previously published financial statements make no mention of this potential lawsuit, presumably because the company did not believe it was probable that such a claim would be asserted.

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that all potential claims related to "reported" items will inevitably be raised regardless of the actual likelihood of such claims?

Third, it is not true that all tax positions must be reported on a tax return. A common example is tax nexus. If the entity takes the position that its activities in a particular jurisdiction are not subject to tax (i.e., the company does not have tax "nexus" in the jurisdiction), it will not file a tax return. What is the logic for requiring an entity to assume in all cases that those positions will be challenged on audit? Should tax positions that are not reported on a tax return be subject to a different standard?

What the foregoing discussion demonstrates is that one cannot validly state that income taxes are somehow unlike any other class of loss contingency and that audit detection risk should never be taken into account in accounting for uncertain tax positions.

**Treatment of Settlements and Non-Binding Audit Determinations**

Many, if not most, uncertain tax positions will be resolved through compromise (settlement) with the tax authority rather than through litigation or through a full concession of the issue by the taxpayer or the tax authority. Although such settlements are common, it is unclear how they are to be taken into account under the Proposed Interpretation.

The Proposed Interpretation provides that a tax position is initially recognized only if it is "probable of being sustained on audit by taxing authorities based solely on the technical merits of the position." In contrast, one of the examples illustrating the operation of this rule restates the rule as "probable of being sustained on audit (including settlement of appeals or litigation) under the relevant tax law." These two different articulations of the initial recognition standard make it unclear how settlement considerations are taken into account in the initial recognition analysis. If a tax position involving solely the validity of a deduction has only a 50% chance of being sustained in litigation, but the entity can establish that there is a greater than 70% probability that the matter can be settled with the tax authority on a basis allowing 40% of the reported tax benefit, what amount is recognized in the financial statements? Is it zero, or is it 40%?

The answer appears to be zero. The Proposed Interpretation notes that a significant difference between the benefit to be recognized in the financial statements and the reported tax position is evidence that the probable recognition threshold has not been met. In addition, the minutes of the FASB meetings on the exposure draft indicate that initial recognition analysis is based on the expected outcome if the position "was contested all the way through the court system." This statement suggests that the potential settlement of the dispute with the tax authority is not a consideration when evaluating a position for initial recognition, and is only relevant in measuring the best estimate of the position once it meets the initial recognition threshold. At a minimum, it appears that an expected settlement below 70% of the reported tax benefit would be evidence that the probable recognition threshold has not been met.

Under the Proposed Interpretation, if the probable recognition threshold is not met initially, the tax position is subsequently recognized in the interim period in which the threshold is met, the matter is "ultimately resolved" with the tax authority, or the statute of limitations lapses. This raises a question whether a non-binding settlement with the tax authority causes the matter to be "ultimately resolved" such that the tax benefit allowed under the settlement can be recognized at the time the settlement is reached.

It is not uncommon for an audit to be concluded without a binding final determination of the taxpayer's liability for the period audited. The audit might close without any action by the taxing authority (a "no change" audit). Or the entity might agree to proposed audit changes by simply signing a waiver of the restrictions on assessment and collection of any tax due (e.g., IRS Form 870) without entering into a formal closing agreement that precludes additional assessments. In such cases, is the matter "ultimately resolved" when the audit closes, or must the entity defer recognition of the previously unrecognized tax benefits allowed under the audit until the applicable statute of limitations lapses?

For example, assume a deduction claimed by the entity is subject to attack under either or both of two legal theories. Under one theory, the deduction would be permanently disallowed. Under another theory, the timing of the deduction would be delayed. The entity is unable to conclude that it is probable that the tax position could be sustained against either theory, and therefore the entity

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74 Proposed Interpretation, ¶ 6.

75 Proposed Interpretation, ¶ A3.

76 Proposed Interpretation, ¶ 9.

77 Minutes of FASB meeting on November 17, 2004 at pp 4-5. reprinted at http://www.fasb.org/board_meeting_minutes/11-17-04_UTP.pdf.

78 The Proposed Interpretation also provides that issues must be evaluated individually "without consideration of the possibility of offset or aggregation with other positions." Proposed Interpretation, ¶ 7. This prohibition against taking into consideration the trading of issues that frequently occurs in settlements of cases with multiple disputed issues implies that the potential settlement of a tax position is not evidence of likelihood that the position will be sustained.

79 Proposed Interpretation, ¶ 8.
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Initially recognized no benefit for the deduction and has been accruing interest on the unrecognized tax benefit as if the deduction would be permanently disallowed. The IRS completes its audit for the relevant tax years and determines that the timing of the deduction should be deferred, but does not raise the potential disallowance of the deduction. It is unclear whether the IRS simply overlooked the disallowance theory or affirmatively determined that the theory could not be sustained. The entity informally agrees to the deferral of the deduction as proposed in the audit report, and pays the tax due. Other issues raised in the audit report are taken to appeals. As is typical, the tax years remain open while the case is in appeals. Although it is the IRS’s practice to not re-open agreed issues, the IRS is not legally precluded from doing so.

Is the entity’s deduction issue deemed to be “ultimately resolved” upon issuance of the audit report and payment of the tax due such that the entity can recognize the agreed tax benefit of the deduction at that time, or is recognition deferred until the disputed issues are settled by appeals and further adjustments are legally precluded through a binding closing agreement or lapsing of the statute of limitations? It appears that the Proposed Interpretation would defer recognition of the tax benefit. The Proposed Interpretation’s presumption that tax positions will be examined, without regard to the probability of such an examination, suggests by analogy that the entity must presume that the deduction disallowance theory will be asserted as long as it is not legally foreclosed, regardless of the relative likelihood of the assertion.

Settlements are a critical component of the tax assessment process, and agreements reached with tax authorities, even if not legally binding, are often reliable evidence of the proper measure of an entity’s tax liabilities. It appears that the Proposed Interpretation ignores expected settlements except in circumstances where the settlement constitutes a legally binding resolution of the matter. By failing to take expected settlements into account initially, recognized tax benefits will be systematically understated relative to the reasonably expected benefits on audit. And by deferring recognition of settlements until there is a legally binding resolution, tax benefits could remain unrecognized longer than is appropriate. Current accounting principles avoid both of these problems by giving management discretion to reasonably estimate the expected outcome of tax disputes taking into account the normal settlement process and reasonably expected administrative practice. This is the same judgment afforded to management in accounting for other disputes under FAS 5.

Implementation Problems

One need only reference the considerable lack of clarity in the FASB’s discussion of the Proposed Interpretation at the February 16 board meeting to understand the complexity and confusion associated with the Proposed Interpretation. Fine distinctions between the “nature” of a deduction or “amount” of a deduction, or between the “validity” of a deduction or the “measurement” or “valuation” of a deduction, will lead to confusion in application. And concepts such as “unit of account” and “bifurcated gain contingency” have no definition and will inevitably produce confusion and inconsistencies in practice.

Consider one very simple example that highlights the complexity of the Proposed Interpretation. Assume a company suffers a deductible loss from the decline in market value of an investment. A conservative estimate of the loss based on stock exchange price quotations is $100. It is probable that this amount of loss will be sustained. However, the company claims a loss of $180 on the tax return, based on the view that the quoted value should be reduced by an $80 minority discount. It is not probable that the additional $80 deduction will be sustained, but the company expects that it can resolve the matter by agreeing to a loss of $140 ($40 of the loss claimed on the tax return will be disallowed).

Question: What amount of tax benefit should be recorded in the financial statements with respect to the stock loss?

Under one theory, zero loss would be recognized in the financial statements because it is not probable that the $180 loss claimed on the tax return would be sustained. This harsh result might be avoided if the loss is bifurcated into two “units of account.” The first unit of account is the $100 loss that is probable of being sustained, and the second unit of account is the additional $80 loss attributable to the minority discount theory. Under this theory, the tax benefit of only the $100 loss is recognized. Apparently, both of these answers are wrong. The correct answer, according to informal discussions with the FASB staff, is that the financial statements should recognize the tax benefit of the $140 loss expected to be sustained in settlement because it is probable that the company has sustained a “valid” loss, and the only issue is the “value” of the loss.

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80 Proposed Interpretation, ¶ 7.
81 It will not always be possible to clearly determine when a tax period is legally closed to further tax assessments. Closing agreements are generally subject to standard conditions (e.g., no misrepresentation of fact) that may be unclear in some cases, and it is possible that a closing agreement could be subject to certain conditions subsequent (e.g., no inconsistent actions in subsequent periods). These situations could complicate the determination when a tax position is “ultimately resolved.”
82 See http://www.fasb.org/board_meeting_minutes/02-16-05_up.pdf at pp. 9-12.
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Compare the analysis under existing GAAP: initially record the benefit of $180 in accordance with the tax return, then reserve $40 for the expected tax deficiency to be incurred to resolve the matter with the IRS. That analysis is straightforward and doesn’t turn on obscure distinctions between “units of account” or “validity” versus “value.”

With more complicated fact patterns common in actual practice, one can easily see the significant potential for confusion and inconsistency under the Proposed Interpretation, and how those concerns are avoided under the current rules.

Another significant trouble spot in the Proposed Interpretation is the concept of the “not recognizing” in the financial statements tax benefits reported on the tax return. This sounds simple, but it isn’t.

One problem is measurement. How does an entity “not recognize” the tax benefit of a position that a transaction does not give rise to taxable income? This situation comes up frequently in the transfer pricing area where entities may not be able to obtain a probable level of confidence that the IRS will not impute income with respect to transactions with related parties. In such situations does the entity accrue a liability for the maximum amount of tax liability that the taxing authority might reasonably propose? What if the tax authority proposes a patently absurd tax deficiency based on a highly inflated valuation of the consideration in the transaction? Is the entity required to accrue a liability for the proposed adjustment, or is some lesser accrual appropriate and how should that amount be determined?

The Proposed Interpretation offers no guidance on these issues, and it is difficult to see how the affirmative judgment approach of the Proposed Interpretation can be logically applied to income exclusion situations. In contrast, under existing GAAP, the entity would simply accrue a liability for the loss that it reasonably estimates will be incurred to resolve the issue.

The other problem is tracking. If a tax deduction not meeting the initial recognition threshold is claimed on the tax return and produces a net operating loss (“NOL”) carryforward, under the theory of the Proposed Interpretation the company will not record the deferred tax asset associated with the NOL carryforward. Instead, the company will account for the deduction as if it wasn’t claimed on the tax return and as if the NOL carryforward doesn’t exist. As a consequence, investors and other users of the financial statements will not see any deferred tax asset in the financial statements and may wonder why the company is not paying cash taxes in the current and future periods. Even the company may have trouble reconciling its financial statements if it is dealing with thousands of tax returns spanning 10 or more tax years, where any one return could have multiple uncertain tax positions that need to be taken into account in reconciling the tax returns to the financial statements.

It is likely that “not recognizing” tax benefits (i.e., breaking the audit trail from the tax return to the financial statements) will cause more confusion and errors in practice than existing GAAP, and will not aid in the goal of transparency. The current practice for measuring and tracking loss contingencies is a better approach.

Conclusion and Recommendations

The correct and preferable approach to financial reporting for uncertain tax positions is the impairment approach applied under existing GAAP as described above. The affirmative judgment approach of the Proposed Interpretation has no technical or policy foundation, would undermine the integrity of financial statements, and would present significant implementation problems.

While I propose retaining existing GAAP, I believe that there are some clarifications of existing GAAP that could be made to confirm existing practice and mitigate any concerns regarding the potential overstatement of tax liabilities.

Positions Lacking a More Likely Than Not Level of Confidence

Concerns about overstatement of tax benefits related to aggressive tax positions can be effectively addressed by invoking a presumption that any tax position lacking a “more likely than not” level of confidence should be fully reserved under FAS 56 if it is probable that the position will be challenged on audit. The presumption could be

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83 See, e.g., DHL Corp. v. Commissioner, 285 F.3d 1210 (9th Cir. 2002). In that case, the taxpayer did not report any royalty income with respect to a trademark that it owned and was used by a foreign affiliate. The IRS asserted that the taxpayer should be charged with imputed royalty income. While valuation was an issue in the case, the primary issue was whether there was a taxable transfer of value.

84 In the DHL case cited in the previous footnote, the IRS notice of deficiency asserted a deficiency based on a trademark valuation of $600 million, whereas the court determined that the value was only $100 million. The IRS conceded at trial that the valuation used in the notice of deficiency was invalid. T.C. Memo 1998-461, 76 T.C.M. (CCH) 1122.

85 Even in the case of deduction disputes, if the entity is unable to conclude that it has a probable level of confidence of sustaining the deduction purely on the merits, it appears that the entire tax benefit must be reserved even in circumstances where it is clear that the IRS will likely settle the issue rather than pursue a full disallowance.

86 The reserve would be based on the tax results under the position or positions that are most likely to be asserted by the tax authority.

87 See below for a proposed change in the treatment of audit detection risk.
Financial Reporting for Uncertain Tax Positions

overcome only if, based on all available evidence, the entity can establish that it is probable that the matter will be resolved (e.g., through settlement) for some amount less than the amount otherwise required to be reserved, and the entity can reasonably estimate the liability that will be incurred to resolve the matter. I believe that such a presumption (with a "more likely than not" level of confidence) would be consistent with common practice because I believe that most entities assume that a material position lacking a more likely than not level of confidence will generally result in a concession of the issue by the taxpayer. The presumption is rebuttable because there may be circumstances where a full concession is clearly not a reasonable estimate of the expected outcome.

Audit Detection Risk

If the FASB is concerned that entities are deliberately overstating tax benefits based on unrealistic assumptions regarding audit detection risk, then I suggest that rather than adopting an absolute rule that unrealistically assumes that all tax positions will be examined and challenged, the FASB might consider a rebuttable presumption regarding the detection of positions taken on tax returns. Under the proposed rebuttable presumption, if a material tax position relates to a tax liability with respect to which the entity has filed a tax return or information return with the relevant taxing authority (or is otherwise disclosed to the tax authority), then it will be presumed that it is probable that the position will be challenged on audit if there is a reasonable basis for such a challenge. This presumption could be overcome only if, based on all available evidence, the entity can establish that the risk of such a challenge is remote. Positions not reported on a tax return and not otherwise disclosed to the taxing authority would be subject to the general rules of FAS 5 paragraphs 10 and 38. Again, I believe that such a rebuttable presumption would be consistent with general practice under existing accounting principles.