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Technical Director  
Financial Accounting Standards Board  
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VIA E-MAIL

**File Reference: No. 1215-001: Accounting for Uncertain Tax Positions – an interpretation of FASB Statement No. 109**

## **I. Summary**

Although we agree with the Board that there is an opportunity for improving the accounting for *Uncertain Tax Positions*, we disagree with the model proposed in the recently-issued Exposure Draft of a proposed Interpretation to SFAS No. 109, *Accounting for Income Taxes* (“SFAS 109”).

Fundamentally, we believe tax contingencies are best viewed in terms of quantifying a liability. To reverse this model and assess tax contingencies in terms of not recognizing an asset contains conceptual flaws. The proposed Interpretation, if adopted in current form, will require companies to record liabilities that are unlikely to ever be settled and will most likely be reversed into income years later. Because liabilities will be systematically overstated, we do not believe financial statement users will be best served because liabilities will be recorded that are not representationally faithful. We believe the proposed accounting model for uncertain tax positions needs to accommodate the fact that tax law is often uncertain and complex.

We support the Board's stated objectives of improving consistency, reliability, and comparability in the proposed Interpretation. Accordingly, we believe the best course of action would be to:

- Retain the accounting considerations for tax reserves within the scope of **SFAS No. 5, *Accounting for Contingencies*** ("SFAS 5"), and
- Provide **implementation guidance** regarding the use of SFAS 5 as applied to income tax contingencies.

If our recommendation to retain the existing the liability model is rejected and the asset model is retained in a final Interpretation then, at a minimum, we recommend lowering the threshold for asset recognition to "**more likely than not.**" This alternative would be a less desirable approach than keeping the liability model in SFAS 5; however, it would still be an improvement over the guidance currently suggested by the proposed Interpretation.

Either of these approaches we recommend above will result in computation of a liability to the Internal Revenue Service that accommodates the uncertainty and complexity of the tax code and will be more representationally faithful than the guidance in the proposed Interpretation to SFAS 109.

We also have a question about the need to amend SFAS 5 for income tax contingencies, if the proposed Interpretation were to be issued in its current form.

## II. Background

The proposed Interpretation discusses that a probable level of confidence may, in the absence of opposing evidence, be demonstrated by obtaining "...*(A)n unqualified should prevail tax opinion from a qualified expert for which all conditions are objectively verifiable.*"<sup>1</sup> In our experience, it is not always possible to adopt positions at a "should opinion" level of confidence because the relevant tax law is often unclear when evaluating whether or when we can take the deduction. Any uncertainty in the law presents a risk, to some degree, that a contrary interpretation might be sustained. In our experience, it is not uncommon for questions of interpretation regarding a new tax law, or the tax law applicable to a new business activity (e.g., doing business on the Internet) to remain unsettled for decades.

## III. Proposed Interpretation Observations

### Liabilities not Representationally Faithful

"Representational faithfulness"<sup>2</sup> is defined as an essential characteristic of reliability in CON 2, *Qualitative Characteristics of Accounting Information* ("CON 2"). The proposed Interpretation causes us concern regarding representational faithfulness. As the Exposure Draft is currently written, tax liabilities will be overstated because of the high threshold ("probable") that will be needed to recognize a "tax benefit" for book purposes. Introducing "probable" as a threshold to this assessment will artificially inflate our liability to the IRS (especially as it relates to new tax law).

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<sup>1</sup> FASB Exposure Draft concerning *Uncertain Tax Positions*, File Reference No. 1215-001, dated July 14, 2005, paragraph 9b

<sup>2</sup> CON 2, paragraph 63 defines **representational faithfulness** as "...correspondence or agreement between a measure or description and the phenomenon it purports to represent..."

We do not understand the Board's conclusion that is discussed in paragraph B16 in the proposed Interpretation, which refers to the definition of "probable" assets and liabilities in a CON 6, *Elements of Financial Statements* ("CON 6") context. We note in footnotes 18 and 21 to CON 6 that the definition of "probable" is not meant to equate to a SFAS 5 threshold (which is referred to in paragraph 6 of the proposed Interpretation). We believe that many assets and liabilities are recognized when the probability of actual future cash flows is far short of the SFAS 5 threshold. For example, derivatives such as deep "out-of-the-money" options are recognized as assets even when the associated probabilities of realization may fall far below the SFAS 5 interpretation of "probable."

#### Measurement Should Rely on Management's Experience

The Board concluded "*measurement should rely on management's experience with the relevant taxing authority on similar matters*"<sup>3</sup> and also "*...the best estimate methodology would provide the most relevant information to financial statement users...*"<sup>4</sup>

Regarding the above text, we agree with the Board's conclusion as it relates to relying upon management's experience; however, we do not agree that applying the "best estimate" method discussed in paragraphs 11 and B28 of the proposed Interpretation<sup>5</sup> only when it is probable that the deduction will be sustained is consistent with relying on management's experience. The proposed Interpretation would fail to incorporate management's experience with the relevant taxing authority in many tax positions. In other words, requiring management to record a worst-case liability when the most likely outcome is to sustain a position does not incorporate management's experience.

#### **IV. Recommendation**

We believe that the optimal course of action would be to supplement SFAS 5 by providing some additional implementation guidance related to the accounting for income tax contingencies. Specifically, when evaluating measurement of the liability, we support the concept of presuming a tax position will be evaluated by taxing authorities (as is currently discussed in paragraph B14 of the proposed Interpretation). We would suggest adding implementation guidance that a company should make an assumption of due diligence on the part of both itself and the taxing authority according to a "prudent business person" standard. This standard would require that a company should expect that it and the taxing authority would take such actions and make such decisions as a prudent business person would in the exercise of due diligence to optimize the financial effects of tax controversies in question. This standard also would assume equal and complete knowledge of facts and law, and equal skill and competency in the representation of both parties. The company should further assume that a court in reaching its judgment would consider all relevant authorities and arguments favorable to both the company and the taxing authority.

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<sup>3</sup> FASB Exposure Draft concerning *Uncertain Tax Positions*, File Reference No. 1215-001, dated July 14, 2005, paragraph B26

<sup>4</sup> *Ibid.*, paragraph B28

<sup>5</sup> *Ibid.*, paragraph 11 instructs the reader to "*...measure the amount of benefit recognized for a tax position that meets the probable recognition threshold as the best estimate of the amount that is probable of being sustained upon audit by the taxing authority...*" which is "*...consistent with its use in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements...(as the)...single most-likely amount in a range of possible estimated amounts.*"

This alternative would result in an improvement to financial reporting in the accounting for uncertain tax positions since it would appropriately lead to a decision to record the liability when appropriate, and it does not abandon the SFAS 5 model used for tax contingencies.

If the liability model is rejected and the Board ultimately retains the asset model, then we request that the Board reconsider the effect of a tax position that has met the “**more likely than not**” threshold for probability of success. In practice, we understand that many companies have a policy to take positions that are at least “more likely than not” to prevail. That is why we believe a single threshold of “more likely than not” should be acceptable for both recognition and derecognition of the tax benefit. This alternative is not as desirable as the liability model under SFAS 5 since an asset approach with this threshold would still lead to some overstatement of the liability; however, we believe this alternative is more representationally faithful than the accounting model suggested by the proposed Interpretation.

The “more likely than not” threshold would support the objectives of improving **consistency and comparability**, since this threshold is widely interpreted to “greater than 50%” probability and would be aligned with the threshold generally used by many tax departments for purposes of concluding whether or not to take a tax deduction. Additionally, we understand that the Board is concerned with the accounting for aggressive tax positions or “tax shelters.” We believe the exposures related to tax shelters would still appropriately be recorded as liabilities since they would fail to meet the “more likely than not” probability of success threshold.

Other Observations: Context within the U.S. GAAP Framework

We believe the guidance in the proposed Interpretation is, effectively, an amendment of SFAS 5. If the proposed Interpretation were issued in its current form (without any modifications), it would seem that SFAS 5 would need to be amended to eliminate the reference to income taxes in paragraphs 39<sup>6</sup> and 69,<sup>7</sup> since income tax contingencies would no longer follow the SFAS 5 model.

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<sup>6</sup> “... For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of \$2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of \$8 million over and above the \$2 million. In that case, paragraph 8 requires accrual of the \$2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the \$2 million that was accrued.” (SFAS 5, paragraph 39)

<sup>7</sup> “In many cases, the accrual of a loss contingency results in the recording of a liability, for example, accruals for a probable tax assessment...In the course of its deliberations, therefore, the Board found it relevant to consider the concept of a liability as expressed in accounting literature.” (SFAS 5, paragraph 69)

Technical Director  
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If you would like to discuss any of these ideas, please feel free to call Ken Evola at (703) 714-4900 or me at (703) 903-3500. We would also be happy to meet with you at your convenience.

Sincerely,

*/s/ John F. Woods*

John F. Woods  
Senior Vice President  
Corporate Controller & Principal Accounting Officer

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