

Deferred Taxes on Foreign Earnings: A Road Map

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Background and Financial Reporting Overview

The accelerating growth of foreign economies, driven by the mobility of technology and enhanced communications, has led to a significant rise in corporate earnings generated outside of home country markets. Multinational businesses have pursued increasing sources of profit, supply, and capital abroad while managing the regulatory and foreign exchange risks of international business operations. Foreign earnings growth often also benefits from favorable local tax rates or holidays intended to attract outside investment. Multinationals based in home countries with a territorial system of taxation may permanently benefit from a reduced level of foreign taxation; for those in countries that follow a worldwide system of taxation, such as that of the United States, tax benefits generally inure as long as the foreign earnings remain outside the home country market.

Based upon an assumption that earnings generated by a foreign subsidiary or corporate joint venture will ultimately be distributed, a liability will be recorded in the consolidated financial statements for eventual home country taxation. This deferred tax liability will apply not only to undistributed foreign earnings, but more broadly to what is known as the “outside basis difference.” That amount represents the difference between a parent’s book and tax basis in the subsidiary, often including currency translation and other accounting adjustments.

The calculation of a deferred tax liability for undistributed foreign earnings is at once complex and subjective. The company must consider a wide variety of domestic and foreign tax laws coupled with the application of such laws to expectations regarding the manner and timing of future repatriations. The potentially hypothetical nature of the calculation introduces implementation issues and other challenges. For that reason, U.S. Generally Accepted Accounting Principles (GAAP) permit a company to overcome the presumption of repatriation and forgo recording a deferred tax liability, as long as it can support the assertion that management has the intent and ability to indefinitely reinvest the profits or otherwise indefinitely postpone taxation in the home country market. This is known as the indefinite (or permanent) reinvestment assertion.¹

Numerous financial and operational considerations factor into whether a company can assert indefinite reinvestment. Such considerations include:

- Financing requirements of the parent company
- Financing requirements of the subsidiary
- Operational and financial objectives of the parent company, both long-term and short-term
- Anticipated foreign or home country mergers and acquisitions
- Remittance restrictions imposed by local governments
- Remittance requirements imposed by debt, lease, or other financial agreements
- Tax consequences of remittance

The determination whether an assertion of indefinite reinvestment applies is not based solely upon the judgment of corporate accounting and tax department management. Rather, the expectations upon which the assertion is based require alignment with multiple business functions within a company’s global organization. This may include treasury, operations, legal, and business development.

Once management has confirmed and documented its intent and ability to assert indefinite reinvestment, the company is required to disclose the amount of undistributed foreign earnings in the notes of the financial statements. The required disclosure also includes a reasonable estimate of the deferred tax liability or a statement indicating that a reasonable estimate is not practicable.

Current Business, Economic, and Fiscal Environment

Asserting indefinite reinvestment traditionally has been a widespread practice among multinational businesses. A majority of companies make the assertion with respect to much, if not all, of their foreign earnings. This has the effect of generally reducing the overall effective tax rate when compared with the statutory home country rate.

In a 2009 study of the Fortune 500 companies, more than 300 U.S. multinationals asserted indefinite reinvestment and disclosed the amount of undistributed earnings in the notes to their respective 2008 financial statements.² The study identified the amount of unremitted earnings of the group to be \$1.02 trillion, with a per-company mean of \$3.74 billion. Compared with previous research, the 2009 study suggests the amount of undistributed foreign earnings of U.S. multinationals has increased steadily in the past five years. A combination of developments in recent years, however, has led many companies, analysts, and regulators to pay closer attention to the possibility that an indefinite reinvestment assertion may become less viable.

Economic Downturn

The prolonged global economic downturn has resulted in tighter lending and credit conditions, which have created a need for many companies to access internal liquidity sources. Increased pressure by creditors to move cash from foreign operations to the home-based market may challenge management’s ability to sustain an assertion of permanent reinvestment. Such pressure can be exacerbated during the course of debt workouts or in bankruptcy, whereby a company may no longer be in a position to control the reinvestment of foreign earnings U.S. tax legislative environment.

U.S. Legislative Environment

During the past several years, the U.S. government has directed increased attention toward the taxation of corporate foreign earnings. In August 2010, President Obama signed into law the Education Jobs and Medicaid Assistance Act, which prospectively limits (and in some circumstances eliminates) the amount of foreign tax credits that may be claimed by U.S. corporations in specified circumstances. Further, the Administration’s 2011 fiscal budget

includes additional international tax reform proposals that would generate revenue of approximately \$100 billion within the next decade. As the indefinite reinvestment assertion is intent-based, a company's decision to assert should consider the effect of proposed legislation — including that proposed by the Obama Administration in the fall of 2011 — on company plans.

Private Equity and Joint Ventures

The growth of controlled or shared corporate ownership transactions has affected corporate governance and decision-making. The decision and ability to assert indefinite reinvestment generally falls under the responsibility of a company's global management team. In some cases, however, management's control may be trumped by external decision makers such as principle owners or joint venture partners. The requirements and expectations of such stakeholders must be aligned with an assertion of indefinite reinvestment.

Management should consider the following when evaluating whether an assertion of indefinite reinvestment, partially or fully, continues to apply:

- Whether global market conditions and events have affected the company's overall strategic and business plans and, if so, how that affects cash requirements and reinvestment plans (e.g., curtailment or postponement of overseas expansion plans).
- Whether management's ability to reinvest foreign earnings has been restricted or eliminated by events that are not within management's control, such as unexpected loan collateral requirements, defined-benefit pension funding, and regulatory capital requirements.
- Whether the parent company has recent losses from operations, is generating enough cash to fund its domestic cash needs, or has experienced a credit rating decline or increased cost of capital.
- Whether management's decision not to remit some or all of its foreign earnings remains economically prudent and aligned

with the plans of all relevant stakeholders who may be in a position to override management.

- Whether management is considering a repurchase of outstanding debt (e.g., because the debt is trading at a significant discount), a share repurchase, or a business combination that may require internal funding.
- Whether the expected tax savings from not remitting foreign earnings still exists (e.g., whether recent or anticipated tax law changes might motivate the company to revise its reinvestment plans).

Measuring Deferred Taxes on Foreign Earnings

Whether for the purpose of disclosure or recording the liability, significant judgement must be applied in measuring the deferred taxes on foreign earnings. Management needs to make assumptions about the operations of its business and consider the effect of planning opportunities. Consideration must be given to the tax rules and regulations of the respective jurisdictions, including the availability of tax holidays and exemptions, appropriate foreign exchange rates, and the amount of available home country foreign tax credits or other benefits. The assessment will also reflect the effect that cumulative translation adjustments and other components of other comprehensive income (OCI) can have on the measurement of unremitted earnings.

Because most multinationals assert indefinite reinvestment and do not disclose the estimated unrecorded liability (on the basis that the calculation is not practicable), measuring the liability may be a new experience even for large sophisticated businesses. In today's environment, a decision-useful model for assessing what a reversal of an indefinite reinvestment assertion will mean from a financial reporting perspective may prove more timely and valuable than ever.

With that in mind, the following checklist may assist companies with the calculation of deferred taxes on foreign earnings. This checklist provides a helpful platform for the development or refinement of an effective assessment process.

Mapping the Legal Entity Structure

Obtaining an understanding of your corporate structure.

- Indefinite reversal assertions should be considered at each tier of the legal entity structure
- The determination as to domestic vs. foreign should be made at each tier and should consider the relevant tax law in the jurisdiction(s) of the entity that holds the investment

Does your legal entity structure include branches or similar disregarded (e.g., "check-the-box") entities?

- Consider the effects on U.S. tax earnings and profits pools (E&P)
- Consider the currency exchange effects on E&P

Does your structure include partnership or other flow-through entities?

- Deferred taxes generally should be measured using outside (rather than inside) basis differences
 - A policy election may apply to "look through" outside basis differences to certain underlying components

Analyzing the Outside Basis Components

Obtaining an understanding of the components of an outside basis difference—typical components include:

- Unremitted earnings
- Items in Other Comprehensive Income (OCI):
 - Available-for-sale (AFS) securities
 - Currency translation adjustments (CTA), including hedges of the net investment in a foreign subsidiary
 - Pension and other post-retirement obligation adjustments
- Other temporary differences may include:
 - Differences that arose in business combinations (i.e., purchase or acquisition accounting)
 - Outside basis differences in underlying (lower-tier) foreign subsidiaries, equity method investments, and flow-through entities
 - Differences related to stock-based compensation
- Previously recorded tax effects relating to:
 - Subpart F income
 - o Consider foreign taxable temporary differences, includ-

Analyzing the Outside Basis Components (Cont.)

- ing income from equity method investments and AFS securities
 - Deferred Subpart F income
 - Qualified Subpart F deficit assets
 - Reserves for uncertain tax positions (UTPs) relating to the taxation of foreign earnings
- Outside basis differences that arose from the subsidiary’s capital transactions (e.g., transactions with noncontrolling shareholders or stock redemptions or issuances)
- Outside basis differences that existed at the date of a change from investee to subsidiary (including the temporary difference from fair value remeasurement of a pre-existing interest) or from subsidiary to investee
- Intercompany loans treated as long term advances

Measuring Deferred Taxes

Consideration of management’s expectations with respect to repatriation:

- Are distributions expected out of both prior and future earnings? If not, has a partial assertion been considered (e.g., indefinitely reinvest past earnings but repatriate future earnings)?
- Has consideration been given to whether foreign law limits the amount of a distribution and, if so, whether management expects other transactions that would result in outside basis difference reversal (e.g., loan from foreign subsidiary)?
- Have the expectations with respect to lower-tier subsidiaries been reflected on a bottoms-up basis through appropriate chains of the legal entity structure?

What is the appropriate tax rate to apply?

- Distributed vs. undistributed rate (in jurisdictions where different)
- Capital vs. ordinary rate
- Does foreign law impose a withholding tax on the expected manner of repatriation?

How do foreign tax credits (FTCs) affect the calculation?

- Have you considered taxes paid by the relevant foreign operations?
- Have you considered the effect of deferred foreign taxes, including deferred foreign tax on the unremitted earnings of lower-tier affiliates not asserting indefinite reversal?
- Have you considered whether your company will claim foreign taxes as a credit or deduction in its U.S. tax return?
- Has the U.S. tax calculation been appropriately “grossed up” for FTCs?
- Have you considered the effect of the expense allocation tax regulations?
- If you expect to claim a credit, have you assessed the credit for realizability?

Measuring Deferred Taxes (Cont.)

Have you considered the effect of differences between E&P and book unremitted earnings?

- Are distributions expected at a time when there would be an E&P deficit, such that they may be a nontaxable return of capital?
- Would the remittance result in a capital gain to the extent it exceeds outside tax basis?
- Have you considered the effect of foreign currency exchange on E&P?

Have you considered the recognition and measurement criteria for UTPs?

- Uncertainties with respect to FTCs should be assessed
- Settlement of a liability for foreign UTPs could affect assumed taxes paid and E&P

Where taxes were previously recorded (e.g., Subpart F previously taxed income), have incremental tax effects been considered?

- Depending on expectations, a company may not have previously recorded withholding taxes or taxes on foreign currency translation

For tax effects resulting in a deferred tax asset (DTA):

- Is it apparent that the temporary difference will reverse (i.e., provide a tax deduction) in the foreseeable future?
- Have you assessed the need for a valuation allowance on the DTA?

Transaction and Subsequent Accounting

Have you recorded in continuing operations the tax effect of a change in assertion in the period in which the change occurred?

- Backwards tracing the tax effect of prior year CTA to OCI is prohibited
- Tax effect of current year CTA is recorded to OCI

Have you considered the allocation of tax to other financial statement components? For example:

- Acquisition accounting
- Fresh start accounting
- Discontinued operations

Has the effect of the liability been considered in relation to valuation allowance assessments?

- The establishment of the deferred tax liability may provide a source of income to support realization of existing DTAs
- A valuation allowance may be required against FTCs even though a valuation allowance is not required against a company’s other DTAs
- Specific intraperiod allocation principles apply to changes in valuation allowances

Assessment Considerations

Have you considered the effect of a change in assertion on the effective tax rate?

- Incremental taxes to be recorded on an ongoing basis should be included in the determination of the company's estimated annual effective tax rate

Have you considered the ongoing effect of a change in assertion on foreign exchange?

- Whether deferred taxes on foreign exchange should be recorded in OCI or earnings is affected by the functional currency of the subsidiary
- Foreign currency effects for intercompany loans that were previously recorded through OCI may now need to be recorded through earnings
- Ongoing foreign currency effects on withholding tax should be recorded through earnings

1. The concept of indefinite reinvestment is a longstanding exception to comprehensive recognition of deferred tax liabili-

ties that was revisited by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in 2004. At that time, the FASB staff analyzed the practical and cost-benefit considerations of computing deferred taxes on unremitted foreign earnings. The results of the research identified incremental complexities associated with measuring deferred taxes on indefinitely reinvested foreign earnings. Accordingly, both Boards agreed to retain the exception.

2. Haroldene Wunder, *The Scope and Distribution of Permanent Reinvested Earnings*, TAX NOTES 88-89 (Oct. 5, 2009).

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