

IFRS' IMPACT ON STATE AND LOCAL TAXATION

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I. INTRODUCTION

International Financial Reporting Standards (IFRS) conversion will have a broad and sweeping effect on all aspects of the tax lifecycle, including State and Local Taxation (SALT). Although convergence will enhance consistency and comparability of financial statements, some practitioners have already voiced concerns about the inability of IFRS to appropriately reflect different tax regimes in financial statements. Furthermore, “as the Internal Revenue Code and *state tax statutes* have developed over an extended period of time with existing US GAAP as the predominant set of accounting standards used in the United States, certain interactions exist between certain provisions of US GAAP and income tax requirements.”² Companies should start identifying the implications of specific IFRS standards on their tax-reporting and compliance, as each change on financial statements due to IFRS conversion will likely have a tax impact.³

Since SALT is a pervasive aspect of every businesses' planning, provision, compliance and controversy tax processes, and the mandatory adoption of IFRS appears to be inevitable in the next few years, prudent tax professionals should invest time to consider the impact of IFRS on SALT. Some practitioners are beginning to ask relevant questions such as “is IFRS incompatible with the US States' tax structure and requirements?” “How and to what extent is US GAAP used in SALT compliance?” “How should I advise my client's to proactively prepare for this paradigm shift in financial reporting standards?” These questions and many more will be addressed in this article.

II. ROADMAP FOR IMPLEMENTATION

On November 14, 2008, the US Securities and Exchange Commission (SEC) issued its long awaited proposed “Roadmap” on the potential use of IFRS in financial statements prepared by US issuers. The Roadmap presents several milestones that will require mandatory use of IFRS in financial statements filed with the SEC by US issuers beginning in 2014, 2015 or 2016, depending on the size of the issuer. It also allows early adoption for years ending after December 15, 2009, by a limited number of large issuers. The SEC will consider the progress made towards achieving these milestones before it makes its final decision in 2011 about whether to proceed with the mandatory adoption of

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² Securities and Exchange Commission (SEC). (2008). 17 CFR. Roadmap For the Potential Use of Financial Statements Published in Accordance With International Financial Reporting Standards by U.S. Issuers. Pg. 39.

³ Griffith, P. 2008. IFRS: It's Not as Hard as You Think. *California CPA*, September 15: 14 - 15

IFRS. Due to the magnitude and probability of convergence, prudent professionals should start advising their clients to prepare for IFRS convergence now.

III. IMPACT ON ACCOUNTING METHODS

Most tax methods are based on or have some correlation with US GAAP. With the impending convergence of US GAAP with IFRS, it remains uncertain if tax authorities will accept IFRS when it differs from US GAAP. Tax authorities have yet to address whether or not companies will have to continue to maintain US GAAP financials in order to be in compliance with tax return requirements.

When companies change book accounting methods (e.g., LIFO to FIFO) or reporting standards (e.g., GAAP to IFRS), the impact this has on tax accounting methods should be considered, as the change has both tax provision and compliance implications. In instances where book and tax methods are currently in conformity, it remains to be seen if IFRS' impact on changing the book method of accounting will lead to a corresponding need to elect a different tax method on Form 3115 for Federal purposes.

Issues relating to tax method changes, however, are not limited to Federal taxation. In fact, most states “piggyback” off of Federal tax law. States that start with Federal income as a basis for taxation typically apply Federal statutes, rules and regulations, and case law.⁴ Thus, for states that piggyback off of Federal tax principles, accounting method changes for Federal purposes will directly impact state taxation. Although most states leverage off of Federal tax principles and laws, states may require different treatment if there is a specific state statute, regulation, or case ruling that differs from Federal. Also, it is important to note that “... all states imposing a corporate level tax may have their own interpretation of acceptable reporting methods. Multistate corporations may be faced with many adjustments to be made on a state and local level that could exceed the complication at the Federal level.”⁵

One of the more notable methods that IFRS convergence will impact is the last in, first out (LIFO) inventory method. This is a method of inventory accounting that is currently used in the US by many different companies to determine net income for book purposes, as well as their tax liability. “If the US accounting standard-setting body, FASB, were to embrace IFRS fully, LIFO would no longer be acceptable for GAAP.”⁶ Thus, under IFRS, US based companies will be required to issue statements that describe the results of both inventory purchasing and marketing decisions more transparently. However, the cost of transparency would be higher taxes due to IRC §472(c) requiring

⁴ Swenson, C.W., Gupta, S., Karayan, J.E., and Neff, J. 2004. *State and Local Taxation: Principles and Planning (2nd ed.)*. Boca Raton, FL: J. Ross Publishing, Inc.

⁵ Bernard, Mary. IFRS and Income Taxes. www.cpa2biz.com.
http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/CorpTax/Income_Taxes.jsp, Posted on August 14, 2008.

⁶ White, George. Lifo Vs. IFRS. www.cpa2biz.com.
http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/impediment.jsp. Posted on June 12, 2008

conformity of the use of LIFO for book and tax purposes. “Once F/S LIFO loses its legitimacy in IFRS, it cannot be used for US tax purposes ... it’s a virtual certainty that Congress would act affirmatively to repeal tax LIFO once convergence becomes a reality”⁷

A few of the other basic differences in accounting methods under IFRS are as follows: 1) purchase of in-process R&D is capitalized, 2) purchase price accounting and capitalization methods are substantially different from US GAAP, 3) may reverse inventory write downs and other impairment charges, and 4) revaluation of property, plant and equipment is permitted. It should be kept in mind that IFRS convergence is still in the developmental phase, which means that there may be fewer differences from current GAAP by the time IFRS is implemented.

IV. IMPLICATIONS ON FIN 48

FIN 48 is an interpretation of SFAS 109 and deals with accounting for uncertain tax positions, including state and local income taxes that are recognized on a company’s financial statements. Publicly traded companies have been required to follow FIN 48 since the end of 2006. However, the FASB voted on October 15, 2008, to defer FIN 48 compliance for all privately held companies and set the new effective date for compliance for fiscal years beginning after December 15, 2008.⁸ On December 30, 2008, the FASB issued FASB Staff Position (FSP) No. 48-3, which further delays the effective date of FIN 48 for certain nonpublic enterprises until annual financial statements for fiscal years beginning after December 15, 2008. The FSP is effective upon issuance.

According to the proposed timeline for implementation of IFRS issued by the SEC, some smaller US issuers will not have to release IFRS financial statements until December 15, 2016.⁹ Nevertheless, once these companies start issuing IFRS financial statements, they will be required to provide two years of comparable information, which will require them to start preparing IFRS financial statements as early as 2014. Consequently, at least for the next few years, smaller public companies will be subject to FIN 48 requirements and privately held companies will have to implement FIN 48.

FIN 48 sets forth that a company should recognize the effects of a tax position “when it is more likely than not that a tax position ... will be sustained upon examination.”¹⁰ This is relevant to SALT, as a state taxing authority may assert that a company has economic nexus with their state by applying a state statute, regulation, or case law, which may require the business to file a tax return in the state. Under FIN 48, deciding not to file a tax return is a “tax position.” This will introduce the need for

⁷ Ibid.

⁸ Financial Accounting Standards Board (FASB). (2008). SDR 10/15/08. Summary of Decision Reached FASB Board Meeting October 15, 2008.

⁹ Securities and Exchange Commission (SEC). (2008). 17 CFR. Roadmap For the Potential Use of Financial Statements Published in Accordance With International Financial Reporting Standards by U.S. Issuers. Pg. 35

¹⁰ Financial Accounting Standards Board (FASB). (2006) FIN 48. Accounting for Uncertainty in Income Taxes. ¶7 – Recognition. Retrieved on 11/29/08 from <http://www.fasb.org/pdf/fin%2048.pdf>

companies to determine if it is “more likely than not” that their decision not to file a tax return in a state will prevail examination by the state’s taxing authorities. A company may also be faced with taking a tax position if a state attempts to force a combination filing of two or more companies.

It is evident that “compliance with state and local income tax laws for enterprises with complex legal structures and operations in numerous jurisdictions can be an extraordinary undertaking. Therefore, it should come as no surprise that complex issues will arise when accounting for uncertain state and local income tax positions in accordance with FIN 48 and SFAS 109.”¹¹

In its current draft, IFRS’ treatment of uncertain tax positions differs drastically from FIN 48. The IFRS exposure draft does not include separate recognition criteria. Instead, it requires, based on the technical merits of the position, that measurement of the benefit to be recognized be based on the probability weighted average of the possible outcomes, including consideration of detection. Currently, IAS 12 indicates that tax assets and liabilities should be measured at the amount expected to be paid. Also, the recognition principles set forth in IAS 37 pertaining to provisions and contingencies are applied in practice. Furthermore, IFRS reporting requires recognition of all potential liabilities; there is no recognition threshold for liabilities. “A convergence of these standards might require the US accepting an ‘expected value’ approach to assessing tax liabilities.”¹²

V. IMPACT ON PROPERTY APPORTIONMENT FACTOR

One of the most substantial differences between US GAAP and IFRS is that IFRS allows certain long-lived tangible and intangible assets to be revalued to FMV. The revaluation model may be applied to an entire class of assets that require revaluation to FMV on a regular basis. Under the Uniform Division of Income for Tax Purpose Act (UDITPA), owned property is valued at historical cost and FMV is not allowed. However, a few states use net book value. By only allowing historical cost to be reported for US GAAP purposes, most states could easily conduct an audit over the property factors used in calculating apportionment by reviewing a company’s financial statements. For example, the Schedule L of a public company’s tax return typically agrees to the balance sheet included in their 10-k report for the related year.

The treatment of leases is another area that IFRS will possibly impact the property factor. Since rent is included in the property factor as a multiple of eight, changing the requirements for lease accounting will make it more difficult for states to readily determine rent payments by reviewing financial statements. As you can see, with the implementation of IFRS, states will once again be faced with decisions on how to modify their compliance to be consistent with IFRS.

¹¹ CCH (2007). FIN 48. *Top Multistate Tax Issues for 2008*. Chapter 4.1

¹² Bernard, Mary. IFRS and Income Taxes. www.cpa2biz.com.

http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/CorpTax/Income_Taxes.jsp, Posted on August 14, 2008.

VI. REDEFINING UNITARY TAXATION

Typically, in practice, parts of the same group of companies, regardless if they are incorporated or not, are usually considered a unitary group if they are required to be consolidated for financial reporting purposes under SFAS 141(r) or other applicable US GAAP standards. This introduces the question whether or not the concept of a unitary business will be altered due to IFRS implementation, as there are numerous differences between SFAS 141(r), *Business Combinations*, and IAS 22, *Consolidated and Separate Financial Statements*, and IFRS 3, *Business Combinations*. Some of the fundamental differences between US GAAP and IFRS treatment of business combinations and consolidated financial statements are as follows: 1) there is no concept of a QSPE under IFRS; 2) unlike US GAAP, assets and liabilities of minority interest are stepped up to FMV; and 3) parent and subsidiaries must conform their accounting policies under IFRS. Thus, since the purchase accounting rules under GAAP will no longer be in effect, there will no longer be a basic rule of thumb for state taxing authorities to follow in order to determine if a group is unitary.

VII. IMPACT ON EFFECTIVE TAX RATES & PROVISIONS

Not only will the presentation of provisions change radically on financial statements due to IFRS convergence, but the underlying deferred tax balances will also change. This will impact the calculation of the Federal and state effective tax rates (ETR) and will require recalculation of deferred tax balances. Since the ETR is calculated based on the ratio of income tax expense to pre-tax income, IFRS conversion could change the ETR by changing either, or both components. Furthermore, IAS 12 requires disclosure of an explanation of changes in the applicable tax rate(s) compared to previous accounting periods. And, if an entity operates in several states (jurisdictions), it may be more meaningful to aggregate separate reconciliations using the rate for each jurisdiction.¹³ In its current draft, IAS 12 appears to indicate that separate disclosure of the state ETR will be required.

In order to prepare for the changes in ETR, tax professionals need to evaluate the potential effect IFRS convergence will have on the ongoing ETR and begin educating their clients on what to expect. Likewise, changes in the book basis of assets and liabilities will require the recalculation of deferred tax assets and liabilities upon conversion based on the new temporary differences. The recalculation of deferred tax balances needed for the required comparative balances sheets and income statements will require substantial time and resources for both practitioners and their clients.

VIII. SALT AND M&A

Consideration of SALT consequences pertaining to mergers and acquisitions (M&A) transactions is very important. Most M&A transactions have broad reaching SALT implications, which include: state tax conformity or non-conformity with Federal

¹³ IAS 12, *Income Taxes*, IASB October 1996 (amended March 2004), para. 85

treatment, filing statute changes, apportionment/allocation changes, nexus changes, and a myriad of other compliance issues. Due to the significant SALT consequences involved, every M&A transaction should be thoroughly reviewed in light of the anticipated changes presented by a convergence with IFRS. Despite the fact that most states mirror Federal tax standards, all tax planning strategies should be closely scrutinized. This is especially important where state treatment deviates from the Federal law. For example, some states impose a franchise or capital stock tax. These taxes are often based on a corporation's net book value, which includes surplus, capital and retained earnings. For states that impose a franchise or capital stock tax based on a corporation's net worth, it is important to consider the differences in debt versus equity classification that IFRS introduces.

Contrary to US GAAP, IFRS classifies certain hybrid instruments with characteristics of both debt and equity based on the contractual obligation to deliver cash, assets, or an entity's own shares. Economic compulsion under IFRS is not considered a contractual obligation. Also, the differences in classification of debt and equity under IFRS can impact whether or not interest is deductible. Thus, despite the fact that some states may have previously allowed deductions for inter-company interest, IFRS may introduce a new curve ball in defining bona fide debt. A joint project with FASB to address instruments with features of both liabilities and equity is currently underway.

IX. SALT IT SYSTEMS AND IFRS

IT systems will require modification so that financial information will be in-line with IFRS accounting requirements. These modifications will impact the general ledger, payroll systems, asset management systems, as well as other financial reporting systems used to compile information used for state tax compliance. Capturing the correct financial data that is categorized by state and local jurisdictions will be imperative for apportionment calculations required in state filings, as well as nexus studies.

It is essential that personnel with SALT knowledge be involved in the strategic planning, design, and implementation of new systems and enhancement of old systems as part of IFRS adoption. Communication with data suppliers about tax requirements presents the opportunity to increase the data available to support more automated processes in the future. Tax professionals should begin considering the implications that IFRS will have on IT systems and be proactively involved in the planning stages of the relevant IT system enhancements.

X. CONCLUSION

Without a doubt, convergence with IFRS will be the most substantial change to SALT ever undertaken by US companies and the accounting profession. As with any transition, there will be a formidable period of change for all stakeholders, including government agencies, private and public companies, and accounting practitioners. However, this change will generate more engagement and fee opportunities for practitioners, as well as reduce the number of financial reporting frameworks with which companies will have to comply.

As the expected date for convergence approaches, it is imperative that SALT professionals start educating themselves and their clients on how IFRS will potentially impact SALT. Also, practitioners should get involved in the convergence project by voicing their concerns and providing feedback to the US financial accounting standards setters, legislative branches, and tax enforcement bodies.