VIA E-MAIL DELIVERY TO DIRECTOR@FASB.ORG

Financial Accounting Standards Board
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Attention: Technical Director
File Reference No. 1215-001

Ladies and Gentlemen:

On behalf of The Tax Council, I am pleased to submit the following comments on an Exposure Draft issued July 14, 2005, by the Financial Accounting Standards Board in which the Board published a proposed interpretation, Accounting for Uncertain Tax Positions (the “Interpretation”) that addressed issues in FASB Statement No. 109, Accounting for Income Taxes (“FAS 109”), and other official pronouncements, and requested comments from the public.

THE TAX COUNCIL

The Tax Council is a non-profit association representing over 120 of the major corporations and businesses in the United States. The association has provided an ongoing forum on national tax policy, tax administration, and financial reporting issues for more almost 40 years. The Tax Council’s members include senior tax officers of companies involved in manufacturing, mining, energy, transportation, consumer products and services, retailing, telecommunications, insurance, and financial services. The Council has a significant and long-standing interest in maintaining the integrity and vitality of America’s self-assessment tax system, at the Federal level and the state and local levels in the United States, and for foreign levies as well, and the financial reporting system of which the provision for taxes is a material part.
Summary of Recommendations

The Council submits that, if adopted, the Interpretation would meet the Board’s goal of substantially reducing the diversity of practices that currently exist for accounting for uncertain tax positions. Having said that, however, the Council further submits that the basic approach taken is not the best one, for reasons further discussed in succeeding paragraphs. The Interpretation as proposed introduces a number of systemic problems that would make the chosen approach difficult, and perhaps impossible in some instances, to apply in practice, and would result in the systematic over-accrual of tax liabilities in the presentation of financial statements of affected enterprises.

Specifically, the Council would prefer that the Board adopt an approach based upon “impairment” concepts rather than the “asset” approach selected, using concepts from FASB Statement 5, Accounting for Contingencies (“FAS 5”). Use of the “probable” standard applicable to the probable recognition threshold for recognizing the benefits of uncertain tax positions would be very difficult in many factual situations. Under the proposed conservative approach dictated by the Interpretation, full reserves would be established on positions having sustention probabilities between more-likely-than-not and probable. As a consequence, the approach would lead to inappropriate distortions of reported net income as tax liabilities are over-accrued in initial periods and reversed in later periods. Similarly, the dual standard approach for recognition and derecognition of items would lead to anomalies. Each of these factors would degrade the enterprise’s attempts to attain clear and transparent financial reporting.

Finally, the proposed timetable for implementation of the Interpretation is unrealistic and unnecessarily costly to reporting enterprises, and without further consideration of transition issues, will itself introduce material flaws into the Board’s efforts. This timetable would require the completion of all necessary tax opinions and underlying analysis in a very tight timeframe, a fact previously discussed by the Board and on which it indicated it expected comments. In addition to the effects on financial statements prepared only three months from now under the pronouncements as so revised, many enterprises may possibly experience even earlier effects in the Management Discussion and Analysis sections of filings with the Securities and Exchange Commission and other public disclosures to shareholders and investors, lenders, and other parties in regard to addressing changes to significant accounting policies under SEC Staff Accounting Bulletin 74. These standards should not be effective before the end of calendar year 2006 at the earliest, assuming they are finalized in the next few months, and it will be important to most companies that they be adopted on a calendar year basis.
STRUCTURE OF THE INTERPRETATION

Under the Interpretation, companies will not be permitted to recognize tax benefits from tax return positions unless the positions are at least “probable” of being sustained by tax authorities.¹

FAS 109 provides rules that set out how the benefits of tax positions taken or expected to be taken in a tax return are to be reflected in current and deferred taxes, but says nothing about the confidence level or threshold that must be met in order for the benefit to be recognized as a tax benefit in the financial statements. Under the Interpretation, a company would be required to assume that an uncertain tax position will be subject to review by the tax authority and then must evaluate the position’s “probable recognition threshold,” or the probability of being sustained upon review by the tax authority. The “probable recognition threshold” standard is measured under the standards provided by FAS 5, where “probable” is defined to mean that “the future event or events are likely to occur.” That standard is a higher threshold than the “more-likely-than-not” standard used in FAS 109 for determining whether a valuation allowance is needed on deferred tax assets.

The Interpretation provides four examples that may support, in the absence of contrary evidence, a conclusion that a tax position meets the probable recognition threshold:

1. Unambiguous tax law supporting the tax position;

2. An unqualified “should prevail” tax opinion that is based on objectively verifiable conditions and issued by a qualified expert;

3. Similar positions clearly presented in prior years’ tax returns that have either been accepted or not challenged by tax authorities during examination; and,

4. Similar positions taken by other taxpayers, “where analogy is appropriate,” that were favorably resolved through litigation with tax authorities.

If the uncertain tax position meets the probable recognition threshold, an amount is then recognized. The amount to be recognized is the best estimate of the amount that would be sustained after an audit by the tax authority and any litigation or appeals process. The best estimate is the single most likely amount in an estimated range of possible amounts, not a probability-weighted estimate. Further, a significant difference between the amount claimed on the tax return and the amount recognized in the financial statements undermines the conclusion that the item met the probable recognition threshold.

¹ The Interpretation would broadly apply to all tax positions accounted for in accordance with FAS 109, including tax positions that pertain to assets and liabilities acquired in business combinations, and including tax positions in previously filed returns as well as future tax returns.
An uncertain tax position that does not meet the criterion for recognition in the period may nevertheless be recognized in a subsequent period if:

1. the probable recognition threshold is met in that period;
2. the tax matter is finally resolved through settlement or litigation with the tax authority in the period; or,
3. the statute of limitations for the relevant tax authority to examine the tax position has expired.

Amounts related to uncertain tax positions are further subject to adjustment or "derecognition" in subsequent periods. An uncertain tax position that becomes less than probable, falling below the initial probable recognition threshold in a later period, will continue to be recognized unless it falls below a "more likely than not" threshold. However, companies would have to reassess the best estimate of the amount that is expected to be sustained at that time. If the probability falls below the "more-likely-than-not" threshold, tax benefits previously recognized would be "derecognized" in the period of the change in the assessment.2

If the tax benefit from an uncertain tax position is recognized in the financial statements at an amount that is smaller than the tax benefit of the related deduction reported in the company's tax return (and the deduction on the tax return reduced taxes payable for the period), a tax liability is created under the Interpretation because the tax-return position is not probable of being sustained. Under the Interpretation, the liability would be classified as current or noncurrent based on the anticipated timing of settlement of the position (amounts that are expected to be settled within one-year of the balance-sheet date are classified as current liabilities.)3

The Interpretation would also require charges to income for interest and penalties on the underpayment. Interest would be appropriate if the relevant tax law requires payment of interest on underpayment of income taxes, and if the tax benefits recognized in the financial statements are less than the corresponding amount in a previous return or one anticipated to be filed, and for

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2 FAS 109 requires that a deferred tax asset be reduced by a valuation allowance when it not more-likely-than-not that the tax benefit will be realized. But the valuation allowance is used to reflect uncertainty about the realization of tax benefits for positions that are expected to be sustained. The Interpretation would therefore prohibit a company from derecognizing tax benefits related to uncertain tax positions by the establishment of a valuation allowance. The Board tentatively concluded that a previously recognized tax position that no longer meets the probable recognition threshold should be derecognized by recording an income tax liability or reducing deferred tax asset in the period in which the enterprise concludes that it is more-likely-than-not that the position will not be sustained on audit.

3 Unless the liability arises from a taxable temporary difference, it should not be classified as a deferred tax liability.
a period the interest is "deemed to have been incurred." Estimated penalties are required if a tax position does not meet the minimum statutory threshold to avoid them.4

Changes in the estimates required by the Interpretation are recognized entirely in the period in which the changes occur. As noted above, these changes may occur when the positions no longer meet the probable recognition threshold, and when there are changes in the best estimate of the amount that is probable of being sustained upon audit by the tax authority, and when there are changes in the more-likely-than-not threshold.

Paragraphs 9 through 11 and 17 of FAS 5 require certain disclosures relating to the nature of a loss contingency and the possible range of loss (or a statement that an estimate cannot be made), and contingencies that might result in gains. (Admonitions to avoid misleading implications regarding the likelihood of realization may require disclosures of uncertain tax positions and their benefits that might be recognized in future periods.)

The Interpretation would require companies to apply the provisions noted above to uncertain tax positions existing as of the end of the period in which the Interpretation is required to be adopted, and the cumulative effect of changes would be reported in the income statement as a change in accounting principle as of the end of the period in which the Interpretation is adopted. Restatement of previously issued interim or annual financial statements and pro forma disclosures for prior periods is not permitted. The Interpretation is effective as of the end of the first fiscal year ending after December 15, 2005.

DISCUSSION

Choice of Asset Approach

The Board proposed an "asset approach" to recognition of benefits from uncertain tax positions and tentatively rejected the alternative "impairment approach," which approach may be affected in part by "detection risk," the risk that a transaction will be reviewed or detected by taxing authorities. The Board presumes that the position will be examined.

Under FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (1985) ("CON 6"), assets are:

probable18 future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

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4 Because classification of interest and penalties in the income statement was not considered when FAS 109 was issued, the Board concluded it would not consider that issue in this proposed Interpretation.
An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

\( n^{18} \) Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain not proved. ...

Adoption of the asset approach presumes that tax positions are assets, and that a company must control them, that the facts giving rise to their existence have already occurred, and that their future benefit has a high likelihood of realization. Said another way, the approach presumes that taxing authorities can take away the benefit at will unless and until the enterprise may ultimately and finally sustain its position and secure unfettered control of the asset. That approach essentially ignores both the nature of the transactions in question and the “environment characterized by uncertainty” described by CON 6 in which business occurs.\(^5\) Such positions do in fact give rise to an asset, cash, that is held and controlled by the enterprise. But the positions in question are not generally controlled by either the enterprise nor the taxing authority unilaterally—they are established under legal principles, and may be adjusted only through due process involving either changes or refinements in the legal principles or by examination by the taxing authority, negotiation and consideration of relative positions and risks, and possibly litigation in administrative and court processes.

An alternative approach would consider “impairment” under principles like those in FAS 5. This approach would require that reserves be established when it is probable that a tax position will not be sustained. Successful and mandatory utilization of this impairment or liability approach would also achieve the Board’s goal of reducing the diversity of practice that currently exists in the reporting of uncertain tax positions, and would remain consistent to accounting principles in FAS 5 for other loss contingencies and generally to GAAP as a whole. The paradigm would shift from whether uncertain tax positions meet the thresholds for asset recognition to whether they are appropriately evaluated and reflected in the enterprise’s tax liabilities. \(^6\)

\(^5\) The Board’s own choice of terminology is instructive—the Interpretation deals with “uncertain tax positions.”

\(^6\) Much of the impetus for the Interpretation stems from current concerns in the enforcement community that some companies have taken into account highly aggressive, or even unfounded, positions on their tax returns and then recognized the benefits in their financial statements. This inappropriate result would not obtain under either the asset approach of the Interpretation or an impairment approach that required appropriate reserves, including interest and penalties, to be applied to the positions.
Board minutes indicate that to some degree the choice of the asset approach was dictated by a concern that the impairment approach required consideration of “detection risk” under FAS 5, par. 38. The Council submits that such an approach does not inherently include such a factor. Paragraph 38 deals with unasserted claims and assessments and recovery in general civil actions (e.g., tort claims and patent infringement) and not specifically with tax matters. Under standards of tax practice applicable to tax opinions as adopted by the American Bar Association, the American Institute of Certified Public Accountants, and the U.S. Department of the Treasury, practitioners may not use audit risk as a basis for their judgment as to whether a position will succeed on its merits. The Council agrees with the public policy behind that principle and agrees with the Board that the risk of audit detection is not an appropriate consideration in determining the accounting treatment of uncertain tax positions. It is not clear that FAS 5 would require otherwise in Paragraph 38, and if there is doubt on that point, a simple clarification would effectively remove this concern.

In developing its proposed asset approach, the Board would establish the probable recognition threshold for uncertain tax benefits as “probable.” The Council believes that this standard is too restrictive, and does not permit these positions to be fairly presented. Neither the Interpretation nor FAS 5 define “probable” in quantifiable terms – FAS 5 simply says that it means that “[t]he future event or events are likely to occur,” contrasting the term with “Reasonably possible” and “Remote.” Common accounting practice would dictate a threshold of around 70-75 percent or more. Given the complexity of many tax issues, the uncertainties of the applicable, underlying facts, the dearth of legal and accounting authority on many critical points, and the exercise of professional judgment required to make this determination, one can reasonably complain that the standard is simply unworkable. Further, given the stakes involved, and recently reinforced requirements for documentation of these judgments under the Sarbanes-Oxley Act of 2002, and other applicable rules, no one would want to be held to such a precise standard.

**Thresholds**

Under the proposed conservative approach dictated by the Interpretation, full reserves would be established on positions having sustention probabilities between more-likely-than-not and probable. This could result in the over-accrual of liabilities, and would likely be different than the approach that management would characteristically apply to its best estimate of the ultimate outcome of all tax positions. Further, appropriate representation and fair presentation of the results of operations would not be accomplished because net income would be understated in

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7 Many larger enterprises are constantly under examination by the Large and Mid-Sized Business Division of the U.S. Internal Revenue Service, as well as many state and foreign tax authorities. In such cases, there is little risk that the taxes of the enterprise will not be examined, limiting any risk of detection to a risk that a particular issue will not be raised in an examination.

8 “In evaluating the significant Federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.” T.D. 9165 [31 CFR Part 10], Par. 3, § 10.35(c)(3)(iii).
the periods in which the reserves were created, and overstated in later periods as audits, settlements and litigation resolved the uncertainties and reserves were reversed. As such, the quality and usefulness of the information presented in the financial statements is degraded and not improved by the use of the asset approach. Further, the existence of unsustainable excess reserves encourages the utilization of earnings management practices that have been the subject of enforcement scrutiny of late.

A more workable solution, if the Board determined that it would continue with the asset approach, would be to use a “more-likely-than-not” standard\(^9\) (i.e., a probability greater than 50%) coupled with the use of a “best estimate” assessment of the ultimate outcome of all tax positions. This would require a “win/lose” determination, a much more attainable and comfortable determination that does not further introduce great new uncertainties into an assessment of the uncertainties in question.

The proposed use of the dual thresholds for recognition and derecognition of the benefits of uncertain tax benefits is also problematic. In addition to our difficulty in understanding the theoretical basis for the disparate treatments, it would seem that the approach would create inconsistencies and distortions in the financial reporting of the enterprise. This is especially likely in situations where a position is reported in multiple years and the assessment of the probable recognition threshold falls from more than 75 percent to something in excess of 50 percent during the years in question. In such circumstances, the benefit would be recognized in some years and reserved in others, creating a radically different outcome in the statements.

**Implementation Timing and Transition Effects**

Lastly, the proposed timetable for implementation of the Interpretation is unrealistic, and will itself introduce both material flaws and unnecessary costs into the Board’s efforts. This timetable would require the completion of all necessary tax opinions and underlying analysis in a very tight timeframe, a fact previously discussed by the Board and on which it indicated it expected comments. In addition to the effects on financial statements prepared *only three months from now* under the pronouncements as so revised, many enterprises may possibly experience even earlier effects in the Management Discussion and Analysis sections of filings with the Securities and Exchange Commission and other public disclosures to shareholders and

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\(^9\)Under the new Treasury tax practice regulations, “marketed opinions” (written advice the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending a plan or investment) must reach a conclusion that the client will prevail on the merits at a confidence level of at least more-likely-than-not with respect to each significant federal tax issue. T.D. 9165 [31 CFR Part 10], Par. 3, § 10.35(c)(3)(iv). [Note the use of the term “will” rather than “should.”] Similarly under provisions of the Internal Revenue Code (recently amended as part of the Jobs Creation Act of 2004), this same standard is required in opinions that may operate to excuse the taxpayer from the imposition of certain penalties in regard to the reporting of transactions in tax returns. Adoption of such a standard in the Interpretation would help to conform the treatments.
investors, lenders, and other parties in regard to addressing changes to significant accounting policies under SEC Staff Accounting Bulletin 74.

In order to comply, enterprises must interpret the final policy of the Board, distribute the changes in internal policies to all business units on a worldwide basis, apply the new policies to affected tax positions and transactions in all relevant accounting records, review and discuss the resulting financial statement effects with all affected internal personnel and external auditors, and develop and create documentation and controls that are compliant not only with these rules but also with the requirements of the Sarbanes-Oxley Act of 2002. For a large multinational enterprise, this may entail an enormous exercise. For example, in a typical year, corporate tax officials will sign hundreds, sometimes thousands, of U.S. federal, state, and local income, excise, and property tax returns, as well as foreign tax returns. For three large companies recently polled for the data in the preparation of other comments, the average of the total number of federal, state and local, and foreign returns filed on an annual basis is approximately 53,000. Each of these returns may contain multiple positions that would have to be evaluated and subjected to these requirements. Further, most companies have multiple open years (years in which the applicable statutes of limitations have not yet run). The collection of required book and tax accounting information and documentation, and the assessment of many thousands of issues against the standards that are finally adopted by the Board and preparation of attendant professional opinions will be a daunting, time-consuming, and very expensive challenge to even the best organized companies. The costs of the exercise, particularly if staff is sequestered to perform the work on an emergency timetable, will be extensive. These standards should not be effective before the end of calendar year 2006 at the earliest, assuming they are finalized in the next few months, and it will be important to most companies that they be adopted on a calendar year basis.

Transitional effects should also be carefully considered. For example, should the standard applicable to positions taken on past-year returns in open years be evaluated on the "probable" standard for new positions or the "more-likely-than-not" standard for derecognizing previous positions? In the initial year of adoption unusual situations could arise for those currently under audit. There may be a number of issues that do not meet the probable standard in the Interpretation. However, the IRS may not have raised them in the current audit, which is not closed because there are a number of items that are going through the appeals process. The Interpretation would apparently provide a liability for such positions that would need to be reversed once the final assessment is signed after other issues go through appeals.

The Interpretation leaves a lack of clarity on other important issues that are raised by the transition to the new standards. For example, the Interpretation indicates that the EITF 93-7 rules on subsequent changes in tax reserves set up in purchase accounting would continue to apply, but leaves open to speculation some important aspects of the application of those rules as the Interpretation does not specifically clarify that any increase in contingencies related to pre-acquisition periods of acquired companies not be taken through the cumulative effective adjustment at the time the new Interpretation is adopted, but continue to be adjustments to
Financial Accounting Standards Board  
Attention: Technical Director  
File Reference No. 1215-001  
September 12, 2005

Page 10

goodwill. The Board should clarify, perhaps in an example, that adjustments made for transactions also covered by EITF 93-7 are covered by the application of those rules and not under the more general rules of the Interpretation. For instance, assume Company A acquires Sub B on 1/1/04. As part of the acquisition, Company A sets up $100 of income tax reserves for Sub B, all of which, under purchase accounting, resulted in a $100 goodwill item. Assume there is no other goodwill booked for this acquisition. Company A adopts the new Interpretation on 12/31/05. As part of that adoption, Company A increases its income tax reserves for Sub B by $50. This increase should likewise be reflected on 12/31/05 through an adjustment to the goodwill accounts created under the purchase accounting for Sub B. Assume further that in 2007, Company A settles its audits of Sub B for $100, meaning the incremental adjustment of $50 set up on 12/31/05 is not needed. The $100 payment reduces Company A's goodwill. Likewise, the Interpretation should make clear that the remaining $50 adjustment is also taken to reduce goodwill. Absent this clarification, some might construe the interpretation to require that the $50 adjustment for the increase in tax reserves on 12/31/05 should be taken as an adjustment to the current income accounts in the cumulative effect adjustment at the time the Interpretation is adopted, and then the method of the reversal in 2007 would be unclear and possibly inconsistent with the more settled principles of EITF 93-7.

RESPONSES TO SPECIFIC QUESTIONS RAISED BY THE STAFF

Scope

Issue 1: This proposed Interpretation would broadly apply to all tax positions accounted for in accordance with Statement 109, including tax positions that pertain to assets and liabilities acquired in business combinations. It would apply to tax positions taken in tax returns previously filed as well as positions anticipated to be taken in future tax returns. Do you agree with the scope of the proposed Interpretation? If not, why not?

We agree with the scope of the proposed Interpretation. We believe it is consistent with the objective of establishing consistency of accounting practice in this area, but ask the Board to take into account the implications of the scope in finalizing the Interpretation.

In order to comply, enterprises must interpret the final policy of the Board, distribute the changes in internal policies to all business units on a worldwide basis, apply the new policies to affected tax positions and transactions in all relevant accounting records, review and discuss the resulting financial statement effects with all affected internal personnel and external auditors, and develop and create documentation and controls that are compliant not only with these rules but also with the requirements of the Sarbanes-Oxley Act of 2002. For a large multinational enterprise, this may entail an enormous exercise. For example, in a typical year, corporate tax officials will sign hundreds, sometimes thousands, of U.S. federal, state, and local income, excise, and property tax returns, as well as foreign tax returns. For three large companies recently polled for the data in the preparation of other comments, the average of the total number
of federal, state and local, and foreign returns filed on an annual basis is approximately 53,000. Each of these returns may contain multiple positions that would have to be evaluated and subjected to these requirements. Further, most companies have multiple open years (years in which the applicable statutes of limitations have not yet run). The collection of required book and tax accounting information and documentation, and the assessment of many thousands of issues against the standards that are finally adopted by the Board and preparation of attendant professional opinions will be a daunting, time-consuming, and very expensive challenge to even the best organized companies. The costs of the exercise, particularly if staff is sequestered to perform the work on an emergency timetable, will be extensive. These standards should not be effective before the end of calendar year 2006 at the earliest, assuming they are finalized in the next few months, and it will be important to most companies that they be adopted on a calendar year basis.

Transitional effects should also be carefully considered. For example, should the standard applicable to positions taken on past-year returns in open years be evaluated on the "probable" standard for new positions or the "more-likely-than-not" standard for derecognizing previous positions? In the initial year of adoption unusual situations could arise for those currently under audit. There may be a number of issues that do not meet the probable standard in the Interpretation. However, the IRS may not have raised them in the current audit, which is not closed because there are a number of items that are going through the appeals process. The Interpretation would apparently provide a liability for such positions that would need to be reversed once the final assessment is signed after other issues go through appeals.

The Interpretation leaves a lack of clarity on other important issues that are raised by the transition to the new standards. For example, the Interpretation indicates that the EITF 93-7 rules on subsequent changes in tax reserves set up in purchase accounting would continue to apply, but leaves open to speculation some important aspects of the application of those rules as the Interpretation does not specifically clarify that any increase in contingencies related to pre-acquisition periods of acquired companies not be taken through the cumulative effective adjustment at the time the new Interpretation is adopted, but continue to be adjustments to goodwill. The Board should clarify, perhaps in an example, that adjustments made for transactions also covered by EITF 93-7 are covered by the application of those rules and not under the more general rules of the Interpretation. For instance, assume Company A acquires Sub B on 1/1/04. As part of the acquisition, Company A sets up $100 of income tax reserves for Sub B, all of which, under purchase accounting, resulted in a $100 goodwill item. Assume there is no other goodwill booked for this acquisition. Company A adopts the new Interpretation on 12/31/05. As part of that adoption, Company A increases its income tax reserves for Sub B by $50. This increase should likewise be reflected on 12/31/05 through an adjustment to the goodwill accounts created under the purchase accounting for Sub B. Assume further that in 2007, Company A settles its audits of Sub B for $100, meaning the incremental adjustment of $50 set up on 12/31/05 is not needed. The $100 payment reduces Company A's goodwill. Likewise, the Interpretation should make clear that the remaining $50 adjustment is also taken to reduce goodwill. Absent this clarification, some might construe the interpretation to require that the $50
adjustment for the increase in tax reserves on 12/31/05 should be taken as an adjustment to the current income accounts in the cumulative effect adjustment at the time the Interpretation is adopted, and then the method of the reversal in 2007 would be unclear and possibly inconsistent with the more settled principles of EITF 93-7.

Initial Recognition

Issue 2: The Board concluded that the recognition threshold should presume a taxing authority will, during an audit, evaluate a tax position taken or expected to be taken when assessing recognition of an uncertain tax position. (Refer to paragraphs B12–B15 in the basis for conclusions.) Do you agree? If not, why not?

We agree that the recognition threshold should presume a taxing authority would examine all positions.

As noted above, Board minutes indicate that to some degree the choice of the asset approach was dictated by a concern that the impairment approach required consideration of “detection risk” under FAS 5, par. 38. The Council submits that such an approach does not inherently include such a factor. Paragraph 38 deals with unasserted claims and assessments and recovery in general civil actions (e.g., tort claims and patent infringement) and not specifically with tax matters. Under standards of tax practice applicable to tax opinions as adopted by the American Bar Association, the American Institute of Certified Public Accountants, and the U.S. Department of the Treasury, practitioners may not use audit risk as a basis for their judgment as to whether a position will succeed on its merits. The Council agrees with the public policy behind that principle and agrees with the Board that the risk of audit detection is not an appropriate consideration in determining the accounting treatment of uncertain tax positions. It is not clear that FAS 5 would require otherwise in Paragraph 38, and if there is doubt on that point, a simple clarification would effectively remove this concern.

If the Board concludes that it must divert from a Statement 5 model, we would suggest that the Board consider amending paragraph 39 of Statement 5, which currently includes an income tax example.

Issue 3: The Board decided on a dual threshold approach that would require one threshold for recognition and another threshold for derecognition. The Board concluded that a tax

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10 Many larger enterprises are constantly under examination by the Large and Mid-Sized Business Division of the U.S. Internal Revenue Service, as well as many state and foreign tax authorities. In such cases, there is little risk that the taxes of the enterprise will not be examined, limiting any risk of detection to a risk that a particular issue will not be raised in an examination.

11 "In evaluating the significant Federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.” T.D. 9165 [31 CFR Part 10], Par. 3, § 10.35(c)(3)(iii).
position must meet a probable (as that term is used in Statement 5) threshold for a benefit to be recognized in the financial statements. (Refer to paragraphs B16–B21 in the basis for conclusions.) Do you agree with the dual threshold approach? Do you agree with the selection of probable as the recognition threshold? If not, what alternative approach or threshold should the Board consider?

We strongly disagree with the dual threshold approach and the proposed "probable" recognition threshold.

The proposed use of the dual thresholds for recognition and derecognition of the benefits of uncertain tax benefits is problematic. In addition to our difficulty in understanding the theoretical basis for the disparate treatments, it would seem that the approach would create inconsistencies and distortions in the financial reporting of the enterprise. This is especially likely in situations where a position is reported in multiple years and the assessment of the probable recognition threshold falls from more than 75 percent to something in excess of 50 percent during the years in question. In such circumstances, the benefit would be recognized in some years and reserved in others, creating a radically different outcome in the statements.

The use of this approach will result in systematic over-accrual of liabilities versus management's best estimate of the ultimate outcome of all tax positions. Net income will be distorted at the time reserves are established and in subsequent periods when reserves are reversed. The liability also will not correspond to expected cash flows.

In developing its proposed asset approach, the Board would establish the probable recognition threshold for uncertain tax benefits as "probable." The Council believes that this standard is too restrictive, and does not permit these positions to be fairly presented. Neither the Interpretation nor FAS 5 define "probable" in quantifiable terms – FAS 5 simply says that it means that "[t]he future event or events are likely to occur," contrasting the term with "Reasonably possible" and "Remote." Common accounting practice would dictate a threshold of around 70-75 percent or more. Given the complexity of many tax issues, the uncertainties of the applicable, underlying facts, the dearth of legal and accounting authority on many critical points, and the exercise of professional judgment required to make this determination, one can reasonably complain that the standard is simply unworkable. Further, given the stakes involved, and recently reinforced requirements for documentation of these judgments under the Sarbanes-Oxley Act of 2002, and other applicable rules, no one would want to be held to such a precise standard.

Under the proposed conservative approach dictated by the Interpretation, full reserves would be established on positions having sustention probabilities between more-likely-than-not and probable. This could result in the over-accrual of liabilities, and would likely be different than the approach that management would characteristically apply to its best estimate of the ultimate outcome of all tax positions. Further, appropriate representation and fair presentation of the results of operations would not be accomplished because net income would be understated in
the periods in which the reserves were created, and overstated in later periods as audits, settlements and litigation resolved the uncertainties and reserves were reversed. As such, the quality and usefulness of the information presented in the financial statements is degraded and not improved by the use of the asset approach. Further, the existence of unsustainable excess reserves encourages the utilization of earnings management practices that have been the subject of enforcement scrutiny of late.

A more workable solution, if the Board determined that it would continue with the asset approach, would be to use a “more-likely-than-not” standard\(^\text{12}\) (i.e., a probability greater than 50\%) coupled with the use of a “best estimate” assessment of the ultimate outcome of all tax positions. This would require a “win/lose” determination, a much more attainable and comfortable determination that does not further introduce great new uncertainties into an assessment of the uncertainties in question.

Subsequent Recognition

Issue 4: The Board concluded that a tax position that did not previously meet the probable recognition threshold should be recognized in any later period in which the enterprise subsequently concludes that the probable recognition threshold has been met. (Refer to paragraph B22 in the basis for conclusions.) Do you agree? If not, why not?

We would agree that a tax position that did not previously meet the recognition threshold should be recognized in later periods in which the company concludes that the threshold has been met, if the “asset approach” is adopted. However, we would prefer the use of a "more likely than not" threshold criteria as noted previously.

Derecognition

Issue 5: The Board concluded that a previously recognized tax position that no longer meets the probable recognition threshold should be derecognized by recording an income tax liability or reducing a deferred tax asset in the period in which the enterprise concludes that it is more likely than not that the position will not be sustained on audit. A valuation allowance as described in Statement 109 or a valuation account as described in FASB Concepts Statement No. 6, Elements of Financial Statements, should not be used as a

\(^{12}\text{Under the new Treasury tax practice regulations, “marketed opinions” (written advice the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending a plan or investment) must reach a conclusion that the client will prevail on the merits at a confidence level of at least more-likely-than-not with respect to each significant federal tax issue. T.D. 9165 [31 CFR Part 10], Par. 3, § 10.35(c)(3)(iv). [Note the use of the term “will” rather than “should.”] Similarly under provisions of the Internal Revenue Code (recently amended as part of the Jobs Creation Act of 2004), this same standard is required in opinions that may operate to excuse the taxpayer from the imposition of certain penalties in regard to the reporting of transactions in tax returns. Adoption of such a standard in the Interpretation would help to conform the treatments.}
substitute for derecognition of the benefit of a tax position. (Refer to paragraphs B23–B25 in the basis for conclusions.) Do you agree with the Board’s conclusions on derecognition of previously recognized tax positions? If not, why not?

We would agree that a previously recognized tax position that no longer meets the recognition threshold should be derecognized in the period when such a determination is made, if the “asset approach” is adopted. However, we believe that a single threshold of “more likely than not” is appropriate for the reasons noted previously.

We would agree that a FAS 109 valuation account should not be used to effect derecognition, if the “asset approach” is adopted.

Measurement

Issue 6: The Board concluded that once the probable recognition threshold is met, the best estimate of the amount that would be sustained on audit should be recognized. The Board concluded that any subsequent changes in that recognized amount should be made using a best estimate methodology and recognized in the period of the change. (Refer to paragraphs B9–B11 and B26–B29 in the basis for conclusions.) Do you agree with the Board’s conclusions on measurement? If not, why not?

We agree with the use of a “best estimate” approach to measure the amount of tax benefit that would be sustained.

Classification

Issue 7: The Board concluded that the liability arising from the difference between the tax position and the amount recognized and measured pursuant to this proposed Interpretation should be classified as a current liability for amounts that are anticipated to be paid within one year or the operating cycle, if longer. Unless that liability arises from a taxable temporary difference as defined in Statement 109, it should not be classified as a deferred tax liability. (Refer to paragraphs B30–B35 in the basis for conclusions.) Do you agree with the Board’s conclusions on classification? If not, why not?

We agree that liabilities arising from the differences between the tax position and amount recognized should be separated into short-term and long-term components, and that such classifications should result from the timing of anticipated settlements.

Change in Judgment

Issue 8: The Board concluded that, consistent with the guidance in paragraph 194 of Statement 109, a change in the recognition, derecognition, or measurement of a tax position should be recognized entirely in the interim period in which the change in judgment
occurs. (Refer to paragraph B36 in the basis for conclusions.) Do you agree with the Board’s conclusions about a change in judgment? If not, why not?

We agree that the effect of a change in recognition, derecognition, or measurement of a tax position should be recognized entirely in the interim period in which the change in judgment occurs, if the “asset approach” is adopted.

However, the inherent difficulties in determining the actual tax liability for interim periods makes the discrete approach employed by the Board conceptually suspect. Accounting for certain elements of the tax provision on a quarterly basis and others (e.g., the annual effective tax rate) on an annual basis strains the meaningfulness of the data presented.

Interest and Penalties

Issue 9: The Board concluded that if the relevant tax law requires payment of interest on underpayment of income taxes, accrual of interest should be based on the difference between the tax benefit recognized in the financial statements and the tax position in the period the interest is deemed to have been incurred. Similarly, if a statutory penalty would apply to a particular tax position, a liability for that penalty should be recognized in the period the penalty is deemed to have been incurred. Because 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. (Refer to paragraphs B37–B39 in the basis for conclusions.) Do you agree with the Board’s conclusions about recognition, measurement, and classification of interest and penalties? If not, why not?

We agree that accrual of interest should be based on the difference between the tax benefit recognized in the financial statements and the tax position in the period the interest is deemed to have been incurred. Similarly, if a statutory penalty would apply to a particular tax filing position that is being reserved, a corresponding liability for that penalty should be recognized in the period the penalty is deemed to have been incurred.

Although we agree with the concept, it should be emphasized that the accrual of interest on uncertain tax positions recognized under the standard posed by the Board in the Interpretation further increases the amount that will likely be reversed in future periods when the positions are sustained, and the distortive effects of using that approach and standard.

Disclosures

Issue 10: The Board concluded that loss contingencies relating to previously recognized tax positions should be disclosed in accordance with the provisions of paragraphs 9–11 of Statement 5. The Board also concluded that liabilities recognized in the financial statements pursuant to this proposed Interpretation for tax positions that do not meet the
probable recognition threshold are similar to contingent gains. Therefore, those liabilities
should be disclosed in accordance with the provisions of paragraph 17 of Statement 5.
(Refer to paragraph B40 in the basis for conclusions.) Do you agree with the disclosure
requirements? If not, why not?

We agree that disclosures of loss contingencies and contingent gains relating to
previously recognized tax positions should be disclosed in accordance with the provisions of
FAS 5.

Effective Date and Transition

Issue 11: The Board concluded that this proposed Interpretation should be effective as of
the end of the first fiscal year ending after December 15, 2005. Only tax positions that meet
the probable recognition threshold at that date may be recognized. The cumulative effect of
initially applying this proposed Interpretation would be recognized as a change in
accounting principle as of the end of the period in which this proposed Interpretation is
adopted. Restatement of previously issued interim or annual financial statements and pro
forma disclosures for prior periods is not permitted. Earlier application is encouraged.
(Refer to paragraphs B41–B43 in the basis for conclusions.) Do you agree with the Board’s
conclusions on effective date? If not, how much time would you anticipate will be necessary
to apply the provisions of this proposed Interpretation? Do you agree with the Board’s
conclusions on transition? If not, why not?

The proposed timetable for implementation of the Interpretation is unrealistic, and will
itself introduce both material flaws and unnecessary costs into the Board’s efforts. This
timetable would require the completion of all necessary tax opinions and underlying analysis in a
very tight timeframe, a fact previously discussed by the Board and on which it indicated it
expected comments. In addition to the effects on financial statements prepared only three
months from now under the pronouncements as so revised, many enterprises may possibly
experience even earlier effects in the Management Discussion and Analysis sections of filings
with the Securities and Exchange Commission and other public disclosures to shareholders and
investors, lenders, and other parties in regard to addressing changes to significant accounting
policies under SEC Staff Accounting Bulletin 74.

In order to comply, enterprises must interpret the final policy of the Board, distribute the
changes in internal policies to all business units on a worldwide basis, apply the new policies to
affected tax positions and transactions in all relevant accounting records, review and discuss the
resulting financial statement effects with all affected internal personnel and external auditors,
and develop and create documentation and controls that are compliant not only with these rules
but also with the requirements of the Sarbanes-Oxley Act of 2002. For a large multinational
enterprise, this may entail an enormous exercise. For example, in a typical year, corporate tax
officials will sign hundreds, sometimes thousands, of U.S. federal, state, and local income,
excise, and property tax returns, as well as foreign tax returns. For three large companies
recently polled for the data in the preparation of other comments, the average of the total number of federal, state and local, and foreign returns filed on an annual basis is approximately 53,000. Each of these returns may contain multiple positions that would have to be evaluated and subjected to these requirements. Further, most companies have multiple open years (years in which the applicable statutes of limitations have not yet run). The collection of required book and tax accounting information and documentation, and the assessment of many thousands of issues against the standards that are finally adopted by the Board and preparation of attendant professional opinions will be a daunting, time-consuming, and very expensive challenge to even the best organized companies. The costs of the exercise, particularly if staff is sequestered to perform the work on an emergency timetable, will be extensive. These standards should not be effective before the end of calendar year 2006 at the earliest, assuming they are finalized in the next few months, and it will be important to most companies that they be adopted on a calendar year basis.

Transitional effects should also be carefully considered. For example, should the standard applicable to positions taken on past-year returns in open years be evaluated on the "probable" standard for new positions or the "more-likely-than-not" standard for derecognizing previous positions? In the initial year of adoption unusual situations could arise for those currently under audit. There may be a number of issues that do not meet the probable standard in the Interpretation. However, the IRS may not have raised them in the current audit, which is not closed because there are a number of items that are going through the appeals process. The Interpretation would apparently provide a liability for such positions that would need to be reversed once the final assessment is signed after other issues go through appeals.

The Interpretation leaves a lack of clarity on other important issues that are raised by the transition to the new standards. For example, the Interpretation indicates that the EITF 93-7 rules on subsequent changes in tax reserves set up in purchase accounting would continue to apply, but leaves open to speculation some important aspects of the application of those rules as the Interpretation does not specifically clarify that any increase in contingencies related to pre-acquisition periods of acquired companies not be taken through the cumulative effective adjustment at the time the new Interpretation is adopted, but continue to be adjustments to goodwill. The Board should clarify, perhaps in an example, that adjustments made for transactions also covered by EITF 93-7 are covered by the application of those rules and not under the more general rules of the Interpretation. For instance, assume Company A acquires Sub B on 1/1/04. As part of the acquisition, Company A sets up $100 of income tax reserves for Sub B, all of which, under purchase accounting, resulted in a $100 goodwill item. Assume there is no other goodwill booked for this acquisition. Company A adopts the new Interpretation on 12/31/05. As part of that adoption, Company A increases its income tax reserves for Sub B by $50. This increase should likewise be reflected on 12/31/05 through an adjustment to the goodwill accounts created under the purchase accounting for Sub B. Assume further that in 2007, Company A settles its audits of Sub B for $100, meaning the incremental adjustment of $50 set up on 12/31/05 is not needed. The $100 payment reduces Company A's goodwill. Likewise, the Interpretation should make clear that the remaining $50 adjustment is also taken to reduce
goodwill. Absent this clarification, some might construe the interpretation to require that the $50 adjustment for the increase in tax reserves on 12/31/05 should be taken as an adjustment to the current income accounts in the cumulative effect adjustment at the time the Interpretation is adopted, and then the method of the reversal in 2007 would be unclear and possibly inconsistent with the more settled principles of EITF 93-7.

We agree that restatement of previously issued financial statements should not be permitted and that the cumulative effect of adoption should be reported as a change in accounting principle.

**IN CONCLUSION**

We thank the Board for the opportunity to present these comments on the Interpretation. We would be willing to meet with the Board or its staff to further explain our views.

Any questions about the views of the Council may be directed to me at (610) 481-4462 or petrinkr@airproducts.com, or to Mr. Roger LeMaster, Executive Director of the Council, at (202) 822-8062 or rlemaster@thetaxcouncil.org.

Respectfully submitted,

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