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**Diann L. Smith**  
General Counsel  
(202) 484-5215  
[DSmith@statetax.org](mailto:DSmith@statetax.org)

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Technical Director – File Reference 1215-001  
Financial Accounting Standards Board  
401 Merrit 7  
P.O. Box 5116  
Norwalk, CT 06856-5166  
[director@fasb.org](mailto:director@fasb.org)

VIA E-MAIL

**Re: Exposure Draft of the Proposed Interpretation of FASB Statement No. 109 – Accounting for Uncertain Tax Positions, Dated July 14, 2005 (the “Exposure Draft”)**

Dear Technical Director:

Pursuant to the formal request for comments by the FASB on the Exposure Draft, the Council On State Taxation (COST) submits the following comments regarding the Draft’s major impact on state and local tax positions. COST is concerned that these positions may not have been fully considered in the production of this draft, as reflected in the emphasis in the examples on federal income tax issues. Because forty-five states and numerous local jurisdictions impose taxes measured by net income, multistate corporate taxpayers will be required to apply the Exposure Draft’s standards to such state and local taxes as well as federal income taxes in preparing their financial statements. Since state and local corporate income taxes have unique issues not found in the federal system, COST strongly suggests that the FASB carefully consider these state and local tax issues before finalizing any further guidance on FAS 109.

It is important to note that COST is not opposed to the FASB’s effort to impose some consistency of treatment of uncertain tax positions for financial statement purposes, and it is likely that a standard will actually help many taxpayers in working with public accounting firms in determining proper financial statement treatment of tax positions. However, as more fully discussed below, because of the unique nature of state and local income tax laws, several of the proposals in the Exposure Draft will be particularly onerous or administratively burdensome for the state and local tax component and thus, COST suggests that a) the effective date be delayed; b) the standard be reduced to “more likely than not”; and c) the Exposure Draft include examples specifically dealing with state and local tax issues.

## About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of 575 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory State and local taxation of multijurisdictional business entities.

### Issues in Applying the Exposure Draft to State and Local Corporate Income Taxes

#### Cost of Implementation

The primary and potentially overwhelming problem with applying the Exposure Draft in the state and local corporate income tax arena is the sheer number of jurisdictions that impose such taxes and the non-uniformity among those jurisdictions. Forty-five states and numerous local jurisdictions impose a corporate income tax. While many of these states adopt elements of a uniform corporate income tax law, the Uniform Division of Income for Tax Purposes Act ("UDITPA"), the vast majority of these jurisdictions fail to adopt UDITPA in its entirety<sup>1</sup>; several of these jurisdictions do not adopt the model act at all<sup>2</sup>, and impose a completely unique income tax; all of these jurisdictions have varying interpretive regulations and judicial opinions<sup>3</sup>. The result is a mind boggling number of unique laws with which a taxpayer must not only attempt to comply, but, under the Exposure Draft, must evaluate and document that such a position is "likely to occur" – otherwise known as the "probable standard".

Under the Exposure Draft, a taxpayer must evaluate each tax position reflected on its returns in every single state and local jurisdiction to determine whether the filed position is "probable" of being sustained on audit. If a taxpayer determines that its position is "probable" it must still separately determine the "best estimate" of the amount that will ultimately be realized. As noted by several other

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<sup>1</sup> Compare Alabama (AL Code § 40-27-1) – uses an equally weighted three factor (property, payroll, and sales) to apportion income to the state with Arizona (AZ Rev. Stat. §§. 43-1131 --Sec. 43-1150 – uses a double weighted sales factor; Compare Missouri (Rev. Stat. of Mo, § 32.200) – "Business income" is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations with Kentucky (KY Rev. Stat., § 141.120(1)(a) which replaces "and" in last clause with "or".

<sup>2</sup> For example, New York, Washington (B&O Tax), Michigan (SBT), and Ohio (CAT).

<sup>3</sup> Compare Alabama does not exclude officer compensation from the payroll factor. (Ala Admin Code r. 810-27-1-4-.13(a)(3) and (4)) with Mississippi excludes officer compensation from the payroll factor. (Correspondence from the Mississippi State Tax Commission, Corporate Income Tax Section, September 14, 2004, CCH ¶11-535.

commentators, these determinations are not easy at the federal level – in which only one tax system is involved. At the state and local level, this difficulty is magnified exponentially. Such an analysis would require significant amounts of additional research into the legal authorities in each state, including statutes, regulations, judicial decisions, administrative rulings, private letter rulings, and general guidance from state tax departments through such items as published audit manuals and newsletters. Taxpayers may need to contact numerous local practitioners to determine whether a “should” opinion can be obtained. The tax issues at the state and local level are no less complicated than at the federal level, but they are exponentially increased due to the number of taxing jurisdictions involved.

### **Unique Aspects of State and Local Tax Systems that Make the “Probable” Standard a Difficult Standard to Apply**

Unlike at the federal level, state and local governments frequently do not have the wealth of legal and technical guidance available to help taxpayers in taking tax positions. In many states, particularly the smaller ones, the regulations are sparse and/or infrequently updated. Many states do not issue any type of revenue department interpretive guidance on complicated issues. Similarly, many states do not issue private letter rulings on controversial issues. Thus, much of the practice of state and local tax is through oral discussions with tax department personnel, other practitioners, or other taxpayers as to how a particular item should be handled. It appears extremely unlikely that a law firm could issue a “should” opinion based on such anecdotal conversations and it is extremely questionable whether a taxpayer would feel comfortable relying on such “lore” to reach the “probable” standard required under the Exposure Draft. Thus, many completely legitimate and even non-controversial positions may not have the necessary written documentation to support recognizing the filing position on the financial statement, making the financial statement an unreliable reflection of the taxpayer’s true liability.

Another problem with the number of jurisdictions at the state and local level is that similar, or frequently identical laws, are interpreted differently either through agency regulations or pronouncements or through judicial decisions. A classic example of this occurs in determining whether income is classified as business income (and thus apportioned among all states in which the taxpayer is doing business) or non-business income (and thus allocated fully to only one state) in the situation in which a business is liquidated or liquidates an entire business line. Relying on identical statutory language, some states have determined that the gain from such a liquidation is business income while others have determined it is non-business income.<sup>4</sup> Most states, however, have not commented on this

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<sup>4</sup> Compare Liquidation of business is nonbusiness income - *Laurel Pipe Line Co. v. Commonwealth of Pennsylvania*, Board of Finance & Revenue, 537 Pa. 205, 642 A.2d 472 (1994) with Liquidation of business is not business income - *Appeal of Oryx Energy Co.*, *Cal. St. Bd. of Equal*, July 9, 2003 (2003 WL 21693922).

situation at all. What should a taxpayer do if it is in a state that has not commented on the rule? How can a taxpayer reach a probable level of certainty when some states have clearly ruled against that position, while other states specifically agree?

Even if a taxpayer is able to reach the “probable” standard, the issue of how to determine the “best estimate” of the amount actually realized remains. May a taxpayer rely on an audit in another state with a similar law if the issue has not previously arisen on the return in the state in question? How should a taxpayer determine its “best estimate” of identical issues in two different states, one where -- based on lack of guidance -- the taxpayer has not reached a probable opinion, but in the other has reached a probable opinion because of previous audit experience?

### **Many Major Areas of State and Local Tax Law Remain Unresolved**

Another problem with imposing the “probable” standard in the state and local tax area is that there are several major issues with enormous potential financial implications that remain unresolved. The first, and perhaps most important of these is the threshold of activity a taxpayer must have before it must file an income tax return in the state. This threshold is governed by the U.S. Constitution’s negative commerce clause, which prohibits states from unduly burdening interstate commerce. It is not an exaggeration to note that since the first state income tax was imposed, taxpayers have never been certain as to what activities will subject them to taxing jurisdiction. The only definitive pronouncement on this issue by the United States Supreme Court (the only Court whose rulings apply uniformly to all states) is in the sales and use tax arena, not the income tax arena. Thus, dozens of controversies in every state as to what level of activity a taxpayer must reach in that state before it is liable for corporate income taxes in that state remain unresolved.

Further complicating this analysis is a trap for the unwary. If a taxpayer determines it does not have the requisite activity and thus does not file a return, the statute of limitations for an assessment never expires. Thus, a taxpayer will be in the awkward position of taking a perfectly legitimate position regarding its filing requirements in a given state, but because of the controversial state of the law, the taxpayer will be unable to reach the requisite “probable” level on the position. Thus the potential liability to the state will never disappear from its financial statements unless the taxpayer is actually audited and the state determines it does not have nexus.

Another area that will cause great angst for state and local taxpayers is in determining both whether the “probable standard” has been met and if so, what is the “best estimate” of the amount to be actually realized for expected refunds for taxes that have been finally adjudicated unconstitutional or otherwise invalid. Many states have a dubious record of paying refunds, even when there remains no

controversy as to the legitimacy of the tax.<sup>5</sup> Can a taxpayer reach the probable standard if a state continues to litigate its responsibility to pay refunds? If that standard can be reached but the state continues to delay full payment, how should the taxpayer determine the “best estimate”?

A significant question also arises as a result of the number of jurisdictions involved. When may a taxpayer rely on the interpretation of another state on a similar law? For that matter, must a taxpayer consider written guidance from the Multistate Tax Commission, a government organization representing less than half the states, if the state in question has not yet adopted the MTC’s position?

The issues and questions raised above are not isolated or taxpayer-specific problems, and they represent only the tip of the iceberg. Unresolved and controversial issues permeate the state and local tax field. Because of the considerable uncertainty for many of the major legal issues in state and local tax, taxpayers and their outside auditors would be greatly aided by a discussion, either in the Exposure Draft or through some other mechanism from the FASB, of how to handle these issues to arrive at the most accurate and consistent financial statement reporting possible.

### **Proposed Solution**

First, because of the number of jurisdictions for which a multistate taxpayer will need to review all of its filing positions, it is imperative that the effective date of the Exposure Draft be pushed back at least one year. Currently, the Exposure Draft requires compliance as of the end of the first fiscal year ending after December 15, 2005. That means, for calendar year taxpayers, a review of all positions for all state and local jurisdictions for all open years must be undertaken in an impossibly short period of time.

Second, the Exposure Draft should abandon the “probable” standard and adopt the more easily understood “more likely than not” standard. Particularly in the state and local tax arena, where there is frequently either no government guidance, little government guidance, or conflicting government guidance, the “more likely than not” standard will allow a more realistic picture on the financial statements of the taxpayer’s true liability. The use of the “probable” standard will likely thwart the goals of the Board for the sole reason that appropriate guidance is lacking at the state level, and thus tax positions that *should* meet the probable standard will fail to do so simply because of a lack of adequate support.

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<sup>5</sup> For example, seven years after the United States Supreme Court declared Alabama’s franchise tax discriminated against interstate commerce in *South Central Bell v. Alabama*, 526 U.S. 160 (1999), Alabama has yet to pay any refunds to many taxpayers and has paid a maximum of only 19 cents on the dollar to those taxpayers who have received a refund.

Third, the Exposure Draft should include examples of state and local tax issues. These examples should help taxpayers determine what type of documentation and support will be acceptable to reach the required standard. The examples should also discuss methods for determining “best estimate”.

Finally, the Exposure Draft should add a set look-back period for those positions, such as not filing in a jurisdiction based on a determination that the taxpayer lacks the requisite contacts with the state for tax liability, for which the statute of limitations would otherwise never close. The vast majority of these positions are never subject to audit or assessment. Taxpayers should be able to finalize and close out such positions on their financial statements after an appropriate period (perhaps using the years for which the federal statute remains open as the guide) notwithstanding the lack of a statute of limitations at the state level.

### **Conclusion**

The FASB’s attempt to bring uniformity to the financial statement reporting standards for uncertain tax positions may very well be a benefit for shareholders, taxpayers, and practitioners. However, if the standard is impossibly high, the financial statements will be of little use. If the standard is imposed too soon, an adequate review of taxpayer positions may be impossible, leading to a certain level of triage based on priorities that could lead to inconsistencies between companies, a result the FASB is precisely trying to avoid. Finally, because state and local corporate income taxes can be an important part of a corporation’s tax liability, guidance through examples will add additional uniformity and understanding and thus increased compliance with any standard ultimately adopted. Finally, for those tax positions that may never be finally closed out at the state level because the statute of limitations never runs, a finite time period should be incorporated in the Exposure Draft under which such positions may not be recognized if they fail the “probable” test.

Sincerely,



Diann L. Smith  
General Counsel

cc: Douglas L. Lindholm, President & Executive Director, Council On State Taxation  
COST Board of Directors