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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Comments on Exposure Draft 2009/2 (Income Tax)

To the Members of the International Accounting Standards Board:

This letter is submitted in response to the request for comments contained in Exposure Draft 2009/2—Income Tax (the "Exposure Draft"). Specifically, these comments are addressed to Question 7, which requests comment on Paragraph 26 of the Exposure Draft discussing the treatment of uncertain tax positions.

Background and Objectives

This goal of this submission is to provide a lawyer's perspective on the potential impact of the proposed method for analyzing uncertain tax positions, which requires a reporting entity to analyze all possible outcomes and then use "the probability-weighted average amount of all the possible outcomes" to measure its current and deferred assets and liabilities. Exposure Draft Paragraph 26. Our comments specifically focus on the effect of the proposal on entities subject to U.S. tax on all or part of their income. Mayer Brown LLP's U.S. Tax Controversy practice is among the largest and most notable practices in the United States. We regularly advise large multinational clients (U.S.- and non-U.S. based) in connection with controversial tax positions, both before and during disputes with U.S. tax authorities.

We are not accountants and do not intend to advise the Board regarding the appropriateness of a particular method of accounting for uncertain tax positions. However, based on our experience providing legal advice to U.S. taxpayers with substantial uncertain tax positions, we believe that the proposed approach will be very complex in implementation and may also compromise entities' ability to obtain candid and privileged assessments of their tax controversies.

Complexity in Implementation

The Board's stated rationale for the "all possible outcomes" approach is that, unlike alternative approaches such as the current IFRS standard or the method used in FASB Interpretation No. 48 ("FIN 48"), "[n]o possible outcomes are ignored in the measurement." See BC 57, 60. While this may be a theoretically sound objective, our experience in representing large taxpayers in controversies with U.S. tax authorities suggests that it is extraordinarily difficult to identify "all possible outcomes," much less determine the probability associated with such outcomes. Initially, complexity arises simply because of the way in which substantive tax provisions may interact.

For example, if an entity undertakes a related party transaction in which the stock of a subsidiary is transferred, it could have uncertainty with respect to (a) the appropriate characterization of the transfer transaction, (b) the value of the transferred subsidiary's business, (c) the impact of transfer pricing and similar adjustments on the value of the business, (d) the capital structure of the subsidiary (e.g., whether the subsidiary issued debt or hybrid instruments that affect its value), and (e) the impact of the transaction on historical positions (e.g., deferred intercompany transactions).

Each of these issues can be complex, but when they interact, the number of possible outcomes grows exponentially. Consequently, in practice it may be extremely difficult to even identify all possible outcomes. Moreover, many such outcomes will, at most, be remote contingencies not likely to have a material effect on an entity's overall assessment of its tax position. However, under the proposed standard, it appears that it will be necessary to assess the consequences of each of these outcomes. This will greatly increase the analysis that taxpayers will have to undertake, even if the net effect of this effort is that a very low probability is assigned to each remote outcome. Hence, as the subsidiary stock transfer example indicates, proposed Paragraph 26 may add very significant analytical and compliance burdens for taxpayers.

Moreover, our experience suggests that there are many factors that can change the relative probability of certain outcomes over the course of a tax dispute. In the interest of resource efficiency, tax authorities may choose to forgo pursuing an issue or "trade off" one issue for another. This problem is exacerbated because of the many years that it can take to resolve large U.S. tax controversies (e.g., Mayer Brown represented a client that recently received a favorable appellate court decision related to the tax years 1980-83), during which time the interaction between various tax positions may change. Finally, as active trial and appellate counsel for large taxpayers, we think it is important to recognize that there is always uncertainty in litigating a tax issue, particularly where there are substantial amounts at issue.

As drafted, Paragraph 26 appears to require entities to consider all of these permutations, which would likely involve a significant resource and monetary commitment in order to gather and review factual information, then analyze the applicable tax law. These analyses would presumably have to be updated as the tax authorities' priorities change, issues are resolved, and judicial developments emerge. Finally, such analyses will remain subject to uncertainty because, even where taxpayers have very strong positions with well-developed and documented facts, it is almost never perfectly clear how a reviewing court will resolve a controversial issue.

We recognize that the Board has stated that it "does not intend entities to seek out additional information for the purpose of applying this aspect of the proposed IFRS." BC 63. However, it is not clear to us whether this statement is intended to relieve entities of the burdens of such analyses or merely to limit additional fact gathering.

Effect on Privileged Communication

Evidentiary privileges, such as the attorney-client privilege and work product doctrine, are an important part of the U.S. tax controversy system because they foster open and frank communication between and among tax advisor and clients, while allowing the advisor a

zone of privacy in which to develop a case without fear that the tax authority may be allowed to unfairly obtain a "free ride" on this work. In U.S. tax litigation, is common for both the taxpayer and government to assert privileges such as the attorney-client privilege and work product doctrine in developing their respective positions. Taxpayers, for example, might generate documents that discuss litigating hazards or comment on relative strengths or weaknesses in their tax positions. Where one side, but not the other, is practically compelled to waive such privileges, the adversarial playing field becomes uneven.

When an entity applying IFRS undergoes an independent financial audit, its financial auditors may believe it is necessary to obtain privileged information in order to assess that entity's measurement of uncertain tax positions. Taxing authorities have taken the position that such disclosures result in waivers of evidentiary privileges, thus potentially exposing this information to discovery and resulting in an uneven playing field. In our view, the effect of statements made to financial auditors on such privileges is the most significant discovery-related issue in U.S. tax controversy.

We strongly believe that, both as a matter of law and policy, taxpayers do not waive applicable work product privileges when such analyses are disclosed to auditors, but we also recognize that this area of law is in development. Many courts are currently considering the application of these tests in the tax context. In United States v. Textron Inc., 553 F.3d 87 (1st Cir. 2009), vacated by, depublished by, rehearing en banc granted by 560 F.3d 513, a panel of the Court of Appeals for the First Circuit held that documents used in the determination of a company's overall tax reserve (roughly equivalent to measurement under Paragraph 26) were protected work product. However, one judge in Textron dissented and the First Circuit recently reheard the case, so this conclusion may change. Similarly, another court recently held that auditor notes reflecting counsel's assessment of tax litigation were protected, but the U.S. has appealed. United States v. Deloitte & Touche USA LLP (D.D.C. 2009). For further background, please see www.mayerbrown.com/publications/article.asp?id=6071&nid=6.

Because of the uncertainty regarding taxpayers' ability to protect the advice of counsel from discovery by tax authorities, the "all possible outcomes" approach may significantly compromise U.S. taxpayers' tax positions. First, because of the complexity of implementation discussed above, taxpayers may enlist their advisors' help in identifying and assessing potential recharacterizations and other remote arguments that must be considered under the "all possible outcomes" standard. Having documented their positions, entities may then find it necessary to provide their financial auditors with these analyses, which could result in those documents being discoverable in litigation. Such documents may not merely be limited to technical tax analyses, but may also extend to counsel's assessment of litigating strategies, the strengths and weaknesses of factual and legal claims, and the quantitative impact of these issues.

Moreover, the financial audit process may itself generate additional documents and analyses as entities and their auditors consider whether all possible resolutions of all possible outcomes have been appropriately considered. These documents will likely reflect the entity's and its advisors' assessment of audit and litigation strategy. Hence, for entities subject to U.S. tax, the breadth of the standard proposed in Paragraph 26 seems likely to result in tax disputes in which tax authorities enjoy the advantages of privileged

communications while taxpayers' assessments are unprotected. We do not believe that such an imbalance helps reporting entities, improves tax administration, or increases financial statement reliability.

We note that many of our clients that apply alternative approaches have considered similar issues. As the Exposure Draft observes, however, FIN 48 requires only that an entity show that a particular amount of benefit is at least 51% likely to be ultimately realized. Hence, while the standard often results in entities providing significant amounts of information to financial auditors, it does not require an assessment of every potential outcome and so does not create a comprehensive, one-sided roadmap into a taxpayer's assessment of the strengths and weaknesses of its positions. In short, while it is certainly true that taxpayers are currently concerned about the possible disclosure of privileged information due to auditor requests, the significantly more extensive analysis required by the proposed Paragraph 26 seems to us to greatly exacerbate this problem.

Finally, several of our U.S. clients have also observed that even under current approaches, the process of assessing the strengths and weaknesses of uncertain positions and then providing such analyses to financial auditors may itself change the relative probability of outcomes. The Exposure Draft may exacerbate this problem by requiring detailed consideration of all potential outcomes. Specifically, Paragraph 26 may increase the likelihood of seemingly remote outcomes because tax authorities will be put on notice of an entity's lawyers' assessment of litigation strategies, which could then change tax authorities' strategy. Furthermore, if tax authorities become aware of the number of different ways that a taxpayer believes a position may affect others, taxpayers may find it more difficult to reach resolution because tax authorities may feel compelled to examine many or all of the overlapping issues prior to resolving any of them.

We do not believe that the Board intends that its measurement standard should compromise an entity's ability to preserve the confidentiality of its assessment or result in a substantive change in an entity's assessment of its uncertain tax positions. However, for IFRS entities subject to rigorous independent financial audits, our experience with U.S. tax controversies suggests that Paragraph 26 may have these effects. While there is no perfect solution to this problem, we believe that the Board can limit the effect of Paragraph 26 on privileged communications by focusing the measurement standard on the most likely areas of dispute and outcome for a given uncertain tax position.

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We reiterate that we are lawyers, not accountants, and so we express no view regarding the accounting propriety of the "probability-weighted average amounts of all the possible outcomes" approach to measuring uncertain tax positions. However, we believe that for entities subject to U.S. tax on all or part of their income, the proposed standard will be extremely complex and difficult to implement given the usual course of resolving large tax disputes. It may also significantly compromise an entity's ability to protect the strategic litigation advice and candid issue assessments provided by counsel during the course of a tax dispute.

Accordingly, we hope that the Board will consider modifying or further interpreting Paragraph 26 in a way that provides an appropriate measurement of current and deferred tax assets and liabilities without creating undue complexity or unnecessarily compromising privileged communications. Thank you for your consideration.

Sincerely,

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