



Letter to the FASB on the Exposure Draft: Accounting for Uncertain Tax Positions, September 12, 2005, providing the SVTDG's comments on the Proposed Interpretation of FAS 109

To: Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Regarding: File Reference 1215-001 – Accounting for Uncertain Tax Positions

Dear Sir or Madam:

We are writing to express our comments regarding the Exposure Draft on the Proposed Interpretation, "Accounting for Uncertain Tax Positions – an interpretation of FASB Statement No. 109". The Silicon Valley Tax Directors Group ("SVTDG") was formed in 1983 to promote high technology tax policy of its members consisting of corporate tax executives from small to large corporations predominantly having their headquarters in the San Francisco Bay Area of Northern California. A listing of the SVTDG members can be found at www.svtdg.org. The members of the SVTDG are affected on a daily basis in complying with the conclusions of the Financial Accounting Standards Board ("FASB" or "Board") as reflected in the Proposed Interpretation and appreciate this opportunity to present our views.

We understand that the reason for the Proposed Interpretation project is to address the diversity of practice that exists in accounting for uncertain tax positions. We agree that requiring consistency of accounting practice for uncertain tax positions would be an improvement in financial reporting.

The Exposure Draft sets forth the view that the tax benefit from an uncertain tax position is to be considered an asset, and only tax benefits from uncertain tax positions that are "probable" of being sustained on audit by taxing authorities based solely on the technical merits of the position may be recognized in the financial statements. The Exposure Draft specifies that the meaning of the term "probable" is to be consistent with its use in Paragraph 3(a) of Statement 5 to mean "the future event or events are likely to occur". While there is no further quantification provided in Statement 5, the public accounting firms typically interpret "probable" in the Statement 5 context as a 70-75% likelihood.

The SVTDG respectfully disagrees with the approach recommended in the Exposure Draft. Specifically, we respectfully disagree with: I) the characterization of tax benefits of uncertain tax positions as assets (i.e. an Asset Method); and II) the utilization of a "probable" (70-75% likelihood of success) threshold for recognition of tax benefits from uncertain tax positions. The following discussion addresses these two points.

I. We disagree with the use of an Asset Method for computing contingent tax liabilities

The SVTDG disagrees with the Exposure Draft's view that the tax benefit from an uncertain tax position is to be considered an asset, which is subject to recognition only if high levels of control over the asset and likelihood of success exist. We believe an Asset Method as set forth in the Exposure Draft, would be unduly complex and difficult to apply in practice, and (when coupled with the "probable" recognition threshold specified in the Exposure Draft) would systematically overstate tax liabilities and create inappropriate earnings volatility.

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Taxpayers self-assess and report their tax liabilities. The global tax law is complex and all too often ambiguous, unclear, or in conflict between jurisdictions. Accordingly, uncertain tax positions are not uncommon. One of the premises in the Exposure Draft for the use of the Asset Method seems to be based on the belief that uncertain tax positions result from taxpayers knowing with certainty their tax liability but instead choosing to take an aggressive position in order to try to create an asset (e.g. a tax shelter or listed transaction). While we acknowledge that tax shelters have existed in corporate America, we believe tax shelters represent a very small portion of total uncertain tax positions. In our experience, uncertain tax positions generally arise due to uncertainties, complexities, and ambiguities in the global tax law and the infinite number of fact patterns to which they apply as opposed to corporate taxpayers affirmatively taking aggressive positions in an attempt to create an asset.

The Asset Method assumes (a) that the global tax law is certain (to determine the hypothetical maximum possible taxes and "probable" benefit positions), (b) that all potential government jurisdictions audit all entities for all years and raise all issues (an omniscience and omnipresent standard), and (c) that only "probable" positions may result in a tax benefit. The practical reality of the global tax law is that each of these assumptions is incorrect – the global tax law is not certain; all jurisdictions do not audit all entities for all years and raise all issues; and there is a tremendous amount of tax law and tax positions below "probable" and these positions result in ultimate tax benefits. In fact, in many cases within the global tax law, there is no position that can be taken that is "probable" due to ambiguity and/or complexity of the laws when applied to a particular taxpayer's facts. This is why so much of corporation's uncertain tax liabilities are negotiated in settlement or resolutions discussions with government jurisdictions.

We envision significant implementation problems if an Asset Method is adopted because it would require all taxpayers to construct hypothetical maximum tax models and then prove any reductions (e.g. the tax benefit "assets" which are "probable" of success based solely on technical merits) to their independent financial auditors. We believe the cost of implementing such a complex model would be significant. The model would have to incorporate the omniscience required in the Exposure Draft (that all possible positions are asserted, for all years, for all legal entities, for all jurisdictions). Obviously, this omniscience doesn't occur in practice, so it would require significant effort and judgment to model.

Further, we believe that an asset model would result in the systematic overstatement of liabilities that would need to be released later or in some cases may never be released due to a lack of an event (e.g. "jurisdiction to tax" uncertainties like nexus and permanent establishment). We believe that implementation of an Asset Method is not justified because, as a result of uncertainties in the global tax law, the asset model could actually increase uncertainty in application of the standard and diversity of practice in the financial statements, in addition to systematically overstating tax liabilities.

We believe that more representationally faithful accounting for uncertain tax positions is achieved through the use of a Liability or Impairment model, such as provided for in Statement 5, than the Asset Method chosen in the Exposure Draft. We believe a Liability or Impairment model, such as provided for in Statement 5, more accurately reflects the practical business realities of how the global tax law operates in practice (e.g. the tax law is uncertain, taxpayers file good faith tax returns with supportable tax positions, these tax returns are the starting point for government audit examination, governments audit at their discretion and propose adjustments to the tax return, and then the audit is resolved via negotiated settlements or litigation).



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Statement 5 contains both a recognition threshold and valuation threshold for determining when a loss has been incurred. We note from earlier Board deliberations that the use of an Impairment approach (such as SFAS 5) was rejected in part due to the lack of presumed audit detection. We also note the Exposure Draft's desire to ensure that detection risk be presumed. We believe that because tax audits are regular occurrences (certainly much more regular than general claims and contingencies) and both the AICPA and ABA standards on tax opinions presume audit detection, we respectfully submit that the risk of audit detection has been factored into the determination of whether a loss is "probable" under Statement 5. Accordingly, we do not believe Paragraph 38 of Statement 5 provides a sufficient basis for rejecting the use of Statement 5 to address tax contingencies.

We believe that explicitly requiring Statement 5 to be used for uncertain tax positions in both the initial years and subsequent years would improve consistency in financial statements by conforming the treatment of tax contingencies with those of other loss contingencies in the financial statements. Statement 5 provides for disclosure requirements and the use of Statement 5 would require provision for the best estimate of all "probable" losses. To the extent there is any concern about tax shelters, we note that appropriate reserves for tax shelters can be addressed under a Liability or Impairment method such as Statement 5 and we should not "throw the baby out with the bathwater" by implementing a wholesale change in accounting principle based on a misconception as to the prevalence of these types of positions. We note further that U.S. tax rules have been significantly changed to address such transactions and have changed behavior towards the U.S. self-assessment tax system through additional tax return disclosure, penalties and tax opinion letter requirements. It is worth noting that in the myriad of responses and proposed regulatory and legislative responses by Treasury, IRS and Congress, not one of them included raising the opinion standard – even for self-proclaimed tax shelters – above the "more-likely-than-not" threshold.

Accordingly, we believe that a required implementation of Statement 5 for uncertain tax positions would achieve the objectives of (a) eliminating diversity of practice in accounting for tax contingencies, (b) providing a workable framework for addressing tax contingencies, (c) providing representationally faithful accounting for tax contingencies, and (d) conforming accounting for tax contingencies with the accounting for other types of contingent liabilities contained in the financial statements.

II. We disagree with the use of the Asset Method with a "Probable" recognition threshold

Second, subject to our primary disagreement above on the use of Asset Method, the SVTDG respectfully disagrees with the Exposure Draft's requirement that only tax "probable" of being sustained on audit by taxing authorities based solely on the technical merits of the position may be recognized in the financial statements. The Exposure Draft specifies that the meaning of the term "probable" is to be consistent with its use in Paragraph 3(a) of Statement 5 to mean "the future event or events are likely to occur". While there is no further quantification provided in Statement 5, the public accounting firms typically interpret "probable" in the Statement 5 context as a 70-75% likelihood. We note that this is a higher threshold than that used in Concept Statement 6, which specifies that "assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events". Concept Statement 6 provides that "probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic, but is neither certain nor proved." In practice, the Concept Statement



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6 definition of "probable" (reasonably expected or believed, but not certain nor proved) is generally considered to be less than the Statement 5 "probable".

The Exposure Draft's recommendation of such a high threshold for recognition of tax benefits is in direct conflict with the practical realities of global tax law, wherein a very significant portion of uncertain tax positions fall into the "more-likely-than-not but not probable" threshold (50.1% - 70% likelihood of success). These positions are often the best position that can be taken due to the complexities and ambiguities of the global tax law (in other words, no position may be taken with a "should prevail" likelihood of success in many areas of the global tax law). By adopting an Asset Method with such a high standard (Statement 5 "probable") for recognition, it is a virtual certainty that this combination will result in systematic overstatement of tax liabilities, and in many cases, such systematic overstatement will be material. We also believe this combination will create significant earnings volatility (first when excess reserves are recorded, and then later when the excess reserves are reversed). If this combination were to be adopted (Asset Method with a "Probable" threshold), we believe taxpayers would have to provide additional disclosure to their shareholders to make them aware that the tax expenses and liabilities so provided in the income statement and balance sheet are not amounts that management believes will ever be paid. We submit that this combination (Asset Method with the "Probable" threshold) is not representationally faithful accounting because it will require the recordation of liabilities that will be in excess of the future cash payments. We also note that this combination will not achieve neutrality in the financial statements. Accordingly, we strongly urge the Board to reconsider the use of the Asset Method and the use of a "probable" recognition threshold.

Assuming the Board decides to go forward with an Asset Method, we strongly urge that the recognition threshold be reduced to a "more-likely-than-not" recognition threshold that is made based on practice and policy considerations as well as technical merits. We believe that measurement should be made using management's "best estimate". A reduction in the threshold for recognition to a "more-likely-than-not" threshold (based on practice, policy, and technical merits) coupled with measurement based on management's "best estimate", we believe will result in more representationally faithful accounting for income tax uncertainties. With those changes, we do not believe additional disclosure would be necessary.

In the event that FASB ultimately decides to continue with the proposed Asset Method, the SVTDG has provided below its response to the invitation to submit written comments regarding the eleven issues summarized at the beginning of the Exposure Draft.

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?

The SVTDG disagrees in general with the scope of the Proposed Interpretation, particularly to the extent it embodies the new "probable" standard, and does not as described below, more broadly take into account the risk of assertion by a tax authority, something that a rational investor would take into account in seeking an accurate financial picture of an enterprise. Thus, as described below with regard to Issue 6, there are a variety of circumstances that do not necessarily reflect the "technical merits" that could result in no assertion of tax liability by a tax authority. Moreover, it is wrong to



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assume in such cases, that the taxpayer is “getting away” with something. A variety of policy and practical considerations are often at play, in addition to technical merits. In addition, much like the struggles in the accounting world, the tax law has struggled with getting the “right answer” even in cases when the literal words might lead one to an absurd result – be it pro-government or pro-taxpayer. The Proposed Interpretation would require a company in cases where the technical language leads to an absurd albeit pro-government result to “get the wrong answer” for financial statement purposes, even though the tax world, including the tax authority, may be comfortably getting the “right answer.”

The SVTDG understands that the Proposed Interpretation was initiated in part as a response to the aggressive accounting for tax benefits of certain tax shelter transactions. U.S. tax rules have been significantly changed to address such transactions and have changed behavior towards the U.S. self-assessment tax system through additional tax return disclosure, penalties and tax opinion letter requirements. An asset based test with a “probable” or an “all or nothing” approach to account for uncertain tax positions is not workable in ordinary day-to-day transactions especially for US-based multinational corporations doing business in tax jurisdictions all around the world where interpretations of law are often ambiguous. Accordingly, the SVTDG believes the method set forth in the Exposure Draft (utilizing an Asset Method with a “probable” threshold for recognition of tax benefits) if implemented at all, should be limited to transactions outside the ordinary course of business (e.g. tax shelters or listed transactions).

In addition, the SVTDG believes that it would be helpful to clarify further that the standard outlined in the Proposed Interpretation would not apply to non-income based taxes such as sales and use taxes, and value added taxes.

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?

The SVTDG disagrees with the approach taken in the Proposed Interpretation that one should presume a taxing authority would, during an audit, evaluate a tax position. From a practical standpoint, the rule should not only take into account the validity of a tax position on its technical merits, but also allow the application of known practices and policies of any applicable jurisdiction including the items identified in the response to Issue #6. The automatic presumption of tax authority review solely based on technical merits does not appropriately reflect the tax return review process and will not result in fairly stated tax contingency reserve amounts. Thus, irrespective of the ultimate probability standard that is applied, it should consider the likelihood of assertion. Otherwise, the SVTDG believes that if the standard is adopted as drafted, then a likely result will be many companies accruing large amounts of contingent tax liabilities that will never be paid.

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 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?



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The SVTDG disagrees with the dual threshold approach and believes that both the recognition and derecognition thresholds should be set at a "more-likely-than-not" level. Identifying when a certain tax position is above or below this threshold is more realistic to achieve on a consistent and regular basis. The alternative view detailed in the Proposed Interpretation indicates an initial recognition threshold much lower than "probable", suggesting that "probable" may be too high of a threshold.

If the initial recognition threshold is not ultimately lowered to "more-likely-than-not", then the preference would be for the standard to (a) provide more specific and realistic examples of what type of evidence can be considered in the "probable" determination and not merely be limited to technical merits but also include practical and policy considerations, and (b) make such examples/definitions as broad as possible to encompass non-technical data inputs that have relevance in determining whether a tax position is sustainable, such as the existence of IRS public statements or private letter rulings, known audit positions, risk of assertion, accepted practices even if not present in a prior audit as well as the other items listed in our response below regarding Issue 6.

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?

The SVTDG agrees that a tax position that did not previously meet the standard and meets the standard in a subsequent period should be recognized at that time using a "more-likely-than-not" threshold as discussed above.

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 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?

The SVTDG agrees that the derecognition level should be set at "more-likely-than-not" as to whether the tax position would not be sustained under audit.

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?



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The STVDG generally agrees with the best estimate approach for measurement purposes. However, we believe that the unit of account approach requires clarification in terms of consistent application in practice. Further definition is necessary to avoid this being applied in practice at too detailed a level of granularity such as at a transactional level. In practice, tax audits are frequently settled based on negotiations and compromise of issues rather than on the technical merits of specific items at a unit of account level of detail.

In addition, the SVTDG noted that the best estimate approach allows subsequent changes using a best estimate methodology recognized in the period of the change. In practice, tax contingency items have remained unchanged barring future resolution of the respective issue. The best estimate approach appears to allow for adjustments to tax contingency items in future periods after initial recognition. It would be helpful if the Proposed Interpretation included examples that may result in a change in management's judgment regarding either the recognition threshold or the best estimate. These could include:

1. Oral statements by the tax authority to the company;
2. The passage of time;
3. Audit plans agreed to between the company and the tax authority;
4. Public statements by the tax authority;
5. Manuals and auditing standards issued by the tax authority;
6. Securing an opinion;
7. Changes in the tax law or interpretation thereof;
8. Treatment of the item in a prior audit;
9. Experiences of other companies with the issue either learned directly from other companies or from advisors;
10. Experiences with other tax authorities with the same or similar issues; this is especially relevant where there is a commonality of the tax systems, e.g., a European Court of Justice opinion applied to a similar issue in a different EMEA country, or an OECD interpretation applied to the issue in any OECD country;
11. Various types of rulings, including private letter rulings, pre-filing agreements, advance pricing agreements, etc... when public information and issued to an unrelated party, they are relevant even if not technically precedential;
12. A notice of proposed adjustment, whether agreed or not, for an amount different than the prior estimate;
13. An information document request; and
14. Issuance of a revenue agent report or similar document.

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?

The SVTDG disagrees with the approach taken in the Proposed Interpretation that tax contingency reserves are to be shown as non-current liabilities, unless it is known that payments of cash are anticipated to occur within the current year.



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Management judgment should be allowed to determine whether the current liability classification is appropriate. For example, in cases where actual timing of an audit settlement process is not known or where the timing of payment cannot be reliably determined, a current classification should be allowed.

Changes 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?

The SVTDG agrees with the approach taken in the Proposed Interpretation. It would be helpful to have a definition or examples of what constitutes a "change in judgment" (see issue 6 above).

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?

The SVTDG agrees with the approach taken in the Proposed Interpretation.

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?

The SVTDG agrees with the utilization of the disclosure provisions contained in Statement 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.)



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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 SVTDG believes that a delayed effective date is appropriate given the complexity in applying the standard as written and the dramatic changes the tax world is already addressing such as new FAS Statement 123R and the Sarbanes-Oxley requirements generally. Implementation in accordance with the proposed effective date would not be achievable for the following reasons:

1. Companies will need to conduct a full review of its historic tax positions (not just ones it may have reserved for in the past) to determine whether the appropriate standard has been met as of the date of adoption;
2. Companies will need to discuss each individual tax position with their independent financial statement auditor to understand where differences of opinion exist; for those positions where differences of opinion exist, companies will need time to address and resolve such differences;
3. Many companies will need to design and implement additional internal controls for Sarbanes-Oxley purposes around the review, approval and documentation of uncertain tax positions; and
4. Multinational companies with significant non-U.S. operations will need additional time to determine how to apply the standard in view of non-U.S. tax law, particularly since many jurisdictions have filing dates later than the U.S. filing date.

Consideration should be given to a one-year delay to fiscal years ending after December 15, 2006, assuming the Final Guidance is out at least seven months prior to that date. Alternatively, consideration should be given to a one-year delay after the finalization of the Proposed Interpretation.

Thank you for your consideration of our comments and views.

Respectfully,
The Silicon Valley Tax Directors Group