TAX MANAGEMENT
MULTISTATE TAX REPORT

November 27, 2009

Reproduced with permission from Tax Management Multistate Tax, Vol. 16, No. 11, 11/27/2009. Copyright © 2009 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Procedure

As the financial crisis on Wall Street has subsided, the Securities and Exchange Commission (SEC) is shifting its focus back to the proposed convergence of generally accepted accounting principles (GAAP) with international financial reporting standards (IFRS). In this article, authors Douglas M. Sayuk, Matthew H. Fricke, and Shamen R. Dugger, of Clifton Douglas LLP, discuss the potential state tax impacts of that convergence, with a particular focus on the differences in calculating uncertain tax positions.

Now That GAAP/IFRS Convergence Is an SEC Priority, Taxpayers Need to Consider Potential Multistate Impacts

By Douglas M. Sayuk, Matthew H. Fricke, and Shamen R. Dugger

Douglas M. Sayuk, CPA, and Matthew H. Fricke are partners with Clifton Douglas LLP, of San Jose, Calif. Shamen R. Dugger, Esq., CPA, is a director with Clifton Douglas. The authors can be reached at Doug@cliftondouglas.com, Matt@cliftondouglas.com, and Shamen@cliftondouglas.com. More information on Clifton Douglas is available at www.cliftondouglas.com.

INTRODUCTION

As the financial crisis on Wall Street subsides, the Securities and Exchange Commission (SEC) has shifted its focus once again to the proposed convergence of generally accepted accounting principles (GAAP) with international financial reporting standards (IFRS). Recently, SEC Chairwoman Mary Schapiro said that, after a nine-month delay, the agency would again take up the review of a proposed road map steering the United States to adoption of IFRS by 2014.[1] SEC Chairwoman Schapiro's priorities are shared by James Kroeker, the SEC's chief accountant, who stated that ''convergence of accounting standards and the pro-

Copyright © 2009 TAX MANAGEMENT INC., a subsidiary of The Bureau of National Affairs, Inc. ISSN 1078-845X

posed road map will be a priority for us in the weeks and months to follow.''[2] In addition, the leaders of the Group of Twenty (G-20) nations earlier this year called for substantive progress toward a single set of global standards,[3] while President Obama reiterated this position in his regulatory reform proposals in June.[4]

The accounting profession in general is also urging the SEC forward, as indicated by two recent surveys performed addressing the convergence effort. On Oct. 5, 2009, Deloitte LLP released a survey showing that ''70 percent of respondents indicated that the SEC should approve its proposed IFRS road map either 'as is' or by pushing back the proposed mandatory deadline by a year.''[5] Soon thereafter, on Oct. 19, 2009, the American Institute of Certified Public Accountants (AICPA) released its IFRS Readiness Tracking Survey, which generally corroborates Deloitte's findings.[6] The AICPA survey found that a 53.6 percent majority supports IFRS use by U.S. public companies; of those, 14.1 percent support an SEC mandate of IFRS, and 39.5 percent support mandated use of IFRS but only after U.S. and international standards are further converged.[7] Eighteen percent said the SEC should not mandate use of IFRS but should allow IFRS as an option for U.S. companies.[8]

Both surveys indicated lack of guidance from the SEC as companies' primary reasons for their delay in IFRS assessment plans.[9] The AICPA survey found 50.6 percent of CPAs expect they will need relevant IFRS knowledge within the next one to three years, with 8 percent saying they need more knowledge now. The AICPA survey also found a 65 percent majority of CPAs want the SEC to address its plans for IFRS adoption by the end of this year (2009).

In this article, we compare U.S. GAAP accounting for income taxes standards under ASC Topic 740 with IFRS accounting for income taxes standards under IAS 12.[10] We then analyze the potential state tax implications if convergence is approved. Finally, we delineate what action steps, if any, companies should be taking now to prepare for a potential convergence. In addition, the article addresses action steps in line with the convergence that may propel a company's tax function to greater utility, regardless of ultimate convergence approval.

BACKGROUND

During January 2009, Ernst & Young LLP released an overview of the differences between U.S. GAAP and IFRS.[11] The overview included a comparison of accounting for income taxes standards under ASC Topic 740 with IFRS accounting for income taxes standards under IAS 12, noting significant differences between the two standards.[12] Table 1, which summarizes these differences, is adapted from the Ernst & Young overview.

Of the differences noted, we believe the following are likely to have the greatest impact from a state income tax perspective:

- uncertain tax positions;
- calculations of deferred tax assets or liabilities; and
- classification of deferred tax assets and liabilities in the balance sheet.

Based on the IASB's original exposure draft proposing IFRS accounting for income tax changes, we also believe uncertain tax positions may be most affected and have, therefore, primarily focused on that difference in this article.

[1] Press Release, American Institute of Certified Public Accountants, AICPA Survey Shows U.S. CPAs Delayed Moves Toward International Accounting Standards After SEC Set Aside Progress on ''Roadmap,'' (Oct. 19, 2009).

[2] *IFRS Survey Results 2009: Current Issues*, Oct. 5, 2009.

[3] *Waiting on the SEC*, AICPA IFRS Blog, Sept. 2, 2009.

[4] *Id.*

[5] The Deloitte survey, conducted in September 2009, had more than 150 respondents, including finance professionals, chief financial officers, and finance managers. Survey participants were self-selected, and responded through a web-based form.

[6] The AICPA survey was conducted via an online questionnaire from Sept. 3, 2009, to Sept. 28, 2009, and included 1,132 CPAs in public accounting firms and in business and industry. The survey's margin of error was plus-or-minus three percentage points.

[7] *Id.*

[8] *Id.*

[9] The Deloitte survey found 45 percent of respondents cited the SEC's delay in finalizing the IFRS road map as the reason for their own companies' delay in IFRS assessment plans. The AICPA survey shows most CPAs believe the U.S. should move toward IFRS, and they are looking to the SEC for leadership and direction.

[10] ASC Topic 740 provides guidance regarding accounting for income taxes (formerly FAS 109) and accounting for income tax uncertainties (formerly FIN 48) under U.S. GAAP. IAS 12 provides guidance regarding accounting for income taxes under IFRS.

[11] *U.S. GAAP v. IFRS: The Basics*, Ernst & Young LLP, January 2009.

[12] On March 31, 2009, the International Accounting Standards Board (IASB) issued an exposure draft (ED/2009/2 *Income Tax)* containing a proposal for improving international accounting for income taxes. The IASB voted Oct. 28, 2009, to defer work on the proposal and indicated that it may ultimately reject the proposal in favor of a complete overhaul of accounting for income taxes under IAS 12. Irrespective of this new development, as of the date of this publication, the U.S. GAAP/IFRS accounting for income taxes differences remain as delineated in the Ernst & Young overview. (5 BNA *Accounting Policy & Practice Report* 972.)

Table 1: GAAP vs. IFRS

 Copyright © 2009 TAX MANAGEMENT INC., a subsidiary of The Bureau of National Affairs, Inc. ISSN 1078-845X

Table 1: GAAP vs. IFRS – Continued

	U.S. GAAP	IFRS
Tax basis	Tax basis is a question of fact under the tax law. For most assets and liabilities, there is no dispute on this amount. However, when uncertainty exists, it is determined in accordance with FIN 48, *Accounting for Uncertainty in Income Taxes.*	Tax basis is generally the amount deductible or taxable for tax purposes. The manner in which management intends to settle or recover the carrying amount affects the determination of tax basis.
Uncertain tax positions	FIN 48 requires a two-step process, separating recognition from measurement. A benefit is recognized when it is ''more likely than not'' to be sustained based on the technical merits of the position. The amount of benefit to be recognized is based on the largest tax benefit that is greater than 50 percent likely to be realized upon settlement. Detection risk is precluded from being considered in the analysis.	Does not include specific guidance. IAS 12 indicates tax assets and liabilities should be measured at the amount expected to be paid. In practice, the recognition principles in IAS 37 on provisions and contingencies are frequently applied. Practice varies regarding consideration of detection risk in the analysis.
Initial recognition exemption	Does not include an exemption like that under IFRS for nonrecognition of deferred tax effects for certain assets or liabilities.	Deferred tax effects arising from the initial recognition of an asset or liability are not recognized when (1) the amount did not arise from a business combination and (2) upon occurrence the transaction affects neither accounting nor taxable profit (for example, acquisition of nondeductible assets).
Recognition of deferred tax assets	Recognized in full (except for certain outside basis differences) but valuation allowance reduces asset to the amount that is more likely than not to be realized.	Amounts are recognized only to the extent it is probably (similar to the ''more likely than not'' standard under U.S. GAAP) that they will be realized.
Calculation of deferred tax asset or liability	Enacted tax rates must be used.	Enacted or ''substantively enacted'' tax rates as part of the balance sheet data must be used.
Classification of deferred tax assets and liabilities in balance sheet	Current or noncurrent classification, based on the nature of the related asset or liability, is required.	All amounts classified as noncurrent in the balance sheet.
Recognition of deferred tax assets and liabilities from investments in subsidiaries	Recognition not required for investment in foreign subsidiary or corporate JV that is essentially permanent in duration, unless it becomes apparent that the difference will reverse in the foreseeable future.	Recognition not required unless the reporting entity has control over the timing of the reversal of the temporary difference, and it is probable (''more likely than not'') that the difference will not reverse in the foreseeable future.
Taxes on intercompany transfers of assets that remain within a consolidated group	Requires taxes paid on intercompany profits to be deferred and prohibits the recognition of deferred taxes on differences between the tax bases of assets transferred between entities/ tax jurisdictions that remain within the consolidated group.	Requires taxes paid on intercompany profits to be recognized as incurred and permits the recognition of deferred assets on differences between the tax bases of assets transferred between entities/tax jurisdictions that remain within the consolidated group.

POTENTIAL STATE IMPACTS

Accounting for Uncertain Multistate Tax Positions

If the IASB's proposed changes related to accounting for income tax uncertainties are approved and subsequently adopted by the Financial Accounting Standards Board (FASB), there likely would be the following significant impacts to current reporting under FIN 48/ASC Topic 740-10:

- tax benefit recognition;
- measurement approaches;
- periods in which measurement changes are recognized; and
- objective standards in assigning sustention probability (although the current exposure draft does not establish such standards).

These impacts are analyzed in detail below.

Tax Benefit Recognition

Companies reporting under U.S. GAAP could find tax benefits not meeting the FIN 48 recognition threshold would, under IASB proposed rules, now be recognized to some degree under application of the probability weighted average of all possible outcomes.

For example, Company A plans to claim an uncertain tax position (*e.g.*, state research credit) on its return that results in a potential tax benefit of $10,000. Company A believes the position has only a 25 percent chance of being sustained.

Under the IASB's exposure draft, Company A would recognize a $2,500 tax benefit (25 percent x $10,000) and a $7,500 tax liability (75 percent x $10,000). Under FIN 48, the tax position would not meet the greater than 50 percent recognition threshold and, therefore, no tax benefit recognition would be allowed for financial statement reporting purposes. Rather, a $10,000 liability would be recorded.

Assume the same example as above, but now Company A believes the position has a 75 percent chance of being sustained.

Under the exposure draft, Company A would recognize a $7,500 tax benefit (75 percent x $10,000) and a $2,500 tax liability (25 percent x $10,000). Under FIN 48, the tax position would now meet the greater-than-50 percent recognition threshold and, therefore, tax benefit recognition of $10,000 would be allowed for financial statement reporting purposes at the largest amount that is more likely than not to be realized.

Measurement Approach

FIN 48 and the IASB's proposal also differ in their measurement approaches. FIN 48 requires companies to use a cumulative-probability approach to measure the amount of tax benefit they must recognize, whereas the IASB's proposal requires the use of a probability-weighted-average approach. The difference in approaches is likely to affect the amounts companies record in their financial statements.

For example, Company A takes a credit for an uncertain tax position (*e.g.*, state apportionment) that results in a tax benefit of $30,000. The tax position meets the FIN 48 recognition threshold. Company A estimates the probability of potential outcomes as shown in Table 2.

Table 2

Potential Benefit	Individual Probability	Probability Weighted Calculation	Cumulative Probability	Benefit Under FIN 48
$30,000	30%	$9,000	30%	0
$20,000	30%	$6,000	60%	**$20,000**
$10,000	20%	$2,000	80%	N/A
$0	20%	$0	100%	N/A
Benefit Under IFRS		**$17,000**		

Under FIN 48, Company A would recognize the largest amount of tax benefit that has a cumulative probability of greater than 50 percent (*i.e.*, 60 percent), in this case, a tax benefit of $20,000 with a corresponding tax liability of $10,000.

Under the proposal, Company A would recognize a tax benefit for the probability-weighted-average of the expected outcomes. Accordingly, Company A would recognize a tax benefit of $17,000 with a corresponding tax liability of $13,000, as shown in Table 2.

Periods in Which Measurement Changes Are Recognized

The proposal and FIN 48 both require that changes in measurement be based on new information. However, for positions that do not meet FIN 48's recognition threshold, the period in which a company recognizes measurement changes under FIN 48 may differ from the period it would recognize those changes under the IASB's proposal.

For example, assume a taxpayer obtains favorable new information supporting a tax position (*e.g.*, state nexus) that has not met FIN 48's recognition threshold. Unless the new information was to cause the tax position to meet the more-likely-than-not recognition threshold, the company would not record a benefit until the company effectively settles the position. Because the IASB's proposal does not establish a recognition threshold, changes in measurement would be recognized when new information is obtained. Under the exposure draft, a tax benefit would be recognized even at a low sustention percentage of 10 percent. In this case, if new information (*e.g.*, new case law, regulations, tax authority guidelines, etc.) became available increasing the probably to 30 percent, the measurement change (*i.e.*, additional tax benefit) would be recognized immediately irrespective of a greater than 50 percent recognition threshold as required by FIN 48. Because the more-likely-than-not standard of FIN 48 is not met, no benefit would be recognized.

Both Approaches Lack Guidance For Objectively Assigning Probabilities

Irrespective of whether the proposal or FIN 48 approach is applied in accounting for income tax uncertainties, the underlying probabilities assigned to an uncertain tax position must be reasonably accurate to assure proper accounting. However, neither approach provides guidance on how to objectively assign prob-

 Copyright © 2009 TAX MANAGEMENT INC., a subsidiary of The Bureau of National Affairs, Inc. ISSN 1078-845X

abilities, thus making this area of tax accounting difficult to substantiate under either standard.

For example, assume Company A above claiming the $30,000 credit decides to change its individual probability thresholds. In this case, both approaches are impacted based on Company A's subjective estimates as shown in Table 3.

Table 3

Potential Benefit	Individual Probability	Probability Weighted Calculation	Cumulative Probability	Benefit Under FIN 48
$30,000	10%	$3,000	10%	0
$20,000	30%	$6,000	40%	0
$10,000	40%	$4,000	80%	**$10,000**
$0	20%	$0	100%	N/A
Benefit Under IFRS	**$13,000**			

Under FIN 48, Company A would recognize the largest amount of tax benefit that has a cumulative probability of greater than 50 percent (*i.e.*, 80 percent), in this case, a tax benefit of $10,000 with a corresponding tax liability of $20,000. This result is significantly different from the result in the previous example where the tax benefit that had a cumulative probability of greater than 50 percent (*i.e.*, 60 percent) was $20,000 with a corresponding tax liability of $10,000.

Under the proposal, the shift in tax benefit is not as dramatic, going from $17,000 to $13,000. However, the difficulty with probability substantiation still exists with the proposal as with FIN 48 due to the nonexistence of objective probability assignment standards.

Calculation of Deferred Tax Asset or Liability

The tax rate used for measuring deferred taxes under U.S. GAAP is the enacted tax rate in place when the timing difference is expected to reverse, whereas under IFRS, the ''substantively enacted tax rate'' is applied. ''Substantively enacted'' is defined to mean ''virtually certain.'' ''[I]n the US, the signature of the president would be necessary for the 'virtually certain' criteria to be met, whereas in other jurisdictions, the giving of 'royal assent' would not be necessary for the virtually certain criteria to be met.''[13] We believe a similar rule would apply to state tax rates, *i.e.*, the state governor would have to sign a tax-related bill for ''enactment'' or ''substantive enactment'' to occur.

From a state income tax perspective, regardless of which standard ultimately prevails, the outcome likely will be the same, *i.e.*, deferred inventory must be measured at enacted state tax rates. From a state perspective, ''substantively enacted'' and ''enacted'' have been determined to have the same meaning, which is a bill signed by the state governor.

Classification of Deferred Tax Assets And Liabilities in the Balance Sheet

We believe this difference likely will be resolved with the application of U.S. GAAP standards requiring classification between current and non-current deferred tax assets and liabilities. However, even if IFRS standards are ultimately applied, we do not foresee a significant impact from a state perspective. In fact accounting for state deferred inventory may be easier with only one classification option. The only drawback potentially would be from an investor perspective wherein financial ratios based on current assets may be skewed.

RECOMMENDED ACTION STEPS

What Company Executives Are Recommending

Despite general agreement that a U.S. GAAP/IFRS convergence or IFRS adoption is on the horizon, there still exists much uncertainty with respect to what companies should be doing now, if anything, to prepare for this effort. Company executives shed some light on this uncertainty Oct. 29, 2009, at an international financial reporting standards conference sponsored by the AICPA and the International Accounting Standards Committee Foundation.

According to the *Daily Tax Report*, executives told attendees that ''companies need to start preparing now for IFRS implementation since it will require a complete corporate transformation.''[14] The executives also ''stressed that the process is much more complex than adopting new accounting. Companies should therefore secure the total support from boards, senior management, business and functional leaders, since IFRS adoption could potentially mean different trickle down effects for different companies.''[15]

Executives at the conference also warned companies not to wait for the SEC to mandate adoption, but to look at the issue from the perspective of what is best for the company. One suggestion was that in order to move forward in a thoughtful and comprehensive manner, companies may have to move forward without having a definite date by the SEC. This would mean preparing dual financial statements. IFRS provides a window of opportunity for companies to evaluate strategically how IFRS impacts the business, how it impacts their ability to negotiate with customers, restructure contracts, and restructure acquisitions—thus a fresh comprehensive overview of the business.

Louis Dulitz, vice president of accounting policies and research for Covidien U.S., told the attendees, ''You're not just supposed to go through some checklist and say these are the only differences I've identified with my auditor, I'm going to focus there. And then five six years later you're going to be very unhappy with the results if you take that approach, so I would recommend looking at not only what is required, but what is optional.''[16]

Dulitz emphasized the importance of first understanding who you are and where you are and having a good grasp of your company's performance history. For example, a company should consider whether it sold

[13] Deloitte's IASB Agenda Project.

[14] Denise Lugo, ''Preparers at Conference Say IFRS Involves Complete Corporate Transformation,'' 209 *Daily Tax Report* 1-4 (Nov. 2, 2009).

[15] *Id.*

[16] *Id.*

companies, bought companies, divested, and whether those companies are overseas, whether they're domestic. Further, it is critical for companies also to understand their own jurisdiction.

"Look at who you are and what's going on around you, issues you might face, each jurisdiction and each place they might be different," he said. Companies should assume lots of areas will be impacted and should prepare in advance for areas of potential impact—which would be unique to each company depending on its structure and interest.

What Clifton Douglas Is Recommending

We are in agreement with these company executives in that we believe the convergence should be perceived not as an adoption of another accounting pronouncement, but rather as an opportunity to sync your business with the changing economy. Convergence is not an end result, but part of an overall process to enhance U.S. company participation in our burgeoning global economy. Will the convergence cost money? Yes. Will the convergence require resources? Yes. Will the convergence absorb additional company time? Yes, potentially a great deal of time. But along with these expenditures the convergence also has the potential to provide the following benefits:

- enhance capital formation,
- achieve critical mass via increased cross-border acquisitions, and
- improve overall investor confidence when it is most needed.

Action Steps From a Multistate Tax Perspective

Although there are not a great deal of specific action steps companies should take immediately regarding multistate tax impacts due to convergence uncertainties, it is prudent for companies to allot time now to review their multistate tax issues in light of the overall tax function. Most companies will address multistate tax issues from four perspectives:

- FAS 109/ASC Topic 740 quarterly tax provision preparation;
- FIN 48/ASC Topic 740-10 updates;
- SOX 404 internal controls maintenance; and
- Tax return preparation.

The more streamlined and synergistic these processes are made now, the more likely they will be beneficial once more specificity is provided on convergence requirements. To accomplish these efficiencies, we recommend the following with respect to multistate tax:

Assemble an Experienced Internal Tax Team: The first step toward convergence is to review your internal tax team to ensure that adequate expertise is available addressing multistate issues from a tax provision, FIN 48, SOX 404, and tax return preparation perspective. Your team does not have to be large, but it should have the technical expertise to address current multistate tax issues as well as remain updated on changes in multistate tax issues per the convergence effort.

Assemble an Experienced External Tax Team: Oftentimes companies do not have the bandwidth internally to address wide-sweeping changes such as the convergence. As costs, resources, and time are generally of concern to most companies, it makes sense now to research the best outsourcing engagement to meet your company needs, including multistate tax concerns. External tax service providers come in many shapes and sizes, so with some research and targeted interviews your company should find a competent service provider that understands your convergence needs while considering company limitations with respect to cost, time, etc.

Meet With Your Auditors: If you have not done so already, now is a good time to meet with your audit firm to address key multistate issues and ensure that these are being considered as part of your company's overall convergence plan. Your auditors understand your company needs and can provide guidance on those areas requiring improvement prior to mandated convergence.

Consolidate Your Tax Compliance Function With One Service Provider: Based on our experience, it is generally inefficient and costly to engage separate service providers for each core tax compliance function, *i.e.*, tax provision preparation, FIN 48 updates, SOX 404 maintenance, and tax return preparation. Oftentimes efforts are duplicated, which results in greater tax compliance fees and general inefficiencies. We believe there is also added risk when different service providers focus on one or two compliance needs, as opposed to one service provider observing and understanding the entire picture of the company in its current state and prospectively.

For example, in preparing tax provisions, a tax service provider must understand all income tax positions taken, which segues idyllically into the interim/annual FIN 48 update analysis that begins with understanding all material tax positions taken or expected to be taken on an income tax return. Similarly, when the same tax service provider is used to prepare both the FAS 109 and FIN 48 analyses, this eliminates gathering similar supporting documentation twice to fulfill the FAS 109 and then FIN 48 requirements. The FAS 109 preparer already has in its possession and thoroughly understands key FIN 48 areas such as state reporting, permanent establishment, transfer pricing, tax credits, and acquisitions/dispositions.

Duplicating efforts and transferring data to different service providers also creates the risk that the FIN 48 preparer does not fully understand company operations to the extent of the FAS 109 preparer and vice versa. Containing both FIN 48 and FAS 109 functions with one central service provider ensures that all material tax positions addressed in the tax provision are also addressed from a FIN 48 perspective.

Ensure Collaboration Between Your Audit Firm and Tax Service Provider: In preparing for such significant changes as the convergence, it is imperative that your audit firm become comfortable with the core compliance deliverables of your tax service provider. In the face of dual reporting and three-year revised financials, your company should ensure that your audit firm can easily obtain and review the information it needs in an organized, familiar format. For example, if tax returns are requested by your auditors for support, your company must ensure that the data is preserved in an organized manner, supported by a clarifying memorandum addressing key multistate tax positions taken.

Leverage the Convergence Investment: The convergence does not have to be a sunk cost for your com-

 Copyright © 2009 TAX MANAGEMENT INC., a subsidiary of The Bureau of National Affairs, Inc. ISSN 1078-845X

pany. In fact, we believe that loss was not the intention of the professional or governmental associations backing approval of the convergence. The effort provides companies with an opportunity to grow along with the changing economy and delineates a means to navigate systematically and over time through these difficult transitions. Invest the money, but do so in an organized manner established to pay future dividends via a more efficient, less costly and less time-consuming tax function. Simply stated, leverage the convergence investment in your company's favor.

CONCLUSION

There is a high probability that the U.S. GAAP/IFRS convergence will be approved. However, even if ultimately it is not approved, this fact should not dissuade companies from acting now to prepare for a global economy that becomes more complex with each passing day. The key areas requiring attention with respect to these changes include multistate tax issues, which for now appear to be most impacted from an uncertain tax position and deferred tax inventory perspective. We believe it is too early to make specific changes with respect to multistate tax issues, but companies can go a long way in preparing their tax functions for the convergence by identifying their internal/external tax teams, communicating with their auditors, consolidating their tax compliance function, and ensuring collaboration between audit and internal/external tax teams. Finally, leveraging the convergence investment to streamline tax functions could lead to future cost reductions and improved efficiencies making a company more agile and able to compete in a global economy.