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<p>For the past two decades, the Securities and Exchange Commission has been pushing for a single set of high-quality financial reporting standards. In an increasingly global business environment, uniform financial reporting allows for easier comparison between US domestic corporations and their foreign competitors, and will help to facilitate increased cross-border investment and capital market participation. These international financial reporting standards are known as IFRS. Given the magnitude of this change, a successful overhaul of financial reporting will require multilateral participation between regulators, standard setters, the private sector, and academia. MTC constituents, namely state tax administrators, should consider the following questions: (1) What is IFRS?; (2) How will IFRS affect corporate tax revenues?; (3) How will IFRS affect sales and use taxes, and gross receipts taxes?; (4) What steps need to be taken in order to prepare for this change?</p>	
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**WORKING TOGETHER SINCE 1967 TO
PRESERVE FEDERALISM AND TAX FAIRNESS**

Multistate Tax Commission Review

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The opinions expressed in the Review are those of the authors and do not necessarily represent the official position of the Multistate Tax Commission or any of its Member States.

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This issue of the **Review** is being prepared just before our fall meetings in Orange Beach, Alabama. Although the major portion of these meetings is devoted to the work of the Multistate Tax Commission, I wanted to point out that there is a significant amount of federal legislation that can affect state tax revenues. Among them are:

- H.R. 1083, Business Activity Tax Simplification Act of 2009
- H.R. 2110, Mobile Workforce State Income Tax and Simplification Act, and H.R. 2600, Telecommuter Tax Fairness Act of 2009
- H.R. 2303, State Tax Administration Act of 2009
- H.R. 1956, Crime Victim Restitution and Court Fee Intercept Act
- Streamlined Sales Tax Legislation
- H.R. 1521, Cell Phone Tax Fairness Act of 2009
- H.R. 1019, State Video Tax Fairness Act of 2009
- S. 43, H.R. 1560, Permanent Internet Tax Freedom Act of 2009

The staff will monitor developments in these pieces of legislation, and any other legislation that is introduced in the coming year.

This issue of the **Review** contains two articles. The first article by Elliott Dubin, MTC's Director of Policy Research, examines the impact of changes in the income apportionment formula on changes in apportioned state corporate income tax base levels. This article was originally presented by him and Jim Landers of the Indiana Legislative Fiscal Affairs Office at the Federation of Tax Administrators' Revenue Estimation and Tax Research Conference in Des Moines, Iowa in September. The paper uses state-level data for all states plus the District of Columbia from 2001 to 2008 to estimate the effect of changes in the apportionment weights. The estimates suggest that increases in the sales factor weight are generally associated with lower apportioned corporate income tax base; but this is not always the case.

The second article is by Elliott Dubin and Ben Devlen, former Policy Research Intern and currently an intern with Wealth and Tax Advisory Services, LLC. Ben plans to pursue an MBA degree at Notre Dame University beginning in January. Their article examines the coming transition from the U.S. Generally Accepted Accounting

Principles (GAAP) to the more standards based International Financial Reporting Standards (IFRS). Dubin and Devlen find that state tax administrators will face a number of challenges should the convergence between the two accounting systems require major financial reporting changes. These challenges would include finding the resources for training staff to handle the changes as well as additional computer hardware and software requirements if the revenue departments must maintain legacy systems. In addition, the change in accounting systems could result in significant changes in business income tax and receipts based taxes.

Have a safe and pleasant Holiday Season. I welcome your suggestions for topics for future issues of the Review.

Joe Huddleston
Executive Director
Multistate Tax Commission

Changes in State Corporate Income Tax Apportionment Formulas and Changes in State Corporate Income Tax Bases¹

Elliott Dubin, Director of Policy Research
Multistate Tax Commission

Abstract

This paper examines the impact of changes in the income apportionment formula on changes in apportioned state corporate income tax base levels. The paper employs a state-level panel comprising all states plus the District of Columbia and spans 2001 to 2008 to estimate the effect of changes in the apportionment weights. The estimates suggest that increases in the sales factor weight are generally associated with lower apportioned corporate income tax base; but this is not always the case.

Corporate income tax capacity is defined in this article, as the standardized corporate income tax base that would result from apportioning corporate profits before taxes for each of 14 major industrial sectors, measured on the National Income and Products Accounts basis, to each of the fifty states and the District of Columbia using two of the apportionment factors used by states – sales within the state relative to total sales and wages and salaries within the state relative to all wages and salaries. Corporate income tax capacity is the sum of the apportioned net income of the 14 industrial sectors. The use of a uniform standardized base to measure revenue capacity allows comparison of states' abilities to raise revenues independent of the policies actually implemented in each state.

I. Introduction

States generally apportion the total net income of a multistate business to their state use a three-factor formula. The most commonly used three-factor formula multiplies the total net income of the firm by the proportion of the firm's sales in the state to total sales and multiplies by that ratio by a weighting factor plus the ratio of the firm's payroll in the state by that factor's weight plus the ratio of the firm's property in the state by the property factor weight. The sum of the weights must equal one (1) in order to neither over apportion nor under apportion the firm's net income to each state in which the firm does business. The algebraic expression of the apportionment formula may be found in the Appendix.

In recent years, some states have increased the weight of the sales factor; and, decreased the concomitant weights of the payroll and property factors, in the apportionment formula. Simafranca provides two reasons why states would adopt this policy. First, increasing the weight of the sales factor reduces the production costs for in-state firms relative to their out-

of state competitors, which over time, and assuming other states do not follow suit, would provide an incentive for these firms to expand their production facilities and hire more workers. Second, it encourages out-of-state businesses to locate their facilities in the state.² When a state increases the sales factor weight, its corporate income tax revenues are expected to decline in the short-run. However, in the longer-run, it is expected that the increased economic activity induced by this policy will result in higher individual income tax revenues, higher business property tax revenues, higher sales tax revenues, and possibly higher business income tax revenues.³

This paper adds to the already large body of literature that examines the impact of the state policy of changing the weight of the sales factor on state economic development measured by changes in state corporate income tax revenues and/or bases, changes in employment, and changes in business investment. Here, we estimate the impact of changes in the weight of the sales factor on the corporate income tax base as measured by the capacity of state and local governments to raise revenue from the

corporate income tax. The measure of corporate income tax capacity was first developed by the former U.S. Advisory Commission on Intergovernmental Relations (ACIR) in 1962, through its Representative Tax System (RTS), to more accurately reflect the amount of revenue from each tax source that is potentially available to each state in a given year. Those estimates were continued with changes to the methodology and the addition of ACIR's Representative Expenditure System (RES).⁴ Since the ACIR was disbanded, the Federal Reserve Bank of Boston has continued publishing these estimates.⁵

The RTS is essentially the average tax system of all the states applied to each state's potential tax base. That is, the RTS provides an estimate of the tax yield that would result from applying a standard, representative set of tax rates to standard definitions of tax bases. The representative tax rate for a particular tax is sum of all state and local tax collections of that tax divided by sum of all state and local uniformly defined tax bases for that particular tax. The *tax capacity* of a state is the taxes the state, and its constituent local governments, would have collected if it were to apply the *representative tax rates* as defined previously to the standard tax bases in the state.⁶ The *standard base* is the base that is potentially taxable; it includes the value (or volume) of all economic stocks or flows that the state and local governments would have been able to tax, in the absence of nonstandard exemptions, exclusions, deductions, and other tax preferences and tax relief items. The use of a standardized base to measure revenue capacity allows comparison of states' abilities to raise revenues from any particular tax or revenue source independent of the policies actually implemented in each state.

For the most part, the data show that increasing the weight of the sales factor increases measured tax capacity which is not to be expected as the payroll and property factors are taxed more lightly following the usual change in apportionment formulas; i.e., increasing the weight of the sales factor. However, this is not true in all cases. In addition, we find that the change in corporate income tax capacity remains after the increase in the weight of the sales factor. This implies that the corporate

income tax base does not necessarily increase as expected, but remains depressed. Conversely, in those states in which the corporate tax base increases when the weight of the sales factor is increase, the upward change also remains. This does not necessarily imply that increasing the weight of the sales factor results in a reduced rate of economic growth.

The next section presents a brief description of the method used to derive the estimates of state corporate tax capacity and a comparison to the ACIR estimates. The third section presents estimates of the impact of changes in the apportionment weights on the estimates of state corporate income tax capacity. The last section is the summary and conclusions.

II. State Corporate Income Tax Capacity

A. Derivation of the Estimates of State Tax Capacity Measures

Ideally, the measure of state corporate tax capacity would be the sum of every corporation's net income attributable to their economic activity in each state. This information is not available; and, even if that measure is not truly objective because, to a large extent, each multistate corporation determines its own net income. The measure of state corporate tax capacity used in this paper is an estimate of the National Income and Products Accounts (NIPA) measure of corporate profits before taxes of domestic industries, for each of 14 industrial sectors⁷ apportioned to each state by using a variant of the apportionment formula presented earlier in this paper. The estimated apportioned earnings of each industrial sector are then summed to derive an estimate of total corporate tax capacity. A state-level panel comprising all states plus the District of Columbia and spans 2001 to 2008 was chosen because it is the only period that contains consistent data based on the North American Industrial Classification System (NAICS). In addition, the earnings from international trade are disregarded because almost all states limit their jurisdiction to "waters edge." The earnings of Federal Reserve Banks are also disregarded because states cannot legally impose their taxes on these institutions.

The NIPA measure of Profits before Taxes is used as the base for state corporate income taxes because this measure of profits reflects the inventory and depreciation accounting practices used for Federal income tax returns and is sometimes referred to as “book profits.”⁸ Most of the states that impose corporate net income taxes use federal net income, with some adjustments, as the basis for apportioning a multistate corporation’s net income. Furthermore, the problem of endogeneity does not exist because the measure of corporate profits (tax capacity) is independent of state tax policies such as tax rates, credits, “throwback” or “throwout” of sales.

The apportionment formula employs the actual apportionment formula used by each state in any year rather than the traditional, equally weighted three factor apportionment formula – sales, payroll, and property.⁹ According to the Federation of Tax Administrators, as of January 1, 2008, only twelve states use the traditional, equally weighted three factor formula; and, eleven (11) states use only one factor (sales) and Indiana and Minnesota will use only the sales factor to apportion income in 2011 and 2013 respectively.¹⁰ The apportionment formula used to estimate corporate income tax capacity for Nevada, Washington, and Wyoming, the three states without any corporate income tax, is 50% sales, 25% payroll, and 25% property.

The lack of data on the distribution of a common definition of property that is used in apportionment formulas, by industry, by state, by year, necessitated a further modification of the method to apportionment industry profits to the states. Here, the weight of the payroll factor is doubled to account for the lack of the property factor. The algebraic expression of the apportionment formula as modified to account for the doubling of the weight of the payroll factor is also in the Appendix.

Before proceeding any further, a concern should be addressed. The lack of data on the property factor on a state by state basis may impart some unknown bias into the estimates of state corporate tax capacity. The two factor apportionment formula used in this article implicitly assumes that the payroll and property

factors are distributed among the states in a similar manner. There is no way of knowing whether this assumption is valid; or if it is not valid, how much error is imparted to the estimates.

B. Data Sources

The sales factor in the apportionment formula is based on industry sales in a particular state relative to total U.S. sales; that is, sales on a destination basis. The quinquennial Economic Census published by the Census Bureau publishes sales by industry by state on an origin basis. In this paper, estimates of sales by industry by state were derived by using the ACIR method to estimate sales on a destination basis within a state. Briefly, annual U.S. input/output make table and use table were manipulated to derive an estimate of industry to industry sales for the U.S. Sales for final uses were weighted by each state’s share of Gross Domestic Product. A detailed exposition of the sources and methods is contained in the Appendix.

Sales factor apportionment weights were provided by research of Commerce Clearing House personnel from CCH archives. “Profits before Taxes (PBT)” comes from the interactive data of the U.S. Department of Commerce, Bureau of Economic Analysis; Table 6.17D (see Table 1 below).¹¹ Data on salaries and wages by state were obtained from the Department of Commerce, Bureau of Economic Analysis SA07 series.¹²

III. Results

Table 2 below presents estimates of corporate tax capacity by state for 2001 through 2008. The annual fluctuations in state corporate tax capacity are due to variations in the level of national corporate profits before taxes, changes in the composition of corporate profits by industry changes in apportionment weights for the sales and the concomitant change in the weight of the payroll factor and changes in the distributions of sales and salaries and wages by industry by state.¹³ These changes result in wide annual fluctuations in corporate tax capacity for each state. For example, between 2003 and

2004 and between 2004 and 2005 U.S. tax capacity rose by 40.0 percent and 36.8 percent respectively and fell by 24.4 percent between 2007 and 2008. Among the individual states the annual percentage changes in corporate tax capacity are much greater. For example, in Idaho, corporate income tax capacity rose by 130.4 percent between 2002 and 2003. Conversely, corporate tax capacity fell by 63.8 percent in Idaho between 2007 and 2008.

with the distribution of profits among industries and national total of profits before taxes unconstrained but, the apportionment weights used by the states constrained to their 2001 levels. That is, the estimates of corporate income tax capacity are the same as those in the previous table with only the apportionment weights held constant at the 2001 values. Constraining the apportionment weights to those used in 2001 permits one to isolate the impact of changes in the apportionment weights on the corporate income tax capacity by state.

Table 3 below contains estimates of corporate tax capacity by state for 2001 through 2008

Table 1: Corporate Profits of Domestic Industries, Before Taxes

Industry	2001	2002	2003	2004	2005	2006	2007	2008	Average 2001-2008
(millions of dollars)									
Domestic industries (less deposits of Federal Reserve Banks)	\$514,146	\$583,944	\$717,643	\$1,004,341	\$1,374,148	\$1,532,043	\$1,388,936	\$1,049,849	\$1,020,631
Agriculture, forestry, fishing, and hunting	1,257	181	2,159	3,156	4,504	4,729	6,031	3,672	3,211
Mining	15,637	5,585	16,071	24,043	43,277	57,015	56,985	67,766	35,797
Utilities	24,773	12,514	12,477	19,803	30,534	53,722	49,308	40,351	30,435
Construction	44,226	40,836	39,757	56,763	84,512	84,582	72,353	61,060	60,511
Manufacturing	46,934	48,385	75,041	173,448	260,260	326,742	296,228	192,393	177,429
Wholesale trade	48,413	51,736	59,652	81,659	100,755	114,024	118,213	85,502	82,494
Retail trade	70,893	80,655	89,004	99,249	127,695	136,458	128,137	84,461	102,069
Transportation and warehousing	917	126	7,543	14,688	29,500	42,137	30,795	10,173	16,985
Information	-24,693	-4,575	4,311	45,224	81,358	92,750	90,637	85,528	46,318
Finance, insurance, and real estate ¹	207,245	251,577	302,518	355,970	445,809	439,210	348,505	248,483	324,915
Professional, scientific, and technical services ²	20,072	31,077	41,052	52,141	65,854	72,746	84,110	75,658	55,339
Health care, educational services, and social assistance	34,715	40,303	44,241	48,444	59,404	63,255	65,395	61,497	52,157
Arts, entertainment, and recreation ³	14,942	17,554	15,881	21,479	28,943	31,394	28,392	22,836	22,678
Other services, except government	8,815	7,990	7,936	8,274	11,743	13,279	13,847	10,469	\$10,294
(Percent of total)									
Domestic industries (less deposits of Federal Reserve Banks)	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Agriculture, forestry, fishing, and hunting	0.24	0.03	0.30	0.31	0.33	0.31	0.43	0.35	0.31
Mining	3.04	0.96	2.24	2.39	3.15	3.72	4.10	6.45	3.51
Utilities	4.82	2.14	1.74	1.97	2.22	3.51	3.55	3.84	2.98
Construction	8.60	6.99	5.54	5.65	6.15	5.52	5.21	5.82	5.93
Manufacturing	9.13	8.29	10.46	17.27	18.94	21.33	21.33	18.33	17.38
Wholesale trade	9.42	8.86	8.31	8.13	7.33	7.44	8.51	8.14	8.08
Retail trade	13.79	13.81	12.40	9.88	9.29	8.91	9.23	8.05	10.00
Transportation and warehousing	0.18	0.02	1.05	1.46	2.15	2.75	2.22	0.97	1.66
Information	-4.80	-0.78	0.60	4.50	5.92	6.05	6.53	8.15	4.54
Finance, insurance, and real estate ¹	40.31	43.08	42.15	35.44	32.44	28.67	25.09	23.67	31.83
Professional, scientific, and technical services ²	3.90	5.32	5.72	5.19	4.79	4.75	6.06	7.21	5.42
Health care, educational services, and social assistance	6.75	6.90	6.16	4.82	4.32	4.13	4.71	5.86	5.11
Arts, entertainment, and recreation ³	2.91	3.01	2.21	2.14	2.11	2.05	2.04	2.18	2.22
Other services, except government	1.71	1.37	1.11	0.82	0.85	0.87	1.00	1.00	1.01

¹Includes Management of companies and enterprises.

²Includes administrative services and waste management services

³Includes accommodation and food services

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Table 2: State Corporate Income Tax Capacity: Current Year Distribution of Profits and Current Year Apportionment Weights

State	2001	2002	2003	2004	2005	2006	2007	2008
	(millions of dollars)							
United States	\$514,146	\$583,944	\$717,643	\$1,004,341	\$1,374,148	\$1,532,043	\$1,388,936	\$1,049,849
Alabama	5,891	6,455	8,098	11,784	16,476	18,745	17,040	12,804
Alaska	1,342	1,237	1,680	2,368	3,473	4,072	3,776	3,376
Arizona	8,322	9,405	11,665	16,158	22,996	26,309	23,742	17,709
Arkansas	3,427	3,825	4,771	6,946	9,540	10,736	9,901	7,476
California	63,708	73,506	90,752	129,036	178,225	197,679	178,680	133,507
Colorado	8,643	9,878	10,298	14,798	20,852	23,627	21,759	18,973
Connecticut	9,571	10,793	13,032	17,805	23,890	26,056	23,672	17,291
Delaware	2,273	2,644	3,182	4,164	5,719	6,004	5,131	3,771
District of Columbia	2,325	2,872	3,540	4,906	6,546	7,194	6,784	5,183
Florida	24,388	28,807	35,525	48,987	68,548	75,618	67,046	49,127
Georgia	14,734	16,735	20,387	28,830	39,689	43,789	40,101	29,566
Hawaii	1,849	2,157	2,610	3,558	4,842	5,313	4,792	3,508
Idaho	1,724	1,913	4,408	6,785	9,678	11,040	10,179	3,689
Illinois	24,520	27,472	33,800	46,535	62,159	68,543	62,407	47,409
Indiana	10,131	11,213	14,026	20,568	27,724	30,628	27,685	20,930
Iowa	4,878	5,570	6,963	10,220	13,727	15,354	14,230	11,125
Kansas	4,166	4,693	5,795	8,320	11,526	13,326	12,330	9,435
Kentucky	5,761	6,326	7,964	11,364	15,697	17,733	16,153	12,187
Louisiana	6,949	7,046	9,219	13,210	19,455	26,501	24,786	18,309
Maine	1,837	2,109	2,550	3,536	4,614	5,008	4,772	3,645
Maryland	9,380	11,085	13,197	18,103	24,603	26,702	24,208	18,668
Massachusetts	15,888	18,138	21,564	29,401	38,391	41,804	38,308	28,745
Michigan	17,438	19,757	24,133	32,326	42,701	45,153	40,140	29,623
Minnesota	10,217	11,691	14,346	20,148	26,825	29,211	26,644	20,129
Mississippi	3,155	3,465	4,276	6,061	8,322	9,549	9,504	7,190
Missouri	9,738	11,095	13,247	18,136	24,633	26,767	24,073	18,235
Montana	1,093	1,155	1,448	2,007	2,883	3,321	3,110	2,580
Nebraska	2,785	3,148	4,006	5,615	7,575	8,510	7,878	6,272
Nevada	3,970	4,467	5,586	8,115	11,668	12,986	11,757	8,896
New Hampshire	2,380	2,740	3,349	4,710	6,311	6,956	6,202	4,628
New Jersey	18,825	22,261	26,570	35,739	47,379	51,757	46,573	34,964
New Mexico	2,338	2,438	3,131	4,375	6,188	7,093	6,595	5,596
New York	47,861	54,001	63,851	85,904	114,964	125,204	106,502	79,919
North Carolina	14,060	15,899	19,740	27,899	38,722	43,974	40,179	29,230
North Dakota	973	1,028	1,291	1,815	2,527	2,920	2,741	2,298
Ohio	19,524	22,109	27,052	37,987	51,008	55,391	49,713	36,703
Oklahoma	4,724	4,836	6,313	8,911	12,775	15,683	14,420	12,420
Oregon	5,558	6,348	7,871	11,582	15,629	18,616	17,081	12,874
Pennsylvania	21,415	24,280	29,991	41,160	55,650	61,564	55,998	42,167
Rhode Island	1,714	2,056	2,582	3,494	4,596	4,991	4,435	3,232
South Carolina	5,711	6,346	7,889	11,039	15,090	16,991	16,091	12,215
South Dakota	973	1,210	1,623	2,233	2,998	3,316	3,068	2,301
Tennessee	8,756	10,123	12,629	18,110	24,470	27,323	24,641	18,316
Texas	39,281	43,769	54,701	78,982	110,982	127,886	119,498	95,264
Utah	3,527	3,938	4,799	6,741	9,623	11,302	10,719	8,230
Vermont	925	1,032	1,262	1,787	2,454	2,705	2,462	1,840
Virginia	12,847	15,110	18,864	26,437	36,505	39,651	35,746	26,985
Washington	9,848	11,770	14,633	20,779	29,025	32,814	30,784	23,598
West Virginia	2,194	2,171	2,882	4,109	5,858	6,714	6,081	5,045
Wisconsin	9,541	10,828	13,174	18,820	25,443	28,209	25,356	19,459
Wyoming	1,069	992	1,376	1,936	2,970	3,708	3,462	3,207

Source: Table 1 and Bureau of Economic Analysis

The bold entries signify the 18 states which have changed the weight of sales factor apportionment weight at least once during the 2001 to 2008 time span. In each case, increasing weight was placed on the sales factor.

The change in state corporate tax capacity due to changes in apportionment weights only is shown in Table 4 below. Each entry in Table 4 is the percentage difference between the corresponding entries in Tables 3 and 2. For example, the entry for New Jersey in 2003 in Table 4 is the percentage difference between the entry for New Jersey in 2003 in Table 3 and the corresponding entry in 2003 in Table 2. That is, when New Jersey changed the weight of the sales factor in its apportionment formula from (1/3) in 2002 to (1/2) in 2003; its corporate tax base fell by 1.5 percent. For states that did not change their apportionment weights during this period, for example, Arkansas, the annual percentage change in corporate tax base is constrained to equal zero (0) in order to avoid confusion. These states will have very small positive or negative calculated changes for a given year because the sum of total profits before tax for all states for each year will be invariant regardless of changes in any states apportionment formula.

IV Discussion of the Results

As noted earlier, corporate tax capacity fluctuates widely from year to year for each state and in total primarily because of cyclical changes in aggregate corporate profits as well as changes in the distribution of profits by industry, and changes in the distributions of sales and salaries and wages by industry by state. Changes in state apportionment factor weights also exert some influence on the changes in state corporate income tax capacity.

It was assumed that the increased weight placed on the sales factor by the 18 states that did alter their apportionment formula during the 2001 to 2008 period was done so to spur economic development. That is, initially states expect to collect **less** corporate income tax revenue from their in-state firms; i.e., those firms with property and/or payroll in the state but a relatively small proportion of their sales in that state. Conversely, the greater weight

placed on the sales factor would perhaps increase somewhat more revenue from out-of-state firms with in-state sales but relatively little or no property or payroll in the state.¹⁴ Over time, however, the lower weights on property and payroll supposedly, are expected to induce out-of-state firms to relocate within that state's borders; or, retain in-state firms that might have relocated elsewhere. If successful, this would boost the local economy and providing additional revenues from corporate income taxes, property taxes, sales taxes and individual income taxes.¹⁵

In this analysis, reducing the weight of the payroll apportionment factor would lower corporate tax capacity if this theory holds. The experience of most of the states that increased the weight of the sales factor in their apportionment formula is **not** the expected one. Of the nineteen states that increased the weight of the sales factor during this period, thirteen experienced increased corporate income tax capacity in the year of the change in the apportionment weights and thereafter (see Table 4.) Only three states, New Jersey, New York, and Wisconsin, experienced reduced corporate tax capacity following a change in the sales factor apportionment weight. Three states, Arizona, Minnesota, and Virginia had mixed results. The states in which corporate tax capacity rose following a change in their sales factor apportionment weights could be characterized as "market" states while the other states could be characterized as "production" states. Edmiston found that "market" economies tended to gain revenues when the weight of the sales factor was increased (corporate tax capacity increased) and the converse is true in the "production" states (corporate tax capacity decreased).¹⁶ Seven states – Colorado, Illinois, Mississippi, New Hampshire, Ohio, Pennsylvania, and Tennessee – increased their sales factor apportionment weight prior to 2001. It is not possible to characterize Colorado, New Hampshire, Ohio, or Tennessee as either "market" or "production" states because there was no subsequent change in their sales factor apportionment weight to predict what would happen to corporate tax capacity following a change in the weight of the sale factor in the apportionment formula.

Table 3: State Corporate Income Tax Capacity: Current Year Distribution of Profits and 2001 Apportionment Weights

State	2001	2002	2003	2004	2005	2006	2007	2,008
	(millions of dollars)							
United States	\$514,146	\$583,944	\$717,643	\$1,004,341	\$1,374,148	\$1,532,043	\$1,388,936	1,049,849
Alabama	5,891	6,456	8,096	11,785	16,476	18,782	17,024	12,785
Alaska	1,342	1,237	1,682	2,372	3,478	4,082	3,820	3,435
Arizona	8,322	9,407	11,661	16,157	22,992	26,365	23,677	17,649
Arkansas	3,427	3,825	4,769	6,946	9,538	10,755	9,886	7,466
California	63,708	73,518	90,711	129,029	178,189	197,909	177,896	132,921
Colorado¹	8,643	9,879	10,295	14,801	20,854	23,663	21,756	18,955
Connecticut	9,571	10,795	13,026	17,803	23,883	26,071	23,456	17,141
Delaware	2,273	2,644	3,180	4,163	5,717	6,005	5,078	3,732
District of Columbia	2,325	2,872	3,539	4,906	6,545	7,198	6,737	5,148
Florida	24,388	28,811	35,507	48,980	68,528	75,673	66,639	48,806
Georgia	14,734	16,737	20,378	28,827	39,680	43,611	39,526	28,960
Hawaii	1,849	2,157	2,609	3,558	4,840	5,315	4,764	3,488
Idaho	1,724	1,914	4,406	6,784	9,676	11,061	10,192	3,679
Illinois²	24,520	27,476	33,786	46,536	62,151	68,627	62,156	47,238
Indiana	10,131	11,214	14,022	20,570	27,722	30,696	27,534	20,414
Iowa	4,878	5,571	6,961	10,221	13,727	15,378	14,202	11,114
Kansas	4,166	4,694	5,793	8,321	11,525	13,350	12,314	9,423
Kentucky	5,761	6,327	7,963	11,366	15,699	17,769	16,153	12,196
Louisiana	6,949	7,047	9,221	13,219	19,466	22,911	21,433	16,892
Maine	1,837	2,110	2,549	3,536	4,613	5,014	4,535	3,430
Maryland	9,380	11,087	13,191	18,102	24,597	26,726	24,074	18,567
Massachusetts	15,888	18,141	21,553	29,398	38,380	41,839	38,027	28,531
Michigan	17,438	19,760	24,125	32,327	42,697	45,222	40,062	29,524
Minnesota	10,217	11,693	14,340	20,147	26,820	29,246	26,604	20,182
Mississippi³	3,155	3,466	4,275	6,062	8,322	9,567	8,697	6,626
Missouri	9,738	11,097	13,241	18,135	24,628	26,800	23,966	18,145
Montana	1,093	1,156	1,448	2,008	2,885	3,327	3,119	2,592
Nebraska	2,785	3,149	4,005	5,615	7,574	8,522	7,855	6,253
Nevada	3,970	4,467	5,585	8,117	11,669	12,999	11,719	8,875
New Hampshire³	2,380	2,741	3,347	4,710	6,309	6,965	6,177	4,607
New Jersey	18,825	22,265	26,972	36,141	47,962	52,311	46,670	34,848
New Mexico	2,338	2,438	3,131	4,378	6,193	7,108	6,625	5,536
New York	47,861	54,011	63,816	85,892	114,931	127,664	116,511	87,286
North Carolina	14,060	15,901	19,732	27,899	38,714	44,038	40,043	29,124
North Dakota	973	1,029	1,291	1,815	2,528	2,925	2,744	2,307
Ohio³	19,524	22,112	27,042	37,987	51,001	55,478	49,562	36,590
Oklahoma	4,724	4,837	6,315	8,919	12,787	15,723	14,517	12,562
Oregon	5,558	6,349	7,782	11,245	15,343	17,727	16,183	12,017
Pennsylvania³	21,415	24,284	29,980	41,160	55,643	61,644	55,804	42,046
Rhode Island	1,714	2,056	2,581	3,494	4,595	4,996	4,405	3,209
South Carolina	5,711	6,347	7,887	11,039	15,087	17,020	15,429	11,509
South Dakota	973	1,119	1,572	2,150	2,896	3,217	2,965	2,162
Tennessee¹	8,756	10,124	12,623	18,109	24,464	27,366	24,574	18,254
Texas	39,281	43,776	54,686	78,996	110,991	128,082	119,302	95,226
Utah	3,527	3,939	4,798	6,742	9,624	11,252	10,661	8,230
Vermont	925	1,032	1,262	1,787	2,411	2,675	2,430	1,818
Virginia	12,847	15,112	18,856	26,436	36,499	39,691	35,572	26,853
Washington	9,848	11,772	14,626	20,777	29,018	32,857	30,679	23,504
West Virginia	2,194	2,172	2,883	4,113	5,864	6,730	6,119	5,098
Wisconsin	9,541	10,830	13,169	18,820	25,438	28,373	25,551	19,627
Wyoming	1,069	992	1,377	1,940	2,976	3,719	3,512	3,270

¹Increased sales factor apportionment weight in 1999.
²Increased sales factor apportionment weight in 1999 and 2000.
³Increased sales factor apportionment weight in 2000.

Source: Table 1 and Bureau of Economic Analysis

Table 4: Percentage Difference in State Corporate Income Tax Capacity: Current Year Apportionment Weights vs. 2001 Apportionment Weights: Current Year Distribution of Profits

State	2001	2002	2003	2004	2005	2006	2007	2008
United States	0.00%	-0.00%	-0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	(Percent Difference)							
Arizona	0.00	0.00	0.00	0.00	0.00	-0.21	0.27	0.34
Colorado ¹	0.00	-0.02	0.03	-0.02	-0.01	-0.16	0.01	0.10
Georgia	0.00	0.00	0.00	0.00	0.00	0.41	1.45	2.09
Illinois ²	0.00	-0.02	0.04	-0.00	0.01	-0.12	0.40	0.36
Indiana	0.00	0.00	0.00	0.00	0.00	0.00	0.55	2.53
Louisiana	0.00	0.00	0.00	0.00	0.00	15.67	15.64	8.39
Maine	0.00	0.00	0.00	0.00	0.00	0.00	5.23	6.25
Michigan	0.00	0.00	0.00	0.00	0.00	0.00	0.19	0.33
Minnesota	0.00	-0.02	0.04	0.00	0.02	-0.12	0.15	-0.26
Mississippi ³	0.00	-0.01	0.03	-0.01	0.00	-0.19	9.28	8.51
New Hampshire ³	0.00	-0.01	0.04	0.01	0.02	-0.13	0.41	0.46
New Jersey	0.00	0.00	0.00	-1.11	-1.22	-1.06	-0.21	0.33
New Mexico	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.09
New York	0.00	0.00	0.00	0.00	0.00	-1.93	-8.59	-8.44
Ohio ³	0.00	-0.02	0.04	-0.00	0.01	-0.16	0.30	0.31
Oregon	0.00	0.00	1.14	2.99	1.86	5.01	5.55	7.13
Pennsylvania ³	0.00	-0.02	0.04	-0.00	0.01	-0.13	0.35	0.29
South Carolina	0.00	-0.01	0.03	-0.00	0.02	-0.17	4.29	6.13
South Dakota	0.00	8.06	3.28	3.86	3.50	3.06	3.50	6.44
Tennessee ¹	0.00	-0.01	0.04	0.01	0.03	-0.16	0.28	0.34
Utah	0.00	0.00	0.00	0.00	0.00	0.44	0.54	-0.00
Vermont	0.00	0.00	0.00	0.00	1.76	1.12	1.29	1.20
Virginia	0.00	-0.02	0.04	0.00	0.02	-0.10	0.49	0.49
Wisconsin	0.00	0.00	0.00	0.00	0.00	-0.58	-0.76	-0.86

¹Increased sales factor apportionment weight in 1999.

²Increased sales factor apportionment weight in 1999 and 2000.

³Increased sales factor apportionment weight in 2000.

Source: Tables 2 and 3.

For the majority of the states that changed their apportionment formula during this period, the resulting change in their respective corporate tax capacity was quite small. However, there were a number of notable exceptions. When Louisiana changed the sales factor apportionment weight from 0.5 to 1.0 in 2006, corporate tax capacity rose by 15.7 percent, 15.6 percent, and 8.4 percent in 2006, 2007, and 2008 respectively. Similar changes in the weight of the sales apportionment factor resulted in increased of more than 9.0 percent in Mississippi, approximately 5.0 and 7.0 percent in Oregon, and about 4.3 percent in South Carolina respectively. Corporate tax capacity rose by more than 8 percent in 2002 in South Dakota and by more than 3 percent in subsequent years following a change in the weight of its sales factor from one-third to one-

half in 2002.

New York increased the sales factor apportionment weight from 0.5 to 0.6 in 2006 and from 0.6 to 1 the following year. Corporate tax capacity in New York fell by 1.9 percent between 2005 and 2006 and another 8.6 percent between 2006 and 2007 following that change in apportionment weight. Corporate income tax capacity fell by 8.4 percent between 2007 and 2008

When states reduce the apportionment weights of the payroll and property factors, the corporate tax base declines in the year of the change and in the following years, as expected for production states while the converse is true for market states. The theory also predicts that the lower apportionment weights on the payroll and

property factors should induce firms to expand their operations or to relocate in those states which have lowered the apportionment weights on payroll and property. The results shown in Table 4 can neither support nor rebut those theoretical arguments.

V. Conclusions

The purpose of this paper is to observe how changes in the apportionment weights affect state corporate income tax capacity. The simple method used here shows that increasing the weight of the sales factor in the apportionment formula generally results in an increased corporate tax base, which was not the expected result. However, there may be other factors not taken into account that could have produced similar results. For, example, if data for a larger number, or smaller number of industrial sectors were used the results could have been different. If a longer time frame with consistent NAICs data were available, the results could have been different since there were a significant number of states that changed their apportionment formula prior to 2001. Furthermore, if a consistent definition of property used in state apportionment formulas were available, the change in corporate tax bases could have been different. Thus, despite the large amount of literature on this subject, there is no definitive answer regarding the long-term impact of changes in the weights of the apportionment factors on either corporate tax bases or longer-term economic development.

APPENDIX

General Apportionment Formula

$$\Pi_{ijt} = \Pi_{it} \bullet \{ \alpha_{jt} (S_{ijt}/S_{it}) + \beta_{it} (L_{ijt}/L_{it}) + \gamma_{it} (P_{ijt}/P_{it}) \}$$

Where:

Π_{ijt} are the profits of industry sector (i) in state (j) at time (t)

Π_{it} is the profits of industry sector (i) at time (t)

α_{jt} is the weight of apportionment factor for sales in state (j) at time (t)

S_{ijt}/S_{it} is the ratio of the sales of industry sector (i) in state (j) at time (t) to total sales of industry sector (i) at time (t)

β_{it} is the weight of the apportionment factor for payroll in state (j) at time (t)

L_{ijt}/L_{it} is the ratio of the payroll of industry sector (i) in state (j) at time (t) to total payroll of industry sector (i) at time (t)

γ_{it} is the weight of the apportionment factor for property in state (j) at time (t)

P_{ijt}/P_{it} is the ratio of the property of industry sector (i) in state (j) at time (t) to the total property of industry sector (i) at time (t)

$$\alpha_{jt} + \beta_{it} + \gamma_{it} = 1$$

However, since we do not have data on the property factor by state, the apportionment formula used here is:

$$\Pi_{ijt} = \Pi_{it} \bullet \{ \alpha_{jt} (S_{ijt}/S_{it}) + (1 - \alpha_{jt}) (L_{ijt}/L_{it}) \}$$

Derivation of Sales by Industry by State, 2001 through 2008

Because corporate sales by destination are unlikely to mirror either payroll or retail sales, neither of these proxies was used to estimate the sales factor in the formula. The Economic Census, published every five years by the U.S. Bureau of the Census, contains data on sales by industry by state; but, these data represent shipments from the state; i.e., sales by state of origin. The apportionment of corporate income is based on sales by state of destination. Estimates of sales by industry by state on a destination basis were derived using a method very similar to the ACIR method found in the September 1993 publication cited previously. As shown below, a proxy for sales by destination was derived through use of Gross State Product by industry by state and annual national input-output tables for 2001-2007 according to the following procedure:

Let:

Tab1_{i,c} = the percentage of the dollar value of industry i's output that is commodity c. The distribution of commodity outputs is based on the "Make of Commodities" table (Table 1) in the US input-output tables.

Tab2_{c,j} = the percentage of the total dollar value of commodity c used as an input in industry j. Where c is not used as an intermediate input, but is purchased by all final users, Gross Domestic Product (GDP) of each state constitutes a 15th industry. The distribution of commodities to industries is based on the "Use of Commodities" table (Table 2) in the US input-output tables.

Then:

Where $A_{i,j} = \sum_{c=1}^{14} (\text{Tab1}_{i,c} * \text{Tab2}_{c,j})$ the percentage of industry i 's output purchased by industry j . $i=1$

When j is GDP, $A_{i,j}$ is the amount of industry i 's output that is sold as final goods.

Now let:

GDP_{j,s} = the percentage of industry j 's Gross Domestic Product located in state s . Where industry j is final use expenditures, the cell value represents that state's share of total sales.

Then:

$$\text{Sales}_{i,s} = \sum_{j=1}^{14} (A_{i,j} * \text{GDP}_{j,s})$$

Where **Sales_{i,s}** = the share of industry i 's output sold in each state s .

Thus, **Sales_{i,s}** is used as a proxy for the sales-by-destination factor in the three-factor formula.

Sources:

Corporate Profits by Industry (2001-2008): <http://www.bea.gov/national/nipaweb/TableView.aspx?SelectedTable=232&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=2001&LastYear=2007&3Place=N&Update=Update&JavaBox=no>

Payroll (2001-2008): <http://www.bea.gov/regional/spi/default.cfm?selTable=SA07N&selSeries=NAICS>

Input-Output Tables (2001-2007): http://www.bea.gov/industry/iotables/table_list.cfm?anon=98817

Gross Domestic Product by Industry (2001-2008): <http://www.bea.gov/regional/index.htm#gsp>

ENDNOTES

¹This paper was originally presented at the Federation of Tax Administrators' Revenue Estimation and Tax Research Conference in Des Moines, IA on September 15, 2009 as: "Tax Expenditure Implications of Changes in State Corporate Income Tax Apportionment Formulas," by Elliott Dubin and Jim Landers. See: http://www.taxadmin.org/fta/meet/09rev_est/pres/dubin_landers.pdf

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⁴Marcia Howard, *RTS 1991, State Revenue Capacity and Effort U.S. Advisory Commission on Intergovernmental Relations*, M-187, September 1993.

⁵Yesim Yilmaz, Sonya Hoo, Matthew Nagowski, Kim Rueben, and Robert Tannenwald, *Measuring Fiscal Disparity across the U.S. States: A Representative Revenue System/Representative Expenditure System Approach, Fiscal Year 2002*. A Joint Report of the Tax Policy Center and the New England Public Policy Center at the Federal Reserve Bank of Boston, November 2006.

⁶*Ibid* p.12.

⁷Agriculture, forestry, fishing, and hunting; mining; utilities; construction; manufacturing; wholesale trade; retail trade; transportation and warehousing; information; finance insurance, real estate, leasing, and management of enterprises; professional and business services; educational services, health care, and social assistance; arts, entertainment, recreation, accommodations, and food services; and other services, except government.

⁸Kenneth A. Petrick, "Corporate Profits: Profits before Tax, Profits Tax Liability, and Dividends: Methodology Paper," U.S. Department of Commerce, Bureau of Economic Analysis, September 2002, page 4.

⁹Marcia Howard, *op. cit.*, pp124-126.

¹⁰Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/corp_app.html

¹¹<http://www.bea.gov/national/nipaweb/TableView.aspx?SelectedTable=232&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=1998&LastYear=2007&3Place=N&Update=Update&JavaBox=no#Mid>

¹²<http://www.bea.gov/regional/spi/default.cfm?selTable=SA07N&selSeries=NAICS>

¹³All states that changed their apportionment formula during this period increase the weight of the sales factor.

¹⁴The questions of nexus will not be discussed here.

¹⁵Sanjay Gupta, Jared Moore, Jeffrey Gramlich, and Mary Ann Hoffman, *op. cit.*

¹⁶Edmiston, Kelly, "Strategic Apportionment of the State Corporate Income Tax: An Applied General Equilibrium Analysis," *National Tax Journal* 55 No. 2 (June 2002) 239-262.

COMING SOON: INTERNATIONAL FINANCIAL REPORTING STANDARDS¹

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Abstract

For the past two decades, the Securities and Exchange Commission has been pushing for a single set of high-quality financial reporting standards. In an increasingly global business environment, uniform financial reporting allows for easier comparison between US domestic corporations and their foreign competitors, and will help to facilitate increased cross-border investment and capital market participation. These international financial reporting standards are known as IFRS. Given the magnitude of this change, a successful overhaul of financial reporting will require multilateral participation between regulators, standard setters, the private sector, and academia. MTC constituents, namely state tax administrators, should consider the following questions: (1) What are IFRS?; (2) How will IFRS affect corporate tax revenues?; (3) How will IFRS affect sales and use taxes, and gross receipts taxes?; (4) What steps need to be taken in order to prepare for this change?

I. Introduction

In an increasingly global business environment, uniform financial reporting standards that allow for easier comparison between US domestic corporations and their foreign competitors, and facilitate increased cross-border investment and capital market participation are necessary. For the past two decades, the Securities and Exchange Commission (SEC) has been pushing for the adoption of such a set of high-quality financial standards. These international standards are known as the International Financial Reporting Standards (IFRS). According to recent SEC guidelines, beginning in 2014, certain large, publicly traded U.S. businesses will have the option to transition from the current reporting standards -- the Generally Accepted Accounting Practices (GAAP) and to issue financial reports using IFRS. By 2016, all publicly traded companies may be using IFRS.

Today, over 100 countries around the world have adopted IFRS. Current users of the international standards include Australia, Israel, South Africa, Switzerland, and all the members of the European Union who list their shares on EU exchanges. All four of the BRIC countries- Brazil, Russia, India, and China have either adopted IFRS, set a firm deadline for the transition, or have committed to the convergence of their own standards to conform to IFRS. Canada, Korea, and Japan are in the process of converging to IFRS and will

do so by 2011. The Mexican Comision Nacional Bancaria y de Valores has announced that all companies listed on the Mexican Stock Exchange must convert to IFRS by 2012.² It now appears that the United States will be among the last to convert, as the SEC has recently suggested a 2016 deadline for implementation. At this time, however, there is still uncertainty as to whether or not the U.S will ultimately make the transition.

Given the potential magnitude of this change, state tax administrators, should consider the following questions:

- **What are IFRS?**
- **How will IFRS affect corporate tax revenues?**
- **How will IFRS affect sales and use taxes, and gross receipts taxes?**
- **What steps need to be taken in order to prepare for this change?**

However, before we begin to answer those questions, we will digress and provide a brief history of IFRS.

Brief History of IFRS:

The development of international financial reporting standards (IFRS) began in 1973 with the formation of the International Accounting

Standards Committee (IASC). The stated purpose of this organization was to promulgate standards "capable of rapid acceptance and implementation world-wide". To that end, the IASC drafted a series of International Accounting Standards (IAS's) which were published in the year 2000 and collectively form the body of IFRS.³ In 2001 the IASC underwent a significant restructuring. Presently, the ISAC Foundation is a non-profit private organization that is governed by 22 trustees who come from North America, Europe, Asia/Oceania and other regions of the world. Trustees are responsible for governance, oversight, and funding of the organization and are accountable to a monitoring board comprised of leaders from the International Organization of Securities Commission, the European Commission, the Japan Financial Services Agency, and the SEC. The IASC oversees the International Accounting Standards Board (IASB) which is responsible for drafting IAS's. The IASB is made up of 15 members from 9 countries, and the board is supported by an interpretations committee and advisory council.

Although the Securities and Exchange Commission (SEC) has only recently established a formal timeline for public companies to transition from U.S GAAP to IFRS, the Commission began pushing for international accounting standards back in the 1980's. In its 1988 Policy Statement the SEC identified the need for a set of international accounting standards that would streamline the regulatory process while still providing useful information to the investment community.⁴ The development of these standards was the result of multilateral cooperation between the International Organization of Securities Commission (IOSC) and the International Accounting Standards Committee (IASC). In response to the National Securities Market Improvement Act of 1996, the Commission was asked to issue a report to update Congress on the development of international accounting standards. This report included analysis of the structure and governance of the IASC and IOSC, and a description of the Core Standards Project which would eventually result in the creation of the IAS's comprising IFRS. The Commission also used this opportunity to reaffirm its position that IFRS were needed to facilitate global investment

and reduce compliance costs and inefficiencies.⁵ In the year 2000 the SEC began to identify and seek comment on the "elements necessary for developing a high quality, global financial reporting framework for use in cross-border filings."⁶ The 2000 concept release included analysis of significant accounting differences in the areas of recognition, measurement, and reporting as well as a description of the IASC. These differences are described in detail elsewhere in the article. The commission also used the release to seek comment on the requirements for accepting, from foreign private issuers, financial statements prepared using IFRS with an accompanying GAAP reconciliation. In 2002 the FASB and IASB affirmed their commitment to converging U.S GAAP with IFRS with the Norwalk Agreement. In this agreement, the two boards decided to "undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and International Financial Reporting Standards..."⁷ A major event in the convergence of the two standards took place in January of the present year when the Commission passed a rule allowing foreign private issuers who normally file form 20-F to use IFRS based financials without a GAAP reconciliation. The reasoning for adopting this rule was two-fold; first, it creates cost savings for foreign issuers, and also because this move was consistent with the SEC's "...efforts to foster a single set of globally accepted accounting standards..."⁸ The most recent development in this saga was the release of the proposed roadmap for the use of IFRS by U.S issuers. The milestones, summarized in exhibit 1, are the criteria by which the commission will evaluate the feasibility of the new standards.

Although the roadmap provides a sense of the direction we are heading in, it creates an element of uncertainty as to whether or not the U.S will make the switch to IFRS. Adding to this uncertainty is the increased pressure, scrutiny, and loss of credibility the Commission has faced as a result of the events of 2008- most notably the subprime-crisis and the Madoff scandal. Given the considerable investment of resources necessary to complete a conversion to IFRS, U.S companies and Tax Authorities may be reluctant to begin preparations for the transition- and are thereby more likely to be caught off guard if and

Table 1

Milestones 1-4 (issues that need to be addressed before mandatory adoption of IFRSs)

1. Improvements in accounting standards (i.e., IFRSs).
2. Funding and accountability of the International Accounting Standards Committee Foundation.
3. Improvement in the ability to use interactive data (e.g., XBRL) for IFRS reporting.
4. Education and training on IFRSs in the United States.

Milestones 5-7 (the transition plan for the mandatory use of IFRSs)

5. Limited early use by eligible entities - this milestone would give a limited number of US issuers the option of using IFRSs for fiscal years ending on or after 15 December 2009.
6. Anticipated timing of future rule-making by the SEC - on the basis of the progress of milestones 1-4 and the experience gained from milestone 5, the SEC will determine in 2011 whether to require mandatory adoption of IFRSs for all US issuers. If so, the SEC will determine the date and approach for a mandatory transition to IFRSs. Potentially, the option to use IFRSs when filing could also be expanded to other issuers before 2014.
7. Potential implementation of mandatory use.

Source: Deloitte

when the SEC decides to make the switch.

The next section discusses the major differences between IFRS and GAAP and tax issues raised by the adoption of IFRS. The third section discusses issues of possible concern to state tax agencies; and the fourth section is the summary and conclusion.

II. Differences between IFRS & U.S. GAAP and Resultant Tax Issues

When considering the effect an IFRS conversion may have on taxes, whether federal or state and local, it is important to take into account that U.S. presently operates under a two-book system. This means that companies maintain one set of books to prepare financial statements in accordance with GAAP and another set for reporting to tax authorities. Therefore,

significant changes to financial reporting numbers will not necessarily create a change in the amounts reported to tax authorities, because tax accounting is subject to statutory requirements.

A. Realization of Income

The key area where IFRS and GAAP differ with respect to revenue recognition is in the reporting of service revenue. Under U.S. GAAP revenue from service engagements which span multiple reporting periods is recognized in accordance with the proportional performance model ("PPM"). The PPM requires that revenue recognition be based on the output measures included in the service contract. In the absence of defined output measures, revenue is deferred until the service engagement is completed. In contrast, IFRS uses a percentage of completion

("POC") models for measuring service revenues. For GAAP purposes, the POC models are typically restricted to long-term construction contracts. Generally speaking, this allows for accelerated revenue recognition under IFRS.

Despite the differences between the two standards, acceleration or deferral of revenues is unlikely to affect income, sales, or gross receipts taxes. Income tax is unlikely to be affected because Internal Revenue Code (IRC) §451 states that income is recognized when it is due, paid, or earned. The percentage of completion model is not allowed for service contracts for tax purposes. Therefore the tax liability arises from payments received or full performance of a service. Similarly, gross receipt taxes are based on cash payments, as opposed to accrual accounting revenues. In New Mexico, gross receipts are defined as "the total amount of money or other consideration received..."⁹ This suggests that revenues booked under the PPM or POC methods would not be taxable until payments were received. Sales tax receipts should not be affected because, for services that are taxable, the tax is generally levied when payments are received. For example, in Florida sales tax is payable "at the time of each transaction"¹⁰. This would seem to suggest that sales tax remittances would not be affected by revenues accrued solely for financial reporting purposes.

B. Repeal of LIFO

There are differences in inventory accounting under IFRS which will have a significant impact on the valuation of inventory accounts. The changes that take place will affect a company's book value and cost of goods sold. This in turn will affect income taxes, franchise and net worth taxes, as well property apportionment factors.

The main difference between GAAP and IFRS with respect to inventory accounting is that the later does not allow the use of the last-in first-out method ("LIFO"). For the most part, the LIFO method results in higher amounts reported for cost of goods sold (COGS), because in periods of rising prices recently purchased inventory is more expensive than older inventory items. Presently U.S. tax law allows for the use of

LIFO only when there is book-tax conformity, see IRC §471. This situation will likely result in higher effective tax rates for manufacturers, merchandisers, chemical or petroleum companies and other inventory intensive businesses which use LIFO. One problem with that is it places publicly traded companies at a disadvantage to their privately-owned competitors who will not be required to comply with IFRS. Exhibit 2 provides a comparison of income statements prepared using LIFO to a non-LIFO method.¹¹

The book value of inventory will generally increase when LIFO is repealed, and this will affect state income tax property apportionment factors. According to Uniform Division of Income for Tax Purposes Act (UDITPA,) "Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes."¹² Businesses could see an increase in their state income tax liability if they have substantial inventory in states which have higher values assigned to property apportionment factors.

Ultimately, it may not be IFRS that puts an end to LIFO. The Office of Management and Budget's most recent proposal includes a provision to repeal LIFO. A section titled "Other revenue changes and loophole closers" includes an estimate that repealing LIFO will decrease the budget deficit by \$61 billion between 2010-2019.¹³

C. Accounting for Property, Plant, and Equipment

Perhaps the best way to illustrate how substantial differences between U.S GAAP and IFRS may not affect tax treatment is to examine the 2006 Bayer AG 20-F filing. The 20-F is the annual financial report filed by foreign private companies with U.S. subsidiaries. Prior to the 2007 rule allowing foreign private issuers to file financial statements prepared using IFRS; companies were required to include U.S GAAP reconciliation in the notes accompanying their financial statements. Exhibit 3 is an excerpt from one these reconciliations; it shows adjustments to Bayer's 2006 income statement.¹⁴

The difference in reported earnings is primarily due to the treatment of the in-process research

Table 2		
Example	Without LIFO	With LIFO
Revenue	\$35,000,000	\$35,000,000
Cost of Goods Sold (COGS)	\$30,000,000	\$30,000,000
LIFO Adjustment	-	\$600,000
Gross Profit	\$5,000,000	\$4,400,000
Expenses	\$1,500,000	\$1,500,000
Operating Profit	\$3,500,000	\$2,900,000
Income before Taxes	\$3,500,000	\$2,900,000
Income Tax	\$1,225,000	\$1,015,000
Extra Cash	\$0	\$210,000

and development acquired in Bayer's purchase of Schering AG. At the time of the filing U.S GAAP required acquired IPR&D to be expensed immediately, unless the research has a future alternative use. Under IFRS these costs are capitalized and treated as an intangible asset. Clearly, such a large difference in reported earnings has a significant impact on key financial metrics and would likely be an item of concern for investors. However, the €1.375 billion write-down would not have lowered Bayer's taxable income because for tax purposes acquired IPR&D costs are capitalized and amortized over time.¹⁵ So then, accounting for IPR&D under U.S GAAP created a book-tax difference that would not have occurred under IFRS. It is important to note that standards have changed since 2006, and under recently adopted FAS 141(R) companies are no longer required to write off IPR&D. In a summary of statement no. 141 posted on its website the FASB describes the revision as part of a "...joint effort by the FASB and the IASB to improve financial reporting about business combinations and to promote the international convergence of accounting standards."¹⁶ This revision is consistent with the FASB's recent efforts toward convergence of GAAP with IFRS.

III. Concerns for State Tax Administrators

As mentioned previously, the transition from GAAP to IFRS raises several important issues and concerns for state tax administrators. In this section we will look more closely at how the transition can affect state tax systems.

A. Changes in Apportionment Factors

In its simplest terms, the net business income of a company is apportioned to each state in which the company does business according to the relative amounts of sales payroll and property that the firm has in each state. Of major concern is the reclassification of certain equity accounts as liabilities, and other changes, can result in higher interest expense which could effect the entire amount of net income that is to be apportioned.

Furthermore, there is a possibility that greater volatility of revenues will ensue because firms would have greater scope regarding the timing of the recognition of revenues under IFRS than they had under GAAP. In addition, firms may alter compensation policies as a result of the new standards for accounting for stock-based compensation; thereby affecting the geographic distribution of payroll. New standards for valuing property, plant, equipment, and inventories may result in greater volatility of the property factor. However, if a state has adopted a substantial portion of UDITPA, and continues to apply it after the conversion; it may not experience significant changes to its apportionment factors.

B. Elimination of FIN 48

In June, 2006, the Financial Accounting Standards Board (FASB) issued interpretation No. 48 - Accounting for Uncertainty in Income Taxes (FIN48). Briefly, FIN 48 calls for the recognition and measurement of **all** tax positions taken or

Table 3	
Adjustment to Bayer AG Income Statement 2006	
(€ million)	
Income after taxes reported under IFRS	€1,695
Business combinations	79
Pensions and other post-employment benefits	(168)
In-process research and development (IPRD)	(1,375)
Asset impairment	23
Early retirement program	(27)
Revaluation surplus	4
Minority interest	(12)
Other	(17)
<i>Deferred tax effect on U.S. GAAP adjustments</i>	<i>67</i>
Income after taxes reported under U.S. GAAP	€269

expected to be taken by **all** U.S. companies. FIN 48 requires companies to determine whether or not a tax position will be sustained upon examination by the taxing authority. Upon completing this "more likely than not" assessment on each position taken, companies are required to determine the amount of benefit to recognize in the financial statements. Any differences between tax positions taken in a tax return and amounts recognized in the financial statements will result in an increase in liability for income taxes payable (or reduce income tax refunds receivable) and/or reduce the company's deferred tax assets or increase their deferred tax liabilities.

Under IFRS, a tax liability must be booked if there is **any** chance of a tax position being rejected by the tax authority. Each tax position is then multiplied by the probability that it will be rejected by the tax authority; the total tax liability is the weighted sum of all the probable tax liabilities. State revenue agencies may need to acquire additional resources in order to cope with the increased demand for pre-filing assistance including: (1) advanced pricing arrangements; (2) letter rulings; or (3) technical bulletins.

C. Other Issues

In addition to revenue concerns, state tax agencies may encounter the need for additional resources in order to accommodate the transition. For example, IFRS will **not** apply

to privately held companies so that agencies any need to maintain legacy systems to accommodate taxpayers who will continue to use GAAP. In addition, revenue agencies will be looked upon to provide guidance regarding their positions on the tax implications of IFRS issues. Perhaps the greatest concern to state tax agencies is the need for additional training and staff or the use of outside consultants and third party experts, as well as computer system development to implement the transition to IFRS. These additional needs will come at a time of constrained state budgetary resources.

IV. Summary and Conclusion

The development of international financial reporting standards (IFRS) began in 1973 with the formation of the International Accounting Standards Committee (IASC). Today, over 100 countries around the world have adopted IFRS. Current users of the international standards include Australia, Israel, South Africa, Switzerland, and all the members of the European Union who list their shares on EU exchanges. All four of the BRIC countries- Brazil, Russia, India, and China have either adopted IFRS, set a firm deadline for the transition, or have committed to the convergence of their own standards to conform to IFRS. Canada, Korea, and Japan are in the process of converging to IFRS and will do so by 2011. It now appears that the United States will be among the last to convert, as the SEC has recently suggested a 2016 deadline

for implementation. The IASB and the U.S. FASB have confirmed their commitment to the improvement and convergence of U.S. GAAP and IFRS in order to produce a single set of high quality financial reporting standards. Support for this effort was expressed by the leaders of the Group of 20 nations at their summit meeting in Pittsburgh earlier this year. The Financial Crisis Advisory Group of the FASB and IASB, and the Monitoring Board of the IASC Foundation also support this effort. At this time, however, there is still uncertainty as to whether or not the U.S. will ultimately make the transition.

State tax administrators would be faced with several issues if the U.S. adopts the convergence of GAAP and IFRS. The primary issue concerns state corporate income taxes. The adoption of IFRS would change the Federal definition of net income, which would change the amount that would be apportioned to the states. In addition the payroll and property apportionment factors may change under IFRS if firms alter their compensation policies as a result of new standards for accounting for stock-based compensation; and, the transition to fair value accounting may alter the distribution of the property apportionment factor. The change in the ability of firms regarding the recognition of revenues can change the level and distribution of the sales apportionment factor. Furthermore, changes in firms' balance sheets can affect state franchise or net worth taxes; and changes in the ability to recognize revenues can affect gross receipts taxes.

In addition to the revenue aspects of the convergence of GAAP and IFRS, state tax administrators will incur other problems. For example, the agencies may be required to maintain legacy systems to serve taxpayers who will continue to use GAAP. Additional costs can include further training and system development costs, and the use of outside consultants and other experts.

While it may appear that the transition from GAAP to IFRS would impose significant burdens on state tax agencies, there are countervailing forces that could reduce the impact. For example, the need for more uniform accounting measures by end users -- securities analysts and share/

bond holders, regulatory agencies, and other government and non-government users could put enough pressure on the accounting boards that IFRS would become more rules-based in the future so that the transition would not seem so traumatic.

ENDNOTES

¹A version of this article was presented at the Federation of tax Administrators' Revenue Estimation and Tax Research Conference in Des Moines, IA on September 15, 2009. See: "Tax Expenditure Implications of Changes in State Corporate Income Tax Apportionment Formulas," Elliott Dubin, Multistate Tax Commission and Jim Landers, Indiana Legislative Services Agency, http://www.taxadmin.org/fta/meet/09rev_est/pres/dubin-landers.pdf

²<http://www.iasplus.com/country/useias.htm>

³http://www.icaew.com/index.cfm/route/156901/icaew_ga/en/Technical_and_Business_Topics/Guides_and_publications/Knowledge_guides/Knowledge_Guide_to_IAS_IFRS#history

⁴See "Regulation of the International Securities Markets" Securities Act Release No. 33-6807 (November 14, 1988) (the 1988 Policy Statement).

⁵<http://www.sec.gov/news/studies/acctgsp.htm>

⁶<http://www.sec.gov/rules/concept/34-42430.htm>

⁷<http://www.fasb.org/news/memorandum.pdf>

⁸<http://sec.gov/rules/final/2008/33-8879fr.pdf>

⁹http://www.tax.state.nm.us/pubs/fyi_105.pdf

¹⁰http://dor.myflorida.com/dor/taxes/sales_tax.html

¹¹<http://www.lifochannel.com/>

¹²UDITPA Reg. IV.11. (a).

¹³<http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf>

¹⁴Bayer AG 2006 form 20-F filing from SEC Edgar Database

¹⁵IFRS, US GAAP, and US tax accounting methods PWC whitepaper

¹⁶<http://www.fasb.org/st/summary/stsum141r.shtml>

MTC Offers Statistical Sampling Course in March and June 2010

Ken Beier, Director of Training

From our experience with state audits, it is clear that appropriate use of sampling techniques contributes to reduced audit cost and improved audit results—for the taxpayer and the tax agency. The MTC statistical sampling course was updated in 2008 and is being offered in:

- Dallas on **March 22-25, 2010**
Meridian Business Center in North Dallas
- Atlanta on **June 14-17, 2010**
Location to be determined

These sessions of the course are open to the private sector participants, in addition to state and local government personnel.

We expect to be scheduling additional MTC Courses—including the **Nexus School, Corporate Income Tax, Computer Assisted Audit Techniques Using Excel, and Basic Random Sampling** for 2010. Current course information and online registration are available at <http://www.mtc.gov/Events.aspx?id=1616>



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MTC Executive Committee Action at its December 3 Meeting in Orange Beach, AL

The MTC Executive Committee voted to send an amendment to Model Uniform Regulation IV.18.(A) proposed by the Uniformity Committee to the next stage in the approval process, a public hearing. Basically, this regulation gives a state the authority to modify its income apportionment formula in some cases.

A proposed change to the Multistate Tax Commission's Equitable Apportionment Regulation, which interprets Uniform Division of Income for Tax Purposes Act language that the amendment would delete language restricting the use of section 18 to cases involving "unusual fact situations (that ordinarily will be unique and non-recurring)," but retain the requirement that it be used when the standard formula "produces incongruous results."

The section 18 language was the subject of a 2008 survey of member states. Many responding states agreed that the language could be construed as too restrictive on the use of section 18 authority, but the survey produced no agreement on how the language should be changed. The current amendment was unanimously approved by both the Income and Franchise Tax Uniformity Subcommittee and the Uniformity Subcommittee at the commission's July meeting.

Other Action

The Executive Committee approved a public hearing on a Uniformity Committee recommendation to repeal the Uniform Principles Governing State Transactional Taxation of Telecommunications -- Vendee and Vendor Versions (1993). This may be the first time the Executive Committee has considered repealing or withdrawing one of the commission's recommendations to the states.

The Executive Committee also voted to delay a decision on a hearing officer report on a proposed model statute on the tax collection responsibilities of accommodations intermediaries.

Calendar of Events

Winter Program Committee Meetings

March 2-5, 2010
Denver, Colorado

43rd Annual Conference & Committee Meetings

July 25-29, 2010
Hood River, Oregon

For further details of these and future meetings, please visit our website at www.mtc.gov.

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