IFRS: What you need to know

Tax implications of an IFRS conversion on debt arrangements*

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The movement towards a single set of financial reporting standards, such as International Financial Reporting Standards (IFRS), will have a pervasive impact on US multinational corporations, including in the area of taxation. While much of the discussion to-date about the tax implications of IFRS has focused on the impacts within the United States, there are significant international tax implications that also must be considered. From repatriation strategies to debt structuring, intellectual property migrations to principal structures, the international tax impact of IFRS on an organization may be very significant. To avoid unexpected spikes in the effective tax rate and to enhance the predictability of cash flows upon transition, tax executives should begin evaluating their current tax planning and assessing the impact a conversion to IFRS will have on these strategies. Early focus on this analysis could provide opportunities for new tax planning otherwise forgone if caught too late in the conversion process.

In analyzing the international tax implications of IFRS, a key area of focus should be a company's debt arrangements and associated tax planning. This area can present both challenges and opportunities during an IFRS conversion as it impacts both cash taxes and the effective tax rate. In order to fully evaluate these impacts in a timely fashion, a tax executive must monitor IFRS developments in the US as well as the multitude of conversion efforts around the globe, as there often are fundamental differences between local GAAP standards and IFRS that may alter the effectiveness of existing debt planning strategies. Differences in accounting definitions and treatment have the potential to result in reclassifications of financial instruments which may impact balance sheet ratios, thus having a trickle-down effect on debt planning. This article will provide a basic understanding of the potential impact of IFRS on debt planning strategies with application to a few selected jurisdictions to illustrate risks, opportunities, and considerations that can be applied on a country-by-country basis.

Action steps for international tax executives

To date, information on the conversion impact of IFRS on international taxes has been somewhat general and ambiguous; hence, there are often more questions than answers and tax executives are left with an unclear path for what they should be doing to prepare. A key to successful planning and conversion will be gaining a greater clarity of the specific issues and concerns impacting jurisdictions, understanding the related impact on a company's international tax strategy, and building solutions to address these complex issues. The following are key steps to consider when evaluating the IFRS impact on debt structures:

- Confirm jurisdictions with significant debt structures
- Assess whether IFRS has been adopted locally for statutory reporting purposes
- Determine the basis for calculating taxable profits (i.e., statutory financial statements versus independent tax calculations)
- Understand the classification of financial instruments for statutory accounting and tax purposes and establish whether IFRS adoption affects this classification
- Understand whether thin capitalization rules, interest coverage rules, etc., exist to limit or disallow interest deductions and establish whether IFRS adoption affects the results of prescribed ratios or metrics
- Quantify the impact on the effective tax rate and cash taxes paid
- Evaluate new debt structuring strategies and opportunities arising from the conversion

Each jurisdiction is unique—understand the basis for statutory accounting and tax reporting

US tax executives assessing the implications of IFRS will need to first determine whether IFRS has been adopted locally or whether local GAAP has been modified to converge with IFRS. In many jurisdictions, including all EU member countries, IFRS has been required for purposes of public and listed company financial reporting for the past few years. However, in many of these same countries, companies have been given an option to continue utilizing local GAAP for statutory reporting. As a result, statutory financial statements are often still reported under local GAAP rather than IFRS. However, more recently, we are witnessing a movement to mandate IFRS for statutory reporting purposes in some of these jurisdictions. In these situations, understanding the implications of IFRS at a statutory reporting level will be important, given the potential for a direct impact on cash taxes as well as the local tax treatment of items, such as debt arrangements.

Once the local country IFRS landscape is assessed, understanding what gives rise to taxable basis in a particular jurisdiction is the next step in evaluating the impact of IFRS around the world. There are three potential ways to measure a company's taxable profits, including an independent, dependent, and quasi-dependent approach.

- In an **independent approach**, taxable income is determined in accordance with a specified set of tax rules and thus, there is generally no reliance on the statutory accounts of the company. Under this scenario, a conversion to IFRS is expected to have very little impact, if any, on the cash tax liability in the jurisdiction; however, deferred taxes and the effective tax rate disclosed in the financial statements may be impacted significantly. This is the case in a jurisdiction such as the Netherlands.
- A **dependent approach** utilizes the statutory accounts to determine taxable income, in which case, an IFRS conversion is likely to impact cash taxes paid. An impact to deferred taxes is less likely; however, it could arise, for example, as a result of converting to new or changing tax accounting standards under IFRS. Luxembourg, Spain, and Sweden are examples of jurisdictions with a dependent approach.
- Under the **quasi-dependent approach**, statutory accounts are used as a starting point for the taxable income calculation, with specific departures allowed under tax law. This is a common approach, especially in EU countries, and can impact both cash taxes and deferred tax balances. Examples of jurisdictions with the quasi-dependent approach include the UK and Italy.

Understanding the nuances of the various ways in which jurisdictions will be impacted by IFRS is important when analyzing debt structures. As further discussed below, this understanding is critical in assessing the classification of financial instruments and determining the impact on thin capitalization rules, interest coverage rules, and other tax provisions that can limit or disallow interest deductions for tax purposes.

General implications of IFRS on debt planning

In jurisdictions where statutory accounting forms the basis for classifying debt versus equity for tax purposes (i.e., dependent as well as certain quasi-dependent jurisdictions), companies must review current financing structures to determine if IFRS conversion will affect interest deductions, cash taxes, and the effective tax rate. Under IFRS, the definition of equity is quite narrow. As such, many companies have found that certain financial instruments that previously qualified for equity treatment under local GAAP are redefined and reclassified as debt under IFRS standards. This reclassification could result in net assets and debt-to-equity relationships being adversely impacted. Finding the appropriate debt-to-equity capitalization ratio under new accounting definitions of what qualifies as debt may require careful study. Companies balancing these ratios while managing existing debt covenant requirements will discover an additional layer of complexity.

Hybrid instruments will require particular attention as those instruments are especially susceptible to reclassification under IFRS. The benefit of hybrid instruments is that they allow for debt treatment in one jurisdiction, giving rise to interest deductions for tax purposes, and equity treatment in another jurisdiction, allowing for potential exemption from tax for dividend payments. As entities convert to IFRS, this difference in treatment may be eliminated where the jurisdiction utilizes a dependent approach to determining taxable profits and IFRS is adopted for statutory reporting. Losing equity treatment for tax purposes will result in a higher effective tax rate on the interest income in the creditor jurisdiction. However, on a positive note, the timing of conversion to IFRS in different jurisdictions could lead to planning

opportunities resulting from accounting “mismatches” as instruments may be treated differently depending on whether a certain jurisdiction converted to IFRS and what the basis is for tax calculations within that jurisdiction.

Case study examples from selected jurisdictions

To better illustrate debt planning considerations and opportunities, the following discussions provide a more detailed evaluation into the particular impact of IFRS in Australia, the UK, the Netherlands, and Luxembourg. As each jurisdiction is examined with respect to IFRS conversion status, taxable basis considerations, financial instrument classification, and thin capitalization matters, tax executives will find that each of the countries discussed is impacted differently and to varying degrees.

Australia—quasi-dependent tax system

Starting from January 1, 2005, all companies in Australia converted to the Australian Equivalents to IFRS (A-IFRS), which uses selected Australian GAAP (A-GAAP) standards where no IFRS standard has been published. From a tax perspective, A-IFRS is the starting point for the taxable income calculation.

Australian tax law provides specific rules for the determination of whether a financial instrument should be classified as debt or equity, thus, the conversion to IFRS did not seem to affect hybrid instruments or other classification questions. However, the Australian thin capitalization rules that limit the amount of interest bearing debt for which a tax deduction is available were significantly impacted by the conversion.

The Australian safe harbor ratio for thin capitalization calls for a calculation of debt and equity components based on an accounting value of assets and liabilities. Specifically, the safe harbor test permits interest deductions on loans up to 75% of net Australian assets (excluding interest bearing liabilities), or effectively a 3:1 debt-to-equity ratio. The thin capitalization rules apply to all debt, including both intercompany and third party debt. For companies that relied on the safe harbor test, the conversion to A-IFRS meant a potential loss of interest deductions and thus an increase in cash taxes. In most circumstances, the switch from A-GAAP to A-IFRS resulted in companies recording additional liabilities on their balance sheet, and in many cases, falling outside of the safe harbor ratio prescribed by the thin capitalization rules.

A few significant differences between A-GAAP and A-IFRS were responsible for throwing the safe harbor ratio in an unwanted direction.

- *Intangible assets*—A-GAAP did not have a prohibition for the recognition of an internally generated intangible asset (except for goodwill). A-GAAP further allowed a revaluation of such an intangible to fair value, provided that it was reliably determinable. On the other hand, under A-IFRS, certain internally generated intangible assets are prohibited from being recognized (e.g., brands, mastheads, customer lists, etc.). Other internally generated intangibles could be recognized at fair value if there was an active market to reliably determine the value. However, the A-IFRS standard indicates that an active market does not exist for trademarks as these assets are unique; therefore, a step-up to fair value is no longer allowed. Valuation differences, along with more rigorous rules with respect to amortization and impairment testing, further contributed to intangible assets being recorded at significantly lower values under A-IFRS.
- *Unfunded pension liabilities*—under A-GAAP, unfunded pension liabilities were not recorded on the balance sheet. A-IFRS requires these liabilities to be recorded, thus significantly increasing the liability side of the safe harbor equation for those companies with unfunded pension plans.
- *Deferred taxes*—prior to A-IFRS, the accounting model and the tax model were very similarly aligned. As such, very few deferred taxes were required. However, as A-IFRS does have some differences to current Australian tax law, new deferred tax account balances were created upon adoption of A-IFRS, thus skewing the debt-to-equity ratio.

The significant swing in many companies’ safe harbor ratio calculation was an unanticipated result of conversion to IFRS, leaving tax executives looking for last minute solutions. An alternative option to the safe harbor test was to demonstrate that total debt, including intercompany debt, is an arms-length amount (ignoring any related party guarantees). Some companies attempted to apply the arms-length standard; however, documentation and effort required for this alternative were substantial and thus not a desired option. Companies significantly affected by this result initiated and supported lobbying efforts to have the tax laws amended. A transition period of 4 years starting with January 1, 2005 was granted during which the tax authorities are allowing the use of A-GAAP for the purpose of the safe harbor ratio calculation.

A bill to amend the tax laws in Australia is currently before Parliament. This bill would allow companies to recognize and revalue internally generated assets (other than goodwill) for purposes of the safe harbor calculation that would otherwise be prevented under A-IFRS. Further, companies would be able to exclude deferred taxes and recognized unfunded pension liabilities in calculating safe harbor ratios under the proposed law. Australia is an example whereby the change in accounting standards had a direct impact on the interest deduction allowed and had the potential to dramatically change the intercompany and overall debt considerations in this jurisdiction.

UK—quasi-dependent tax system

Beginning in 2005, UK public companies have been required to report financial statements under IFRS, though UK GAAP is still allowed for statutory reporting. Non-public companies have had the option to adopt IFRS or remain under UK GAAP for statutory reporting purposes, with a limited number of these companies electing IFRS. However, mandatory adoption of IFRS for all companies for statutory reporting purposes is expected in 2011 or 2012.

Taxation in the UK is based on the profits reported in the statutory accounts. As such, companies may have different tax results dependent on whether they prepare UK GAAP or IFRS accounts. HM Revenue & Customs (HMRC) in the UK has undertaken a considerable exercise to ensure that the tax code accommodates the adoption of IFRS in a manner which creates as level a playing field as possible and minimizes the opportunity to avoid tax. Significant changes to UK tax legislation have arisen as a consequence.

In contrast to Australia, the existing UK thin capitalization rules appear to be less of a concern upon adoption. While adoption of IFRS generally increases liabilities, adversely impacting thin capitalization ratios, the considerations by the tax authorities of the two jurisdictions vary significantly. The current UK thin capitalization ratios are based on the UK group's consolidated accounts and an acceptable ratio is often negotiated with the tax authorities versus a precise calculation or safe harbor. The increase in liabilities may leave companies with less leverage, but the negotiation process continues to allow companies flexibility. However, draft legislation released on December 9, 2008 proposes new interest capping provisions aimed at further restricting interest deductions of a worldwide group.

The proposed legislation broadly seeks to ensure that the UK group's "net financing costs" are limited to the level of the worldwide group's "net external financing costs." The proposed legislation further suggests that the UK group's net financing costs are to be determined by reference to the costs set out in tax computations; however, the net external financing costs of the worldwide group are to be determined based on financial statements prepared under IFRS. If the worldwide consolidated financial statements are not prepared under IFRS, as is currently the case for US based multinationals, then it is necessary to determine whether the amounts disclosed based on local GAAP would be materially different if prepared under IFRS. In practice, this could mean that companies currently not operating in an IFRS environment would still have to compute their net external financing costs under IFRS. The UK Treasury has asked for comments on how to amend the rules in order to accommodate multinational groups that do not currently report under IFRS. The impact of this legislation could be significant, and therefore, an interesting development to watch.

An additional area in the UK that is likely to be of concern to tax executives is the classification of a financial instrument as debt or equity. IFRS requires a substance over form approach when assessing the classification of a financial instrument. Though hybrid instruments are generally not utilized in the UK due to the anti-arbitrage legislation, preference shares are expected to be impacted by this new approach. If preference shares have a fixed term (e.g., five years) and a fixed dividend rate, then these shares may require treatment as debt rather than equity under IFRS. The shares would therefore be shown as debt in the balance sheet and payments previously accounted for as dividends could be treated as interest expense. However, for tax purposes, preferred shares are governed by specific tax rules which dictate treatment as share capital, regardless of accounting classification. As such, the preferred shares would continue to be treated as equity and the payments would be treated as dividends in tax calculations. The result will likely be an increase to the effective tax rate as interest recorded for book purposes would not be an allowed deduction for tax purposes.

US multinationals with substantial UK operations will want to focus attention on their structure now to determine whether tax planning could be affected by the new proposed legislation discussed above or mandatory adoption effective in 2011 or 2012. Preferred shares is one example in the UK where IFRS will impact the accounting treatment upon adoption; however, a careful examination of all financial instruments utilized in the UK

is certainly warranted to avoid any unnecessary surprises in the effective tax rate and to capitalize on possible opportunities that may be available. Furthermore, as new legislative developments are revealed, tax executives will need to monitor their structures closely to ensure they have sufficient time to plan around the potential impact.

The Netherlands—independent tax system

Similar to the UK, Dutch public companies have been required to report financial statements under IFRS since 2005 due to the EU directive. However, for statutory reporting purposes, all companies have the option to report under IFRS or Dutch GAAP. Despite IFRS adoption on a consolidated reporting level, as in the UK, a large number of public companies continue to use local GAAP for statutory reporting.

Dutch tax accounts are based on what is known as the “sound business practice” principle, which consists of an extensive set of tax valuation principles that have been developed for years through both jurisprudence and tax law. Despite an independent tax system, Dutch GAAP and tax law have historically been similar and therefore companies did not typically have significant deferred taxes. Since the Netherlands’ tax basis is still determined under the same principles previously established, conversion to IFRS primarily impacts deferred tax account balances.

With respect to the classification of financial instruments, the Netherlands has separate qualifications for tax purposes. Even before the conversion to IFRS, certain instruments were in the “grey” area and required evaluation under specific tests in the tax rules to qualify for liability treatment. Consequently, conversion to IFRS would appear to have a limited impact on debt versus equity classification for tax purposes in this jurisdiction.

A few provisions of the Dutch tax law, however, refer directly to financial statements, such as the “escape” clause under the thin capitalization rules. Under these rules, companies first assess thin capitalization based on a safe harbor test, which is limited to a 3:1 debt-to-equity ratio. This calculation is performed using tax basis balance sheet amounts. Alternatively, taxpayers failing the safe harbor test can “escape” this provision by calculating the debt-to-equity ratio based on the consolidated financial statements of the worldwide group. As long as the debt-to-equity ratio measured at the consolidated group financial statement level is higher than the safe harbor ratio, the taxpayer is allowed full deductibility of interest expense for tax purposes.

In the context of a US multinational group with Dutch subsidiaries, a conversion from US GAAP to IFRS could have a direct impact on thin capitalization in circumstances where a Dutch company relies on the US consolidated group’s debt-to-equity ratio. As previously mentioned, the trend for many companies is an increase in liabilities under IFRS. Therefore, when the US parent company converts to IFRS, the result may be that the group’s debt-to-equity ratio increases, thus offering additional debt structuring opportunities, absent any Dutch tax law amendments.

The Netherlands presents an example whereby the immediate adoption of IFRS in the local jurisdiction does not directly impact the debt structure. However, a careful monitoring of the group ratio, especially upon conversion to IFRS by the group’s parent, may give rise to additional opportunities for intercompany debt that were previously not available or less attractive.

Luxembourg—dependent tax system

Consistent with the EU directive, Luxembourg public companies are required to report under IFRS. So far only banks and insurance companies in Luxembourg have the option to use IFRS as adopted by the EU for statutory reporting purposes whereas other industries are required to use Luxembourg GAAP. The Luxembourg authorities are working on a draft commercial law which will give other companies the choice to use IFRS for statutory accounts. Taxation is currently based on profits prepared under Luxembourg GAAP, and book-to-tax differences are few and far between. With a transition to IFRS, companies in Luxembourg will likely see increasing volatility in taxable profits and therefore, fluctuating cash tax liabilities. Tax authorities are currently evaluating such implications and deliberating changes to the tax code to separate the book and tax treatment for various items, thus potentially creating a more independent tax approach in an IFRS reporting model.

Luxembourg has no written thin capitalization rules for tax purposes. However, when capitalization questions are raised, tax authorities commonly take a practical approach, allowing a comparison of tax basis debt-to-equity ratios to other companies in the same market and/or industry. As such, a conversion to IFRS could, presumably, affect companies within a market in a similar manner, and therefore, would not draw particular attention to any one company.

However, with respect to financial instruments, Luxembourg relies heavily on accounting treatment to determine classification for tax purposes, though there are some exceptions. Therefore, conversion to IFRS is expected to impact the classification of certain instruments for tax purposes. With foresight into this impending change, tax professionals and tax authorities have raised questions as to whether tax treatment should continue to follow accounting standards or whether a legal interpretation would be more appropriate.

Without tax law amendments, conversion to IFRS may have significant consequences on debt structures currently in place in Luxembourg, especially those structures in a cross-border context. Hybrid instruments commonly used in Luxembourg structures, including convertible preferred equity certificates and automatically redeemable shares, could be impacted by changes in treatment with potential consequences to cash taxes. Because companies will likely have an option to adopt IFRS or remain under Luxembourg GAAP for statutory reporting purposes, the consequences can be modeled and structured to the company's benefit. In addition, the delayed timing for IFRS conversion for the majority of companies in Luxembourg offers an opportunity to re-evaluate the existing debt structure. Luxembourg is an example where the option to adopt will have noteworthy ramifications to debt structures with the potential for advantageous short-term strategies.

Other items of note

Though it is not possible to address all debt structure considerations within this article, a few ancillary issues are worth mentioning. To the extent that intercompany debt is modified for preventive or advantageous measures with IFRS adoption, the impact on currency translation treatment in the consolidated financial statements must be evaluated to determine appropriate recognition through either the income statement or other comprehensive income. Additionally, fair value accounting under IFRS is an area of great interest and has attracted significant debate as a result of the current market environment. Unexpected swings, both positive and negative, due to fair value accounting can bring surprises when evaluating net assets and other thin capitalization ratios and metrics.

What this means for your company

As evident by the examples discussed in this article, each jurisdiction will have its own unique set of circumstances and considerations when assessing the impact of IFRS on tax planning for debt structuring. The adoption of IFRS for statutory purposes may present difficulties and challenges, including complex matters surrounding the classification of financial instruments and changes to thin capitalization results. However, there are also opportunities to leverage under the right set of facts.

Ultimately, timing will be a key factor as the international adoption of IFRS for statutory and tax purposes is still very inconsistent, creating potential accounting and tax mismatches especially relevant in cross-border transactions. While certain countries have adopted IFRS for their statutory accounts, other countries remain under their local GAAP and use IFRS for public reporting only. Yet a third group of countries leaves it up to the company's management to decide whether to adopt IFRS or keep local GAAP for statutory accounts. Combined with unique sets of tax laws in various jurisdictions, such differences in adoption method and timing are opening doors for a myriad of opportunities.

Contacts

The white paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper who welcome any questions about the tax implications of IFRS:

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