



IFRS Is Coming, What Does This Mean for Tax?

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Many companies are in the early stages of considering what impact the transition to International Financial Reporting Standards (“IFRS”) from U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) will have on financial reporting; however, are they also thinking about the impact it will have on tax reporting?

IFRS is the accounting standard currently used in many parts of the world. Over 100 countries currently require or permit IFRS or a variation of IFRS. Many other countries, including the United States, are planning to require or permit IFRS, or are working on convergence with IFRS. As a result, IFRS seems to be the most likely approach to achieving a single set of high quality, globally accepted accounting standards.

Panelists at the Securities and Exchange Commission (“SEC”) Roundtables in December generally agreed that U.S. domestic companies registered with the SEC should be required to file IFRS financial statements at some point in the future and that the SEC should establish a timeframe for implementing the requirement. The panelists included a broad spectrum of individuals from U.S. financial statement issuers to auditors, regulators, and academics. Suggestions on a specific date ranged from 2010 to 2015. Accordingly, while U.S. companies do not know the exact date of transition, it appears that IFRS is coming and may be replacing U.S. GAAP in the near future.

Impact on Tax Accounting Methods

Many elements in a company support the issuance of financial statements. Consequently, converting financial statements from one reporting standard to another would have broad implications beyond just financial (book) accounting. Tax accounting, as well as many other areas in the company would be affected.

It will be important for tax return preparers to understand any differences between the old book reporting method and the IFRS reporting method to determine the proper treatment for tax reporting purposes. Thus, along with re-training preparers of financial statements in a new book accounting method, companies will need to ensure that internal users of financial accounting information, such as the tax department, understand the nuances between the different book methods. Generating awareness will be especially important in the year of change because some of the effects of the conversion may be recorded in equity.

Consider, for example, items that are currently treated the same for book and tax purposes. If the book treatment changes as a result of implementing a new IFRS method, companies would need to determine how to continue using the historical tax method. This may lead to several questions: Is there a financial conformity rule that needs to be followed under the tax law? Can the historical tax method be continued or will the new book method omit information needed to produce the historical tax method? Does the company have the information available to compute the book/tax differences? Is the new book method an acceptable method for tax reporting purposes? Depending on the answers to these questions, companies may need to file Form 3115, *Application for Change in Accounting Method*, to change some historical tax methods.

To further explore this issue, let's examine how software development costs and inventory (specifically the last-in, first-out ("LIFO") method) could be effected if the current book method changes to a new book method under IFRS.

Different Book Methods—Software Development Costs

Assume that the accounting for software development costs under the current and new book methods is similar—both require capitalization when certain criteria are met. However, the timing and the amount capitalized is different because capitalization under the current book method occurs earlier than capitalization under the new book method.

For tax reporting purposes, the IRS, under Revenue Procedure 2000-50, will not disturb a taxpayer's treatment of software development costs when all the costs properly attributable to the development of software by the taxpayer are consistently treated as: (1) current expenses and deducted in full (in accordance with rules similar to the applicable section 174(a) rules); or (2) capital expenditures that are recoverable through deductions for ratable amortization (in accordance with rules similar to section 174(b) and the regulations thereunder, over a period of 60 months from the date of completion of such development or, in

accordance with the rules provided in section 167(f)(1)(A) and the regulations thereunder, over a period of 36 months from the date the software is placed in service). Further, software development costs may also be currently deductible under either section 162 or 174. Therefore, most taxpayers deduct these costs as incurred.

Keeping in mind the differences between the current book and tax methods, taxpayers must track software development projects each year to attain proper, consistent treatment in the tax return. To maintain the historical tax method following the conversion to a new book method, taxpayers would need to understand which costs run through retained earnings as a result of the adoption of the new book method and the differences between the old and new book methods. If these differences are not tracked correctly there is a high possibility of error, which may lead taxpayers to unknowingly reporting a different position than their historical tax method.

Method Not Permitted under New Book Method—LIFO

Following the conversion to a new book method, the use of the LIFO tax method may not be permitted. This is in contrast to the current book method that allows the LIFO method as a permitted inventory valuation method.

For tax reporting purposes, section 1.471-2(d) allows a taxpayer to determine the cost to be included in ending inventory under the LIFO method; however, there is a LIFO conformity requirement. To initially adopt LIFO, a taxpayer must establish that it only used the LIFO inventory method (1) in its report or statement of income, profit, or loss to shareholders (or other equity owners) or beneficiaries, or (2) for credit purposes for such year pursuant to section 472(c). Further, in order to have the right to continue to use LIFO for subsequent years, the taxpayer must continue to comply with the conformity requirement under section 472(e)(2). If the conformity requirement is violated, the IRS has the authority to disallow the adoption of LIFO or to terminate its use.

Does this mean that LIFO will no longer be permitted when a company converts to a new book method that does not allow LIFO reporting? If so, companies may want to start planning now to manage the impact of terminating the LIFO method. Taxpayers may generally use the automatic change provisions under Revenue Procedure 2002-9 to terminate LIFO and the resulting section 481(a) adjustment will be recognized over four years pursuant to Revenue Procedure 2002-19. However, before making such a change taxpayers will need to consider the effect

on other items. For example, how will a LIFO termination affect uniform capitalization costing and the section 199 manufacturing deduction?

It is unknown at this point whether a new global book accounting method will permit LIFO (IFRS presently does not allow LIFO). The only thing currently foreseeable is that the treatment of LIFO would have a far-reaching effect. Foreign companies may suddenly have an opportunity to use LIFO. Alternatively, U.S. companies may no longer be permitted to use LIFO for book and tax reporting purposes (under the conformity rule) unless the current U.S. tax law is changed and the LIFO conformity requirement is eliminated. At the present time, there does not appear to be any movement by the IRS, Treasury or Congress to address the LIFO conformity conundrum.

Conclusion

It is important to note that it is likely that any global accounting standards that the U.S. may transition to in the future will be different from the IFRS that exists today. Ongoing convergence efforts could continue to lessen the differences and may ease some of the anticipated burden.

Nevertheless, as discussed above in a general context, converting financial statements from one book method to another would be a significant undertaking. As such, companies need to start thinking about managing the transition, including the related tax implications. For that reason, it would be prudent for all members of the financial reporting community, as well as tax practitioners, to watch the IFRS movement and start thinking about what the transition will mean to them.

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