



## U.S. GAAP and IFRS Convergence: Don't Forget the Impact on State and Local Taxes

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It is no secret that every corner of the world is now at our fingertips. The internet and other forms of multimedia have made connecting with distant parts of the globe as easy as clicking a button, and as a result of this access, the ability of individuals to interact with numerous global markets has greatly increased. However, despite the fact that investors have unprecedented access to markets around the world, they still do not have a consistent accounting standard on which to evaluate the financial results of companies operating in numerous different countries.

To rectify this problem, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) are attempting to converge the International Financial Reporting Standards (IFRS) and the U.S. generally accepted accounting principles (GAAP). If this convergence project is successful, the U.S. Securities and Exchange Commission (SEC) will be in a position in 2011 to determine whether to incorporate IFRS into the U.S. domestic reporting system. Further, if the SEC determines in 2011 to adopt IFRS, U.S. issuers would likely report under this system by 2015 or 2016.

Since the possible adoption of IFRS in the United States is about five or six years away, it is important to have a basic understanding what the IFRS is, what significant convergence projects are currently under consideration, and what deadlines are being set for potential standards to be issued. Once these major convergence projects have been identified, it is then important to examine what impact these possible changes will have on state and local taxes.

### Background on IFRS

The IFRS are a set of established accounting standards promulgated by the London-based IASB. The IASB, which began operations in 2001, is committed to developing a single set of global accounting standards that require transparent and comparable information in general purpose financial statements. Currently, over 100 countries have moved to, or are allowing, IFRS.

### Significant Convergence Projects Under Consideration

In a November 2009 joint statement, the IASB and FASB affirmed June 2011 as the target date for completing major IFRS and GAAP convergence projects. However, pursuant to the "Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards" issued by the IASB and FASB on June 24, 2010, the two organizations have stated that certain "projects we believe are a relatively lower priority or for which further research and analysis is necessary are now targeted for completion after the original June 11 target date." It appears that the target date for these lower priority projects is December 2011.

The IASB and FASB identified the following projects as priority projects in the progress report:

- Financial instruments;
- Revenue recognition;

- Leases;
- Presentation of other comprehensive income;
- Fair value measurement;
- Improved disclosures about derecognized assets and other off-balance-sheet risks;
- Consolidations (particularly in relation to structured entities); and
- Insurance contracts.

While many companies may focus on the federal tax implications arising from the above convergence projects, important state tax implications must be considered as well.

### **State and Local Tax Implications of IFRS and GAAP Convergence**

The IFRS and GAAP convergence will touch all facets of state and local tax, including tax accounting, income taxes, net worth taxes, as well as other areas. The following is a discussion of *some* of the state and local tax impacts:

#### **Changes to Book Income = Changes to Federal and State Taxable Income**

Book income statements and balance sheets are the starting point for both federal and state taxable income. Therefore, to the extent book income changes as a result of the IFRS convergence, federal taxable income will change, unless the IRS takes action to provide some relief to taxpayers. Further complicating matters, there is no certainty that states will follow the Service's lead. As a result of massive budget deficits, states have shown a propensity for decoupling from certain federal provisions (e.g., Section 199 and bonus depreciation).

#### **Revaluation Model Wreaks Havoc on Net Worth Taxes**

IAS 16, "Property, Plant, and Equipment," permits two accounting models: the Cost Model and the Revaluation Model. The Cost Model is currently used under GAAP. The Revaluation Model requires that assets be carried at fair market value less any subsequent accumulated depreciation and impairment. Revaluations should be carried out regularly to ensure the carrying amount of an asset is not materially different than its fair market value.

Generally speaking, to the extent a revaluation results in an increase in value, the increase should be credited directly to equity under "revaluation surplus." The revaluation surplus will accumulate in equity, and therefore should have an adverse impact on a taxpayer's net worth or capital-based tax liabilities. A decrease resulting from revaluation would first reduce any accumulated revaluation surplus and any remaining amount would be recognized as an expense.

#### **Uncertain Tax Positions: IAS 37 vs. FIN 48**

IAS 12, "Income Taxes," the IFRS equivalent to FAS 109, *Accounting for Income Taxes*, does not address the treatment of uncertain tax positions. IAS 12 looks to IAS 37, "Provisions, Contingent Liabilities and Contingent Assets," for guidance.

By now, everyone is familiar with the FIN 48 two-step approach: (1) **recognition** — is the position more likely than not to be sustained based on its technical merits if all facts are known, and if so, (2) **measurement** — determine the amount of the potential benefit that can be recognized in the financial statements. IAS 37 employs a drastically different method by using the probability-weighted average of *all* possible outcomes to arrive at the "expected outcome." Therefore, the potential of discovery and settlement can be considered when determining the potential financial statement benefit.

#### **No More LIFO?**

The definition of "inventory" pursuant to IAS 2, "Inventories," is similar to the GAAP definition of "inventories." However, the last in, first out (LIFO) method of accounting is prohibited under IAS 2 (FIFO and the weighted average cost methods are permitted). Currently, the "LIFO conformity" rules in IRC Section 472(c) provide that a taxpayer electing LIFO for income tax purposes must also elect LIFO for financial reporting purposes. Hypothetically, if taxpayers are forced to change their accounting method from LIFO to FIFO, they could be required to collapse their LIFO layers and, thus, take into income the recapture of the LIFO reserves.

A question then arises as to whether the IRS will provide some type of relief from the above scenario resulting from the elimination of LIFO for book purposes and whether states will follow suit.

#### **Revenue Recognition Rules Effect on Sales Factor**

IAS 18, *Revenue Recognition*, provides that revenue should be recognized when it is probable that any future economic benefit associated with the item of revenue will flow to the entity and the amount of revenue can be measured with reliability. While this treatment is not all that disparate from the revenue recognition rules under GAAP, there may be some items that are either

accelerated or deferred, whereby affecting a taxpayer's sales factor.

### Lightning Round: Other Issues to Consider

- How will changes to the treatment of stock-based compensation affect the payroll factor?
- How will the required move away from LIFO and the subsequent revaluation of inventories affect the property factor?
- How will changes in the revenue recognition rules affect gross receipts taxes?
- How will the revaluation model affect property taxes?

### Alvarez & Marsal Taxand Says:

Be prepared. We have only scratched the surface of the significant state and local tax implications of the IFRS and GAAP convergence. As we go farther down the path of convergence, more significant issues will become apparent. So, as the SEC continues down *its* roadmap to adoption, tax departments should be developing *their own* roadmaps to address the convergence.

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