

## Five Ways a Conversion to International Financial Reporting Standards Could Impact a Global Tax Structure



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The movement toward International Financial Reporting Standards (IFRSs) as a single set of globally accepted accounting standards is quickly gathering momentum. Numerous countries, including the United States, are actively working towards either more closely aligning local country GAAP with IFRSs (commonly referred to as convergence), or fully adopting IFRSs as their GAAP (conversion).

The fact that IFRSs are rapidly gaining acceptance around the world is spurring U.S. companies to assess the potential implications of adopting that set of standards. One area in which the movement to IFRSs could have a significant impact is tax planning for global product and financial supply chains. This article highlights five important ways in which the movement to IFRSs could have an impact on global tax planning.

### Tax planning for product and financial supply chains

Tax planning for a company's product supply chain focuses on income generated by select profit drivers — such as intangibles, functions and risks — that might be located in tax-favorable jurisdictions. Such tax planning also focuses on determining that the related transaction flows and commercial activities support tax deferral or other tax planning objectives.

An example of business and tax planning for the product supply chain is establishing a central entrepreneur in a foreign jurisdiction that provides discrete services (such as manufacturing) for other related parties.

Meanwhile, tax planning for a company's financial supply chain typically has three objectives:

- Enhancing the deployment of excess cash within the organization on a tax-efficient basis,
- Rationalizing intercompany payment streams, and
- Effectively managing the ability to remit earnings on an after-tax basis through the utilization of foreign tax credits and other tax attributes.

Establishing a finance company to monitor and facilitate the deployment of cash within a group of companies or enterprises is an example of such planning. Increasingly, companies are seeking to deploy integrated planning that simultaneously achieves tax efficiencies across both the product and financial supply chains.

The movement to IFRSs presents potential challenges and opportunities to companies pursuing, or having recently completed, such integrated planning. It also requires that companies as well as their tax advisers and auditors understand and evaluate how various strategies will operate over time in multiple countries that are converting to IFRSs at different times. In particular, attention should be paid to five key areas:

- The likely elimination of FAS 109, paragraph 9(e) and the resulting impact on tax planning for high-value intangibles.
- Potential changes to the definition of debt and equity and their impact on recognition of currency fluctuations.
- The impact that conversion to IFRSs could have on when, and how much of, the Cumulative Translation Account (CTA) is ever recognized in income.
- The use of shared service centers.
- Timing of entity rationalization.

### Elimination of FAS 109, paragraph 9(e) and its tax planning impact for high-value intangibles

Many U.S. companies have sought to better align the commercial use of their intangible asset value outside the United States with the tax burden arising from the income earned from such use. Historically, the preferred method for achieving such alignment was to have the U.S. parent and a foreign subsidiary enter into a cost-sharing arrangement (CSA). Under the CSA, the two participants would share the costs to develop an intangible, such as patented technology, in proportion to their anticipated benefits to be realized from the developed intangible. Frequently one of the participants, typically the U.S. parent, would make available to the CSA pre-existing intangibles for which the other participant, a non-U.S. subsidiary, would pay arm's length compensation representing taxable income to the recipient. This is commonly known as the "buy-in." Under existing U.S. tax regulations applying to CSAs, buy-ins can be structured in a number of ways (e.g., a royalty, a lump-sum payment, etc.).

Intercompany transactions are often recognized currently for tax purposes even though recognition of the transaction is deferred in the consolidated financial statements. In the case of the buy-in described above, the U.S. parent will generally be subject to tax currently on the buy-in payment, and the non-U.S. subsidiary will receive a local country tax basis equal to the amount of the payment. In the context of consolidated financial reporting, however, profit recognition on intercompany transactions is generally deferred with an equal and offsetting reduction in the book basis of the transferred asset.

FAS 109, paragraph 9(e) requires that the recognition of income taxes paid on intercompany profits arising from the sale of assets remaining within the group (e.g., the buy-in payment) be deferred. Commonly, a prepaid income tax account is established or the intercompany profits eliminated in consolidation are reduced accordingly for the related current tax expense. In general, the prepaid tax account is amortized into tax expense over the asset's economic life (assuming the subject of the sale is a wasting asset). Further, paragraph 9(e) prohibits the establishment of the deferred tax asset on the temporary difference between the tax basis in the buyer's hands and the book basis as reflected in the consolidated financial statements. To the extent there is a tax rate differential between the two jurisdictions, the impact on the effective tax rate is recognized over the economic life (which should correspond with the income associated with the asset).

As a result of the interplay between the existing cost-sharing rules in the United States and FAS 109, paragraph 9(e), U.S. taxpayers currently have potential flexibility in structuring these transactions to achieve certain business, intellectual property, and tax objectives without skewing the effective tax rate for financial reporting purposes. For example, a buy-in could be structured such that it is treated as a sale, thereby allowing the tax impact of the buy-in to be spread over a number of periods. Or, a buy-in may be structured in a manner that does not create a sale, such as a license, resulting in recognition of the tax consequence in the current period.

This flexibility, however, would be absent under IAS 12, the standard on accounting for income taxes under IFRSs. The reason is that IAS 12 requires (by having no “9(e)” exception) that the tax provision reflect both (1) the current tax expense or benefit on intercompany transactions and (2) the deferred tax asset or liability for the temporary difference between the tax basis in the buyer’s hands and the book basis as reflected in the consolidated financial statements. How long 9(e) remains available has been uncertain for awhile. In 2004, the Financial Accounting Standards Board (FASB) stated that it would eliminate paragraph 9(e) in order to align it with IAS 12, and until recently the working assumption was that this would occur as part of a short-term convergence project. More recently, in August 2008, the FASB announced it was postponing indefinitely its IAS 12 convergence project; however, this announcement was quickly followed by the SEC’s issuance of a proposed roadmap to mandatory conversion of IFRSs, which could occur in some instances as early as 2014.

Regardless of whether FAS 109 is revised or IAS 12 becomes applicable due to conversion, the result for U.S. GAAP filers is likely to be the same — the recognition of tax expense or benefit in a period earlier than the related pretax income/expense is recognized. This outcome could likely have the greatest impact on cross-border intercompany transfers of high value/low basis assets — a category in which intangible property squarely falls.

Complicating matters is the fact that the cost-sharing rules under U.S. Treasury regulations are in a state of transition. In 2005, the U.S. Internal Revenue Service issued new proposed cost-sharing regulations, and the final regulations are expected to be issued in the very near future. Under the proposed regulations, the transaction that would be equivalent to the existing buy-in transaction will be required to have characteristics that are much more akin to a sale (e.g., territorial exclusivity and transfers in perpetuity), increasing the likelihood that it will be treated as a sale for book purposes. It is anticipated that the final regulations may include similar requirements.

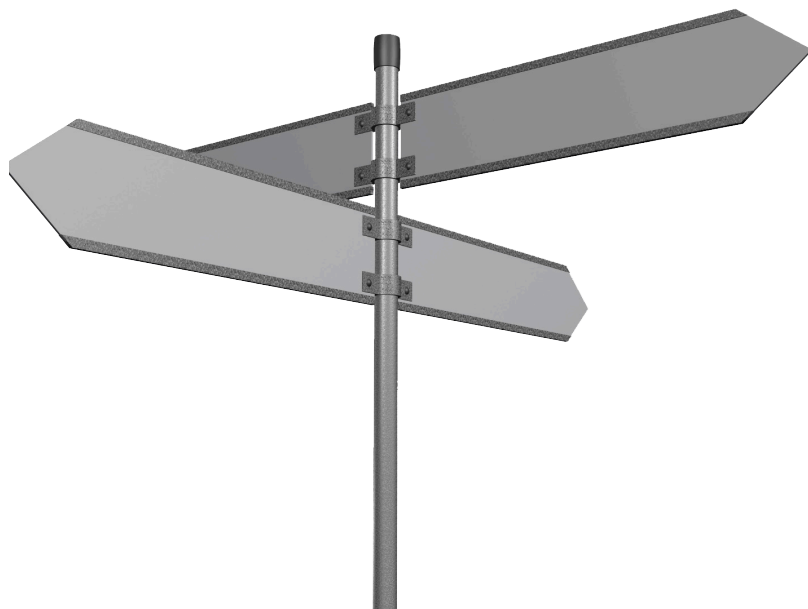
If the final cost-sharing rules require buy-ins to be more “sale-like,” then companies contemplating cost sharing will need to evaluate carefully the tax provision impact of the absence of a FAS 109, paragraph 9(e) type of exception under IFRSs. Ultimately, the interaction of the final cost-sharing regulations and the elimination of FAS 109, paragraph 9(e) may lead to an environment in which cost sharing is less utilized by taxpayers as they seek alternatives that provide both greater flexibility and less volatility for financial reporting purposes.

## Impact of potential changes to the definition of debt and equity on recognition of currency fluctuations

Finance companies often utilize hybrid instruments — meaning instruments that are treated as debt in the obligor’s jurisdiction and as equity in the affiliated holder’s jurisdiction — as a means to facilitate tax-deductible repatriation from the local country with tax-favorable treatment of the income in the recipient’s jurisdiction. Such instruments are generally characterized as equity under both U.S. GAAP and IFRSs, resulting in currency fluctuations on the instrument being recorded through equity as translation gain or loss. In contrast, the currency fluctuations on debt instruments (that are not long term in nature) are recorded through the profit and loss statement.

The International Accounting Standards Board and FASB are actively engaged in a convergence project on the classification of financial instruments with the characteristics of equity. To date, the commentary on this topic has indicated that these efforts may result in a narrowing of the range of instruments that could be treated as equity. Thus, while debt may still be introduced at the local country level to generate interest deductions, it may more frequently require the holder of the instrument to recognize currency gains and losses.

Changes in the definition of debt and equity may have a dramatic effect on tax planning. While it is expected that any change to the definition will not take effect until 2011, depending on the issuance and effective date of a revised accounting standard, planning today should take into account the potential for a changing landscape. Any change will impact such things as the term of the instruments currently being contemplated, as well as clauses regarding the conditions under which the terms of the instrument may be changed or the instrument terminated before its natural term. In addition, the potential impact of a change in the classification of an instrument on any debt covenants may also require careful consideration. In short, financial instruments being deployed today will need to be able to take into account the potential for a sea of change in the rules of the game.



## Conversion to IFRSs and the impact on recognition of the CTA

The rules under U.S. GAAP and IFRSs are similar with respect to the treatment of gains and losses from (1) transactions in a non-functional currency, (2) remeasuring financial statements into the functional currency, and (3) translating financial statements into the reporting currency. There are two aspects of foreign currency, however, that may be affected by a conversion to IFRSs. The first relates to a technical difference between FAS 52 and IAS 21, while the second relates to an optional exemption available under IFRS 1 to reset the CTA component of equity to zero upon adoption of IFRSs.

The first aspect of foreign currency under IFRSs that needs to be understood is that IAS 21 requires amounts to be transferred from the CTA to the income statement upon the disposal, or partial disposal, of a foreign operation. For this purpose, equity includes both non-retained earnings elements of equity (e.g., paid-up capital) as well as any pre-acquisition retained earnings. This is a significant divergence from FAS 52, which provides that currency translation gains or losses are only recognized in the income statement once the company has ceased carrying on a business in that foreign jurisdiction.

With respect to the amount of the CTA (or “accumulated translation reserves”) possibly at issue, IFRS 1 provides an optional exemption to the general restatement and measurement principles that apply on adoption of IFRSs. Specifically, an entity may elect to recognize all translation adjustments arising on the translation of the financial statements of foreign entities in retained earnings at the opening balance sheet date under IFRSs (that is, reset the translation reserve included in equity under previous GAAP to zero). If the entity elects this exemption, the gain or loss on subsequent disposal of the foreign entity will be adjusted only by those accumulated translation adjustments arising after the opening balance sheet date under IFRSs. If the entity does not elect to apply this exemption, it must restate the translation reserve for all foreign entities from the time they were acquired or created. Whether a company chooses to avail itself of the exemption will depend largely on its ability to restate its cumulative translation account under IFRSs.

The practical ramification of these issues is that companies will be well served to establish transparent, well-defined processes around tracking CTA and the related tax effects.

## IFRSs and the potential for greater use of shared services centers

An important benefit of IFRSs is that it provides a platform on which financial reporting processes, particularly those related to local country statutory reporting, can be further optimized within an enterprise. Such optimization often will entail establishing or expanding shared services centers to centralize transaction processing and financial reporting as well as to

centralize internal control and policy-making functions. From a tax planning perspective, the creation, expansion, or relocation of a shared services center affords the opportunity to assess the value such organizations provide to the various constituencies within the enterprise and to design a corresponding tax-efficient structure. This assessment should include a careful analysis of:

- The proposed locations for a center, both geographically and within the enterprise’s legal structure;
- The income tax, transfer pricing, and indirect tax consequences arising from the contemplated transactional footprint; and
- Perhaps most important, the manner in which the intangibles deployed through the shared services center (e.g., standardized processes, systems, etc.) are funded, developed, and directed.

## IFRSs – a springboard for entity rationalization?

The adoption of IFRSs will be a substantial undertaking for most global enterprises, typically requiring extensive internal and external resources. One technique to reduce the time and cost of this conversion is to complete any potential legal entity rationalization before adopting IFRSs. Many companies find themselves with excess legal entities, arising either from prior acquisitions, tax, or legal structures that have outlived their usefulness, or arising from a change in business operations. Some companies have literally hundreds of duplicative entities; rather than implement IFRSs at all of them, it may be better to eliminate the unneeded entities first.

In addition to reducing the time and cost of implementation of IFRSs, entity rationalization carries a number of other potential benefits, including:

- Reducing the accounting, information technology, legal, treasury, and human resource costs and risks associated with unnecessary entities;
- Providing a much more understandable structure for management; and
- Providing greater certainty about, if not access to, various tax attributes.

## Getting ahead of the curve

Conversion to IFRSs will affect a company’s global tax structure in numerous, complex ways. By examining the potential ramifications before undertaking a conversion, companies will be better positioned to see possible roadblocks and plan strategically for the impact on both their global product and financial supply chains.

For additional resources and information on IFRSs, visit the [Deloitte IFRS website](#).

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