

CFO insights: IFRS: Select Tax Considerations

Accounting standards worldwide are increasingly shifting toward International Financial Reporting Standards (IFRS). Many countries have already adopted IFRS as their required reporting standard for public and non-public companies; others are in the process of adopting IFRS (e.g., Canada and Korea). While some countries are converting to IFRS, others are working to converge their own local generally accepted accounting principles (GAAP) to align more with IFRS. The convergence and conversion activities taking place in the United States are only a small part of a global shift toward consistent accounting standards. For CFOs of global multinationals, the tax implications of changing accounting standards across multiple tax jurisdictions are complex and need careful evaluation. They present potential pitfalls leading to increased or more volatile effective tax rates (ETR) or new opportunities to reduce foreign taxes. This CFO Insights article outlines some areas for consideration in IFRS adoption related to tax. It is not comprehensive but a basis for preliminary discussion and an assessment of the likely implications of IFRS on tax spend or savings.

Local Tax Changes Can Drive Global Impacts

Many of the jurisdictions that have adopted IFRS for statutory financial statement reporting purposes continue to require maintenance of local GAAP books as their starting point for tax calculations. Other jurisdictions, like Korea, India and Brazil, are as yet undecided on whether to permit IFRS-based statutory accounts for tax purposes. However, more jurisdictions either rely directly on the statutory accounts for tax purposes, or local GAAP itself is converging with IFRS, and CFOs, along with tax departments, need to consider how the global trend toward IFRS impacts their ETR.

To the extent that there is a change in local GAAP or statutory reporting, there may be an immediate impact on certain aspects of foreign tax reporting, with a corresponding effect on the overall ETR of those U.S. multinationals that assert that those foreign earnings are indefinitely reinvested offshore. The magnitude of impact may be hard to evaluate, but there is general agreement that those companies with a good grasp of the local ETR and how changes to local accounting standards will affect that rate are in a better position to properly plan for and efficiently manage a migration to IFRS.

Cash Flow Implications

For a multinational that is indefinitely reinvested in the earnings of its foreign subsidiaries, changes in local jurisdiction taxes have the potential to impact the ETR as well as cash taxes. So, if taxable income is based on the statutory accounts, and the basis for statutory reporting changes as a result of a conversion to IFRS, there can be a direct impact on the parent's ETR. The IFRS tax impacts will naturally vary by jurisdiction. For example, in the UK, tax deductions for certain intangible assets and goodwill are driven by the expense recorded in the statutory accounts. UK GAAP provides for up to 20-year amortization for such assets. A company adopting IFRS in the UK, would be required to adopt an impairment model, whereas the adoption of IFRS for Small and Medium Enterprises (if this becomes available in the UK) may provide for a 10-year amortization period. Given the potentially significant impact on tax deductions in the UK, several companies have chosen not to convert their UK subsidiaries early to IFRS.

In the United States, although the tax rules are generally independent of the statutory accounts, convergence with IFRS is expected to impact such items as:

- 1. Inventory valuation** – the Last In First Out (LIFO) method of inventory valuation is permissible for tax purposes as long as the statutory accounts are recorded using the same method. LIFO is prohibited under IFRS and the book/tax conformity requirement would no longer be met, resulting in an increase in U.S. taxable income. Companies will need to carefully plan for any change in inventory methods to effectively manage the impact of this transition.



2. Revenue recognition – In general the recognition of revenue for tax purposes is independent from financial statement accounting. However, two administrative exceptions to the general rules of revenue recognition for tax purposes address certain types of advanced payments. These rules make reference to the timing of recognition of revenue for financial statement purposes. Current proposed changes to the revenue recognition standard under U.S. GAAP as part of IFRS convergence efforts could impact the timing of revenue recognition in certain instances, with a related impact on cash taxes.

Global Tax and Treasury Planning

Global financing, distributable reserves, and transfer pricing are three other areas of impact directly relevant to CFOs. These are discussed below:

Global financing

In most jurisdictions there are limitations on the tax deductibility of interest on affiliated debt. The most common limitations are based on some ratio of debt to equity ("thin capitalization") or some ratio of interest to profits before tax ("earnings stripping"). The majority of countries impose thin capitalization rules, and the statutory accounts provide the measure for debt and equity (the U.S. being a notable exception, relying mainly on earnings stripping and tax definitions of debt and equity).

For a variety of reasons, including tax reasons, companies rely on intercompany debt to leverage up their operations in foreign jurisdictions. Highly leveraged subsidiaries in jurisdictions that base their limitations on debt and equity data from the statutory accounts run the risk they may be denied interest deductions on affiliated debt as a result of a change in the statutory accounting standard. It's not all bad news though – the impact may be positive if equity increases as a result of the change in standards. In addition, there is a project to converge IFRS and U.S. GAAP with respect to the characterization of financial instruments as debt or equity. While the preliminary discussion document issued by the Financial Accounting Standards Board suggested that many instruments currently treated as equity would be recharacterized as debt (e.g., perpetual instruments such as certain callable common stock or preferred stock), they appear to be retreating from this position. Companies should continue to watch for developments in this area as changes to the characterization of an instrument from equity to debt would put pressure on tax deductions for related party interest.

Distributable reserves

Retained earnings or some other concept of distributable reserves are generally required for companies to pay their dividends. Unless a country's current GAAP is already substantially similar to IFRS, the conversion or convergence with IFRS has the potential to alter distributable reserves.

For example, in the UK, companies considering a conversion to IFRS should be prepared for a potential reduction in distributable reserves, because of differences in the accounting for pensions. Such changes in accounting can thus adversely impact a company's dividend policy and, in the worst case, prevent dividend payments.

While pension accounting is a key driver of changes to equity in many jurisdictions, including the U.S. and Canada, other aspects of IFRS can also materially impact retained earnings and other equity accounts. For example, the potential for increased use of fair market value accounting and changes to the impairment models could lead to additional adjustments to equity accounts. The result is that CFOs should keep distributable reserves on the radar. Tax is a critical function in this context as the ability to move cash around the organization is often a joint treasury-tax decision.

Transfer pricing

Most countries around the world require documentation to substantiate that intercompany pricing is at arm's length and that, as a result, taxable income or deductions are not understated or overstated, respectively. It is common for companies to use financial data from comparable companies operating in a non-controlled (non-related party) environment to provide the necessary support. A wider adoption of IFRS could have both positive and negative effects on the development and implementation of transfer pricing policies. In one respect, implementing transfer pricing policies may eventually become easier. Fewer procedures may be required as more companies use IFRS and differences in profitability arising solely from differences in accounting methods are reduced between comparable companies.

In addition, the increase in financial information provided under IFRS may increase transparency, thus making it easier to adjust financial statements for differences in the level of capital employed and financing provided to customers and received from suppliers. A number of companies, however, may experience increased complexity for

some period of time where taxing authorities continue to rely on local statutory accounts computed on historic local GAAP for purposes of determining taxable income. To the extent that profits on the local statutory statements differ from those under IFRS, tax authorities may not readily accept such financial statements. Companies should monitor both their local statutory financial statements as well as financial statements based on IFRS to determine profitability targets and stay abreast of practices in each country.

From a transfer pricing standpoint, the adoption of IFRS will affect different companies' transfer pricing policies in different ways, depending on each company's exact circumstances, functions and risks. For example, for companies that use the comparable uncontrolled price (CUP) method to determine their transfer pricing for tangible goods, essentially no change to their transfer pricing should occur since the CUP method uses market prices to determine the appropriate price between related entities. Alternatively, companies that rely on balance sheet or profit and loss ratios may find that their ratios are affected and their transfer pricing should be revised.

What Should CFOs Do?

As IFRS adoption continues across the globe there may be a number of different tax impacts on multinationals. To effectively navigate the changes, CFOs need to ensure their accounting department is effectively coordinating with the tax and treasury departments, and accounting decisions are being made with appropriate consideration of the related tax implications.

With so many changes anticipated in the next 12 months, both in U.S. GAAP and adoption of IFRS in different jurisdictions, there are going to be many inherent tax implications. From that perspective, CFOs should not be waiting for the SEC to make its announcement concerning IFRS in the U.S. They should be planning for the impacts of IFRS on their organization in the immediate future. A preliminary assessment of the statutory landscape and related tax implication can help CFOs prioritize which jurisdictions require the most focus from a treasury perspective and those that perhaps require a deeper analysis from a cash tax perspective.

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