MEMO# 19070

August 5, 2005

FASB PROPOSAL ON ACCOUNTING FOR UNCERTAIN TAX POSITIONS; CONFERENCE CALL THURSDAY, AUGUST 11

 [19070] August 5, 2005 TO: ACCOUNTING/TREASURERS COMMITTEE No. 11-05 TAX COMMITTEE No. 26-05 RE: FASB PROPOSAL ON ACCOUNTING FOR UNCERTAIN TAX POSITIONS; CONFERENCE CALL THURSDAY, AUGUST 11 The Financial Accounting Standards Board recently issued a proposed interpretation, Accounting for Uncertain Tax Positions.1 The Exposure Draft would require issuers to recognize, in their financial statements, the impact of a tax position, if that tax position is probable of being sustained on audit based solely on the technical merits of the position. In evaluating whether the probable recognition threshold has been met, the Exposure Draft would require the presumption that the tax position will be evaluated during an audit by the taxing authority. Individual tax positions that fail to meet the probable recognition threshold would result in recognition of a liability for income taxes payable. The Exposure Draft applies to all entities that prepare financial statements in accordance with generally accepted accounting principles, including investment companies. Comments on the proposal are due no later than Monday, September 12th. We will hold a conference call on Thursday, August 11 at 2:00 pm Eastern time to discuss the FASB proposal and a possible Institute comment letter. The dial-in number for the call is 888-810-3139 and the passcode is 57211. If you intend to participate on the call, please notify us by sending an email to Agnes Thomas at agnes@ici.org. If you cannot participate on the call, please provide any comments you may have on the Exposure Draft to Greg Smith (smith@ici.org or 202/326-5851) or Keith Lawson (lawson@ici.org or 202/326-5832). FASB Reasons for the Proposal According to the Exposure Draft, no controversy exists with recognizing the benefit of a tax position in an issuer's financial statements when there is a high degree of confidence that the tax position will be sustained on audit by the taxing authority. However, in certain cases tax law may be unsettled or subject to interpretation, and whether a tax position taken in a tax 1 Proposed Interpretation, Accounting for Uncertain Tax Positions, (July 14, 2005) (the "Exposure Draft"). The Exposure Draft is available from the FASB website http://www.fasb.org/draft/index.shtml. The Exposure Draft is a proposed interpretation of FASB Statement No. 109, Accounting for Income Taxes. 2 return will ultimately be sustained is uncertain. FASB Statement No. 109 does not explicitly prescribe a confidence threshold to be met for the benefit of an uncertain tax position to be recognized in the financial statements.2 As a result, diverse accounting practices have

developed resulting in inconsistency in accounting for uncertain tax positions. SEC staff have voiced concerns about reported tax assets in operating company financial statements stemming from claimed tax deductions that may not survive challenge on audit. Recognition and Measurement The Exposure Draft would require issuers to assume that an uncertain tax position will be subject to review by the tax authority and then evaluate whether the position is “probable” of being sustained by the tax authority’s review. The term probable would have the same meaning as in FASB Statement No. 5 (i.e., the future event or events is likely to occur).3 The Exposure Draft lists four examples of facts and circumstances that would demonstrate a probable level of confidence: • Unambiguous tax law supporting the tax position; • An unqualified “should prevail” tax opinion from a qualified expert for which all conditions are objectively verifiable; • Similar positions in prior years’ tax returns that have been obviously presented in the tax returns and have been either accepted or not disallowed or challenged by taxing authorities during an examinations; and • Legal precedent from similar positions taken by other taxpayers, where analogy is appropriate, that has been favorably resolved through litigation with taxing authorities. The amount recognized for an uncertain tax position that satisfies the probable recognition threshold would be the best estimate of the amount that would be sustained after an audit by the taxing authority, including any litigation or appeals process. The best estimate is not a probability-weighted or expected-value approach; rather, a best estimate represents the single most likely amount in a range of possible amounts. An uncertain tax position that did not initially meet the probability threshold for recognition would be recognized in a subsequent period if the threshold is met, the tax matter is resolved through negotiation or litigation, or the statute of limitations for the tax authority to examine the tax position has expired. Derecognition An uncertain tax position that satisfies the recognition threshold may subsequently become less than probable due to changed circumstances. However, an uncertain tax position would continue to be recognized unless it becomes more likely than not that the tax position would not be sustained on audit. Use of a valuation allowance is not a permitted substitute for derecognition when it is more likely than not that the tax position will not be sustained. 2 FASB Statement No. 109, Accounting for Income Taxes (February, 1992). 3 FASB Statement No. 5, Accounting for Contingencies (March, 1975). 3 Investment Company Considerations Investment companies typically qualify as “regulated investment companies” under tax law by distributing all of their taxable income and satisfying other conditions. Such funds record no provision for income taxes payable in their financial statements. The Exposure Draft would require funds with uncertain tax positions to record a liability for income taxes payable unless the fund satisfies the probable threshold described above. If the uncertainty could cause the fund to fail to qualify as a regulated investment company, the liability would be based on corporate income tax rates (without deduction for dividends paid). Gregory M. Smith Director - Operations/Compliance & Fund Accounting