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Global Tax Implications of International Financial Reporting Standards

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On August 27, 2008, the Securities and Exchange Commission (SEC) paved the way for certain U.S.-based SEC registrants to adopt the International Financial Reporting Standards (IFRSs) optionally. This action follows the announcement by the Financial Accounting Standards Board (FASB) to defer its consideration of the convergence project to align the accounting for income taxes under IFRSs and U.S. Generally Accepted Accounting Principles (U.S. GAAP). The decision to defer anticipates SEC rulemaking. In light of the positive support for using IFRSs in the United States, it is important to keep in mind that the activities of U.S. regulators are only one facet of the global trend towards accepting IFRSs as a single accounting standard. As part of an effective global tax-planning approach, conversion activity in the United States represents one step in a journey that is well underway. Other factors to consider include the potential implications associated with the transition to IFRSs already well underway in other countries and the shorter-term changes to local reporting standards in those countries. These factors may have unanticipated consequences, which may have an impact on the global planning efforts of U.S.-based multinationals to manage their effective tax rate on a sustainable basis while effectively utilizing cash offshore or repatriating excess cash.

Convergence and conversion

In 2006, the FASB and the International Accounting Standards Board (IASB) published an updated Memorandum of Understanding (MOU) that reaffirmed the Boards' shared objective to develop high-quality, common accounting standards for use in the world's capital markets—the so-called "convergence." The MOU further elaborated on the objectives and principles first described in the Norwalk Agreement, published in October 2002. Not long ago, the IASB and the FASB agreed to proceed with convergence on two tracks:

1. Decide whether to eliminate major differences between IFRSs and U.S. GAAP through short-term projects and

2. Make continued progress in other areas that require improvement.

Conversion, on the other hand, refers to transition from a local set of accounting standards to IFRSs. For example, the SEC's consideration to permit the use of IFRSs for certain domestic SEC registrants is likely to result in some companies converting from U.S. GAAP to IFRSs. The SEC's recent activity with respect to conversion has, for now, slowed some of the FASB's convergence initiatives. In fact, short-term convergence of some accounting standards in the United States may be pre-empted by the full adoption of IFRSs. The FASB recently reviewed the overall direction of its convergence project on income taxes and discussed various options, including whether to issue a revised version of FAS 109, or IAS 12, or to do nothing. The project has been put on hold until the FASB understands future SEC rulemaking on IFRSs and determines how that rulemaking should affect standard-setting going forward. On August 13, 2008, though, the FASB did indicate its intention to move ahead this year with the convergence project on "Financial Instruments with Characteristics of Equity"— an effort that will influence global tax planning.

The IASB continues to move ahead with convergence in accordance with its original plan — developments that U.S. company tax departments should not overlook since a conversion to IFRSs will require the adoption of IAS 12.

It's five o'clock somewhere

The convergence and conversion activities taking place in the United States are only one part of a global shift toward consistent accounting standards. Somewhere in the world, accounting standards are changing today. Many countries have already adopted IFRSs as their required reporting standard for public companies. Several countries are in the process of adopting IFRSs (e.g., Canada and Korea), and other jurisdictions are contemplating converging their own local GAAP to align more with IFRSs. It is these changes to local GAAP that should be of greatest concern to global tax departments.

By and large, countries rely on local, or statutory, GAAP as the starting point for tax calculations. Most of the jurisdictions that have adopted IFRSs for financial statement reporting purposes require maintenance of local statutory books for tax purposes. Some jurisdictions, however, may begin to drop this requirement as the global trend towards IFRSs continues. For example, the Canada Revenue Authority is beginning to consider the tax impact of conversion to IFRSs. U.S. company tax departments should, therefore, be focused on both changes in local GAAP accounting standards and IFRSs.

If local GAAP changes, there may be an immediate impact on certain aspects of foreign tax reporting, with a corresponding effect on the overall effective tax rate for those U.S. multinationals that rely on reducing foreign taxes to maintain their effective tax rate. The magnitude of impact may be hard to evaluate. There is general agreement, however, that those companies with a good grasp of the local effective tax rate, and how changes to local accounting standards will affect that rate, are in the best position to properly plan for a migration to IFRSs. For example, European companies with shared service centers, and therefore, visibility to local statutory reporting for tax purposes, are better able to predict and plan for the impact of changes to the effective tax rate brought about by changing local accounting standards.

IFRSs — More than tax accounting

Could this shift affect your organization? It is possible that a change in pre-tax income brought about by a change in local accounting standards is not going to have an impact on your organization's effective tax rate in any material way. However, it is equally likely that it will. Depending on specific circumstances, companies operating in countries requiring or moving towards the use of IFRSs should consider the following issues as integral to a global tax planning methodology.

Local interest deductibility

The adoption of IFRSs, or other local country convergence activities, may change retained earnings and have a related effect on a subsidiary's ability to deduct interest for tax purposes. The results may be positive or negative, depending on the facts and circumstances. For those countries that use IFRSs as the basis for statutory reporting, changes in the relative amounts of debt and equity may trigger local interest deduction limitations (e.g., thin capitalization, earnings stripping, and interest cover rules). Highly leveraged subsidiaries may be denied interest deductions in jurisdictions that base their limitations on debt and equity data from the statutory accounts. Nevertheless, many companies may have opportunities to improve leverage in other jurisdictions.

A change to retained earnings is not the only issue. In November 2007, as part of a short-term convergence project, the FASB issued a preliminary view on "Financial Instruments with Characteristics of Equity," which the IASB reissued as a discussion paper. In that document, the FASB proposed a narrow definition of equity that would limit the ability to classify certain financial instruments as equity. Although this debate is far from settled, companies should continue to watch for developments, as many instruments that currently qualify as equity under U.S. GAAP could be recharacterized as debt (e.g., perpetual instruments such as certain callable common stock or preferred stock) as a result of this convergence project. For those countries that use IFRSs as the basis for statutory reporting, changes to the characterization of an instrument from equity to debt may trigger the interest expense limitation rules referred to earlier. An exposure draft is expected in the second half of 2009.

Hybrid instruments

Hybrid instruments, such as those for which the recipient of "interest" is treated as receiving a dividend but for which the payor gets an interest deduction, are common in international planning. Unlike the United States, some jurisdictions rely heavily on the financial accounting treatment to characterize a financial instrument for tax purposes. A change in the definition of equity arising from a change in accounting standards may unexpectedly eliminate the tax benefits of hybrid instruments since the income may be treated as interest rather than a dividend.

Foreign currency gains and losses

Foreign currency gains and losses recorded in the income statement may cause fluctuations in the effective tax rate due to differences in the rates applied to record the income and those used to calculate the related tax impact. It will be important to understand whether there are differences between the way IFRSs and local GAAP treat currency fluctuations, in particular with respect to whether they are recorded through the income statement or in equity (e.g., translation gains and losses or in accounting for hedges). In countries where tax follows the statutory accounts, the treatment of exchange gains and losses as a result of local adoption of IFRSs may have a material impact on the local tax liability.

Amortization and other deductions

Amortization deductions for goodwill and other intangible assets can have a material impact on the global effective tax rate. The tax basis in an asset generally drives the calculation of the deduction for tax purposes. Some countries allow the use of either IFRSs or local GAAP as the basis of statutory reporting for tax purposes. Consideration should be given to the tax accounting methods under both standards since a change in method could result in a material and immediate change in tax liability. An analysis of the statutory reporting options may reveal that the overall tax results under IFRSs are not as favorable as under local GAAP reporting. These tax consequences could also affect decision-making around timing of a conversion to IFRSs as well as eliminate the need for two sets of records in certain countries. An awareness of those items that impact the effective tax rate in any one jurisdiction will enable companies to determine whether a change in standards in that jurisdiction, either optional or mandatory, will affect the global effective tax rate.

Transfer pricing

Most countries 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. 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. Wider adoption of IFRSs 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 IFRSs 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 IFRSs 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, as taxing authorities continue to determine taxable income by relying 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 IFRSs, 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 IFRSs to determine profitability targets and stay abreast of practices in each country.

Share-based compensation

A complex, and potentially significant, aspect of global tax planning relates to share-based compensation. The objective is to provide competitive remuneration plans in a manner that does not adversely affect the effective tax rate. Share-based compensation rules vary greatly under local GAAP, IFRSs, U.S. GAAP, and local tax rules. At the most basic level, a company must evaluate the impact of converting to IFRSs locally in order to assess its ability to deduct share-based compensation in the local tax return. An updated tax-planning methodology should consider the interplay between local tax rules and corporate recharge, reimbursement, and transfer pricing arrangements for share-based compensation.

Repatriation strategies

Finally, global tax planning considers both effective tax rate and cash repatriation strategies. The changing statutory accounting standards are likely to affect financial statement earnings from both a transitional perspective (adjustments to opening retained earnings) and an ongoing perspective. Companies may have opportunities to revise cash repatriation strategies as a result of both changes in earnings available to be repatriated under local rules and, in multi-tiered structures, the tax characterization of distributions in the hands of the parent company (e.g., dividends versus return of capital).

It's the journey that's important

As internal and external shareholders increasingly scrutinize the global effective tax rate, tax executives need to be confident in their understanding of the forces that affect that rate, as well as their ability or inability to influence those forces. Without the proper visibility needed to plan for the impact of changing accounting standards on the effective tax rate, companies have little chance to mitigate an adverse tax consequence or take advantage of the opportunities that such changes might present.

While U.S. companies should start planning for a transition to IFRSs in the United States and preparing their tax departments accordingly, they should also consider the changes in accounting standards taking place in all jurisdictions today. Companies should view such changes as an integral part of their global business planning efforts to avoid unexpected volatility in the effective tax rate while effectively deploying earnings offshore or repatriating excess earnings. As the conversion to IFRSs becomes increasingly inevitable, they need to remember that it is always five o'clock somewhere.

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