

The Differential Influence of U.S. GAAP and IFRS on Corporations' Decisions to Repatriate Earnings of Foreign Subsidiaries

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During the highly charged and largely uninformative 2010 election season, a number of candidates attempted to make political capital out of the alleged “tax breaks” given to domestic corporations that do business overseas. The implied assertion was that certain incumbents had supported favorable treatment for companies moving jobs and investment to other countries, to the detriment of the domestic economy, balance of trade, and employment opportunities in the United States. Although the allegation was rarely fully detailed—in the way that such negative ads typically, and necessarily, are not—it appears that some or most of the accusations were alluding to the longstanding tax regulations that defer U.S. corporate income taxes on most earnings of foreign subsidiaries of domestic corporations until they are remitted, or repatriated, via dividend payments made to the parent company. (Note that certain passive sources of foreign earnings, such as interest and dividends, are taxed currently as so-called “passive Subpart F” income. Thus, the following discussion pertains only to active sources of earnings, which generally are profits derived from such business operations as manufacturing or merchandising activities.)

A number of academic and other writings have addressed the impact of the available tax payment deferral on corporate investing and financing decisions—and thus, indirectly at least, on the employment and other macro-economic effects of such tax policy. Less frequently addressed has been the impact of the financial reporting requirements under



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U.S. GAAP on such decisions, although in recent years there have been several academic papers, some of which are cited below, which have expanded the discussion to speak to this concern. These generally find that financial reporting objectives (more acerbically referred to as “earnings management”) play an important role in repatriation decisions—in fact, being as central to corporate decision making as are the real, economic impacts of repatriations (e.g., those deriving from higher tax obligations, availability of investment opportunities, and so forth).

Of increasing relevance today, but not yet widely addressed, is the matter of how the differential financial reporting for income taxes under U.S. GAAP versus under International Financial Reporting Standards (IFRS) might impact corporations' proclivity to reinvest foreign-based earnings overseas on a permanent or indefinite basis. This question will become increasingly important as domestic corporations are given the choice of reporting under either of these standards, which the SEC is committed to permitting in the near term. (Note that, if the SEC mandates IFRS as a successor for U.S. GAAP, the question of electing one or the other basis for financial reporting will be eliminated, but the understanding of IFRS-required accounting for “indefinite reversals” of the tax effects of foreign earnings will become even more important. Such a universal mandate appears to be at least five years away, as of late 2010.)

The primary purpose of this article is to explain the differences in the required or permitted financial reporting of the tax effects of deferred repatriation of foreign earnings. Before doing so, however, it will be useful to review the tax rules giving rise to this deferral opportunity; the unique experience of the 2004 tax act (the American Jobs Creation Act, or AJCA) that granted a one-time incentive for repatriation of those previously unremitted foreign earnings, which could be the model for another such attempt to incentivize another round of remittances; and the known or posited tax, financial reporting, and macro-economic effects of the current deferral opportunity.

Tax and Economic Considerations

Deferral of Taxes on Foreign Earnings of Subsidiaries of Domestic Corporations

According to the Code Secs. 951 through 965, the United States taxes the worldwide income of its

domestic corporations, but it generally does not tax foreign earnings until they have been repatriated.¹ The United States then permits taxpayers to claim foreign tax credits for income taxes paid to foreign governments, up to the amount that would otherwise be due had the income been earned in the United States. An exception exists for passive sources of foreign income (“passive Subpart F income”), which are taxed as earned under U.S. corporate tax laws, whether or not remitted to the parent company.

The availability of tax deferral is, *ceteris paribus*, a factor positively influencing the decision to not repatriate foreign earnings, although the relative availability of economically attractive investment opportunities abroad versus those in the United States also plays an important role (and, according to economic theory, should play the dominant role) in such decisions. The decision to repatriate is further complicated by matters such as financial reporting rules, the expectation of future changes in tax rules (e.g., making it wise to not repatriate if near-term reductions in the burden of U.S. taxes, either in general or specifically relating to foreign earnings remittances are expected), and possibly a range of other variables, including the relative ease of permanent income shifting to lower tax jurisdictions (e.g., *via* transfer pricing).² If foreign tax rates exceed U.S. corporate rates, there would be no economic incentive other than the availability of superior investment opportunities abroad to not repatriate,³ since all potential taxes would have already been paid, although there might still be a financial reporting goal being served.

What is clear is that a large amount of foreign earnings have been retained in subsidiaries, instead of being paid as dividends to domestic parent companies. Various estimates are that as much as \$1.5 trillion of unrepatriated foreign earnings of domestic corporations currently exist, which, if remitted at current rates, ignoring foreign tax credits, would yield some \$500 billion in tax receipts, barring another tax holiday.⁴ The extent to which the failure to repatriate foreign earnings is due to the desire to postpone tax payments, as opposed to other reasons, has been widely debated and researched.⁵

The deferral of tax on unrepatriated earnings, it has been noted, was legislated during a time when foreign earnings of U.S. corporations constituted only a small share of total earnings. Changes in international commerce and the decline in the relative importance of U.S. economic activities in

the decades since may necessitate a change to the longstanding policy of taxing worldwide earnings of domestic corporations.⁶ Were such a relaxation of rules to occur, there would inevitably be major behavioral changes affecting investments, repatriations, and even financial reporting practices, all or most of which would likely reduce current incentives for costly tax planning and avoidance schemes and dysfunctional investment decisions.⁷

In the absence of any immediate prospects for changes to the worldwide earnings taxation requirements under U.S. law, repatriation or non-repatriation of foreign earnings remains an actively debated topic, and a replication of the 2004 initiative to encourage such repatriation (and thus taxation, albeit on a reduced scale) is a possibility.

The AJCA of 2004

The American Jobs Creation Act of 2004 (AJCA) provided a special, one-time dividends-received deduction computed as 85 percent of certain foreign earnings that were repatriated (*i.e.*, distributed to the U.S. parent or investor by the foreign subsidiary or investee company). This provision was effective for certain foreign earnings repatriated either during the taxpayer's last year beginning prior to October 22, 2004 (the AJCA enactment date) or, alternatively, during the taxpayer's first tax year that began in the first year after enactment. Apparent ambiguity in the wording of this provision of AJCA resulted in requests by taxpayers that Congress or the U.S. Treasury clarify certain of its requirements. The interpretation of these provisions affected decisions made by the management of affected taxpayers regarding when and whether to repatriate or reinvest affected foreign earnings.

It had long been hypothesized that the opportunity for tax deferral would inspire nonrepatriation of foreign-sourced earnings, and those accumulated earnings (and more specifically, the cash being accumulated overseas) would be invested in foreign factories and other facilities, thereby creating employment opportunities in other nations, rather than here in the United States. It is therefore tempting to jump on the band wagon to incentivize U.S. multinational corporations to repatriate foreign earnings to stimulate our sluggish economy hasten the pace of recovery from the Great Recession of 2008–2010.

As noted, the policy permitting deferral arose when there was a much lower expectation of material amounts of foreign earnings occurring. However, over recent decades, many changes have occurred. U.S.

corporate tax rates are higher than those in most other countries, making nonrepatriation more attractive, holding all other factors constant (which, however, do not remain constant). Production of goods (and more recently, of services) in other nations has become ever more competitive with that in the United States, both in terms of cost and, increasingly, in terms of quality, as the near-annihilation of the U.S. electronics industry and the serious decline in the U.S. automobile industry, among many others, have attested. The 2008–2010 recession (shared, to a large extent, among many other developed and developing economies) has made unemployment a very politically sensitive concern, and has revealed structural issues that are deemed unlikely to become resolved even if domestic economic growth is restored to pre-recession levels.

The Homeland Investment Act of 2004, which was incorporated into the aforementioned American Jobs Creation Act of 2004, provided for a one-time tax holiday on the repatriation of foreign earnings, thereby allowing U.S. multinationals to access earnings retained abroad at a lower cost. It created a new Code Sec. 965 provision that granted an 85-percent dividends-received deduction for repatriation of foreign earnings, if those earnings were deployed for defined, acceptable purposes.⁸ As discussed later in this paper, it appears that the stated objectives were not fully achieved.⁹

It has been estimated that, at the time the AJCA was enacted, foreign subsidiaries of domestic corporations had approximately \$1 trillion in unremitted earnings. Many academic and other researchers have concluded that from \$300 to \$360 billion of those foreign earnings were repatriated during the brief period that the tax holiday was in effect.¹⁰ Since the effective tax rate (before foreign tax credits) on these repatriated earnings was only 5.25 percent (= the 15% unsheltered portion of remittances x 35% top corporate rate), the Treasury only netted about \$15 billion, versus the normal, and presumably eventually forthcoming, yield of about \$100 billion. What was otherwise a mere deferral became a permanent forgiveness of taxes otherwise due.

The stated objective of the tax holiday was to encourage repatriations that were then deployed in ways that would increase domestic economic activities, in general, and employment, in particular. If the 2004 program were to be replicated in 2010 or 2011, it most certainly would be sold as a jobs creation initiative.

However, the evidence on the efficacy of the tax holiday is at best mixed. While survey data (based on responses by corporate officials to questionnaires) unsurprisingly report that all repatriated funds were used for officially sanctioned purposes (mainly capital investments, research and development, and employee hiring and training),¹¹ empirical research concludes otherwise, showing that a preponderance of repatriated funds was used to finance share repurchases or dividends, which were prohibited uses.¹²

The collection of a mere \$15 billion in taxes on \$360 billion in otherwise taxable repatriated earnings conveys the heavy cost of this program. Although some have cited the \$15 billion as being incremental tax receipts that otherwise would not ever have been obtained, arguably from an economic policy perspective the decision should have been evaluated by comparing the \$85 billion forgone to the incremental receipts from taxes on the profits on plant and other investments made and taxes on the salaries paid to newly hired workers, with appropriate adjustments for time value of money. If, as reported, as much as 90 percent of the remittances were used to fund share repurchases or other distributions to stockholders (some of which would have admittedly created taxable income and thus tax receipts), it would seem to be unlikely that the tax holiday was economically warranted, holding aside other (e.g., political) objectives that may have been achieved.

Furthermore, some research has suggested that at least certain corporations improperly obtained tax benefits on nonqualified repatriations (e.g., by “round-tripping” earnings that had not been described in the reporting entities’ GAAP-basis financial statements as being permanently reinvested abroad prior to the tax holiday), or that they failed to use repatriated sums for approved purposes (e.g., by exchanging repatriated funds for domestic, already-taxed retained earnings that had been earmarked for plant expansion, R&D, or other authorized purposes). Since money is fungible, it would certainly have been feasible to manipulate otherwise-planned upward distributions of earnings in order to gain the benefit of huge, only-temporarily-available tax savings.

One comprehensive study of the impact of AJCA analyzed how firms responded to the temporary reduction in the tax costs of repatriating foreign earnings under that Act, and reached three main conclusions.¹³ The first finding was that the domestic operations of U.S. multinationals were not financially constrained at the time of the Act, meaning the

absence of domestic job-boosting investments was not due to lack of investable funds, but rather was a reflection of perceived scarcity of profitable investment opportunities. The ability to access an internal source of capital at a lower cost (i.e., the tax-favored repatriated foreign earnings) did not boost domestic investment, domestic employment, or R&D.

The authors of that study note that statements made by Congressmen and lobbyists in support of this provision indicated that they believed that reducing repatriation taxes would increase the domestic activities of U.S. multi-national enterprises. However, this expectation was not borne out in actual experience. Even firms that showed some evidence of being financially constrained, or that explicitly lobbied for the tax holiday, did not increase domestic investment, domestic employment, or R&D. Additionally, they found that repatriations were positively associated with capital flows from the U.S. parents to their foreign affiliates, suggesting that “round tripping” of capital was engaged in, presumably to then repatriate it at the lower tax rate.¹⁴

Credit is tighter today than it was in 2004, and arguably a tax holiday may allow some U.S. corporations access to cheaper funds by repatriating cash. This could conceivably have some impact on our economy. The overwhelming evidence, however, is that the tax holiday of 2004 did little to change the behavior of most U.S. multinationals. If a project was worthy of investment here in the United States, it could have been financed by means other than repatriated cash. Is this still true today? For most corporations, except those in the weakest and most over-leveraged state, it is likely that they will rationally make their financing and investment decisions separately, and thus a repatriation of cash will cause virtually no change in behavior.

A secondary finding was that U.S. corporations’ actions—repatriating foreign earnings and using most of the net proceeds to fund share repurchases and dividends—is indicative of their effective corporate governance, since shareholders benefited from these actions. Absent good governance, it is argued, the proceeds would have instead been used to more directly benefit management, e.g., through higher levels of compensation or uneconomic investments made to justify expanded administrative costs.¹⁵ To the contrary, there is little or no evidence that self-serving expenditures were incurred using newly repatriated funds.

One study found that 67 to 92 cents of every dollar repatriated found its way in to a share repurchase

program or dividend increase. While this use of repatriated cash was not what the AJCA was intended to produce, increased dividends to shareholders or for share repurchase programs, both of which theoretically lead to higher stock prices, can cause behavioral changes in the shareholders which can be seen as the having an ultimate effect of increasing business activities and thus economic growth. In other words, a higher dividend rate puts cash in the pockets of the shareholders, which could encourage domestic spending. Higher stock prices certainly lead to the wealth effect—the holder of the portfolio feels wealthier and therefore has a higher propensity to spend. While government officials intended repatriated cash to be used for building new plants, buying new equipment, hiring new workers and increasing R&D spending, even if it was not used as intended it may well have had a net positive effect on the economy in the years immediately following 2004. Nevertheless, the fact that the cash was used for purposes other than plant expansions does strongly suggest that corporations were not cash starved and unable to fund worthwhile investments before the tax holiday.

The third finding was that the fungibility of money rendered regulations aimed at directing financial policy ineffective. The reported research clearly shows that the guidelines incorporated into AJCA were ineffective in getting repatriating firms to increase their domestic investing and job-creating activities. There is seemingly no reason to expect that yet another undertaking to encourage repatriation of foreign earnings, such as are now being proposed by influential economists and others,¹⁶ would have a different outcome.

Other studies also found little or no effect from the AJCA. For example, research by Faulkender and Petersen concludes that a better understanding of finance theory would be vital for designing optimally targeted tax incentives.¹⁷ Consistent with the Modigliani-Miller theory of finance (see discussion below), they determine that, although the tax holiday lowered the cost of internal financing, investment decisions are separate and distinct from financing decisions, and thus there should have been little expectation that the availability of tax-favored repatriated funds would have stimulated capital investment in the United States. They also found that repatriations exceeded available cash held by the foreign subsidiaries, suggesting that corporations used various subterfuges, such as “round

tripping,” to obtain these tax benefits. That further underscores the practical difficulty of operationalizing a tax holiday strategy, even if some or most of the remittances are deployed for the purposes intended (which, in the case of AJCA, they were apparently not).¹⁸

These authors of the study also note, as did other academicians, the flawed presumption that U.S. corporations had been constrained as to their capital resources, and would therefore have put to productive use the funds repatriated as a result of AJCA. Their analyses found only a statistically insignificant difference in investment behavior as between those corporations reporting tax-favored repatriations and those not so reporting. Similarly, there was little evidence of increased employment by repatriating corporations. Overall, the AJCA's goals were accomplished only as they affected the small subset of corporations that had been financially constrained (*i.e.*, having a shortage of investable funds) before the repatriations. The inference is that a repeat of this program would be far too blunt an instrument to efficiently achieve any economic objectives relating to job creation in the United States.

Theory of Finance Considerations

The presumption that a tax holiday would stimulate new capital investment (or other job or growth-creating actions) in the United States is not necessarily consistent with fundamental theories and findings in the fields of finance and financial economics. Corporations logically make investments when doing so adds to the wealth of owners, operationally defined when the net present value of future cash flows exceeds the cost of the investment. Importantly, as established first by Modigliani and Miller,¹⁹ investment decisions are separate from financing decisions, and thus, *inter alia*, corporations should make profitable investments regardless of financing options available to them. An obvious implication is that, even in the absence of tax-favorable repatriation of foreign earnings opportunities, corporations should have been obtaining funds by other means to make domestic investments—including through the use of unrepatriated foreign earnings to indirectly finance or to secure borrowings used to finance them—if such investments held the promise of profitability.

Put another way, there would be good reason to suspect that, had profitable investments been available in the United States, domestic corporations would

have financed such investments regardless of the tax-favored opportunity for a repatriation of foreign earnings. Alternatively stated, the net proceeds of these tax-favored repatriations would not likely have found new, profitable investment opportunities—an expectation borne out by research findings showing that most such proceeds were instead largely distributed to shareholders.²⁰

It must be acknowledged that dissonant findings also have been cited by academic researchers and others, which may suggest that corporate actions regarding investment decisions were not always rational.²¹ Most significantly, it appears that U.S. corporations' holdings of foreign cash balances were disproportionately large, suggesting that earnings were not repatriated due to the desire to avoid punitive U.S. income taxes, notwithstanding the fact that there were not sufficient, profitable investment opportunities abroad to absorb such cash holdings. This resulted in the maintaining of cash balances having little promise of meaningful economic returns.²² In fairness, it could also have been the case that there was, at that time, a perceived paucity of profitable investment opportunities in the United States as well. This would have made the holding of foreign cash balances preferable to the alternative, involving repatriation, the payment of 35-percent tax, and then holding the after-tax residuals as U.S. cash balances. At the very least, holding the cash abroad would have preserved greater resources for future deployment, perhaps even in the hope of lowered repatriation taxes under a future tax regime.

Macro-Economic Effects of Deferral and of the Incentive to Repatriate Under AJCA

It is widely believed that earnings generated in Asia are not likely to be repatriated even under a tax holiday, since investments in that part of the world have been recently profitable, and because the tax rates of those foreign countries are often very low. Profits earned in other parts of the world, however, where tax rates are higher and profitability of new investments are potentially lower (Europe, for example) would likely result in the repatriation of funds. As another possible solution to the perceived problems caused by the failure to repatriate earnings of foreign subsidiaries, therefore, there is now growing enthusiasm for a lower U.S. corporate tax rate instead of a tax holiday to incent the U.S. multinational to remit dividends to the U.S. parent companies.

This would be a more sweeping change with wider implications, however. Lower U.S. tax rates may lead to higher investment, job creation, and spending here in the United States, even with a repatriation rate of zero. Aligning our top tax rate with the top tax rates of other nations may “level the playing field” in multiple ways. U.S. multinationals would be more likely to build new plant, hire new workers, and spend more domestically. Foreign corporations may also be more likely to build new plants, hire workers and spend more here on our soil if their U.S. earnings are not to be taxed at a punitive rate. It would likely follow that the multinationals would also bring home foreign cash, especially where the foreign tax rate was equal to the U.S. rate and would result in no new tax liability. The policy change would also more likely avoid another build up of nonrepatriated cash in foreign subsidiaries since the tax rates would be closer to parity. In a similar way, as these authors have argued before, bringing U.S. GAAP and IFRS closer to parity would also benefit all multinational corporations by “leveling the playing field” on the accounting aspects of running businesses, just as equalization of tax rates would do. This last matter is addressed in the following paragraphs.

Financial Reporting Considerations

Accounting for Deferred Taxes in General

Under U.S. GAAP (and also under IFRS), the financial statements are to report the tax effects of income and expense reported in the current period, without regard to when the taxes are actually remitted to the taxing authorities. While the actual rules under current financial reporting standards are much more complex than this simple observation would suggest—and now are driven by a strict balance sheet orientation, in contrast to the earlier, “matching concept”-driven income statement approach that was in force, under U.S. GAAP, from the 1960s until the mid-1990s²³—for clarity of exposition these refinements will not be detailed.

Under this general principle, known as accrual accounting, income taxes would be reported in the consolidated financial statements in the period when the related foreign income is being reported. Because consolidated financial statements of domestic corporations would include, without limitation, the earnings of foreign subsidiaries, in the absence of

special financial reporting rules taxes on those foreign earnings would be reported, notwithstanding any permitted deferral of the actual payment obligations. The resulting tax expense would be accompanied, in the financial statements, by recognition of a deferred tax liability, since there would be no current cash outflow. Thus, the reporting entity's ratio of post-tax to pre-tax income (among other possible relationships of interest to financial analysts, investors, *et al.*) would be the same with or without the tax payment deferral opportunity afforded by the Code. This is consistent with GAAP's (and IFRS's) general demand that economic substance be reported, which is not limited to current cash inflows and outflows.

Accounting for Deferred Taxes on Foreign Earnings Under U.S. GAAP

Notwithstanding this imperative, the availability of the indefinite deferral of tax payments associated with unremitted foreign earnings under Code Sec. 965 has long inspired arguments in favor of the non-recognition of tax effects until remittances occur or become likely. An amendment to APB 11, APB 23 (issued in 1972), affirmed that “undistributed earnings of a subsidiary in the pretax accounting income of a parent company, either through consolidation or accounting for the investment by the equity method, results in a temporary difference.”²⁴ It held that “it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free.”²⁵ However, it further held that:

The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. Experience of the companies and definite future programs of operations and remittances are examples of the types of

evidence required to substantiate the parent company's representation of indefinite postponement of remittances from a subsidiary. If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings should not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period; such adjustment of income tax expense should not be accounted for as an extraordinary item.²⁶

Thus was born the “indefinite reversal criterion,” whereby domestic reporting entities could avoid accruing income tax expense on earnings of foreign subsidiaries (and also of equity method investees, which is not explicitly addressed in this paper), if it could justify the assumption that those earnings would be indefinitely invested in foreign tax jurisdictions (or would be repatriated in tax-free liquidations, which is not pertinent to the present discussion). This standard, although imposed during the era of the primacy of the “matching concept” and of income-statement driven accounting principles, was preserved when SFAS 109 was promulgated, marking the dawn of financial reporting standards having a primarily balance sheet orientation.

Under APB 23, those domestic financial reporting entities reporting under U.S. GAAP that are able to assert—and convince their independent auditors—that they intend to reinvest those foreign generated earnings in other countries indefinitely can avert current recognition of income tax expense associated with those earnings. Among other effects, this practice results in a higher ratio of reported post-tax earnings to pre-tax earnings, lower effective tax rates, greater profitability and higher returns on sales, assets and equity, than would otherwise be the case.²⁷ Some have asserted that these favorable financial reporting consequences may actually have motivated the non-repatriation of foreign-generated earnings that would have otherwise resulted in additional capital investment, and thus jobs, in the United States.

Note that, if in later years the ostensibly “indefinitely reinvested” foreign earnings are in fact repatriated, higher tax expense will be reported under U.S. GAAP, making the effective tax rates in those subsequent years higher than would otherwise have been the case. This would accordingly result in reduced measures of corporate performance, such as those revealed by the ratio of post-tax to pre-tax earnings, returns on sales, assets, and equity, and so forth. However, many if not most corporations would view the availability of a currently favorable set of performance indicators as being attractive, notwithstanding the possibility of having unfavorable impacts on the reported results in future periods.

Some have observed that the amount of repatriated earnings under the AJCA represented as much as a six-fold increase over otherwise-anticipated annual remittances of foreign earnings, and that the scale of this influx of dividends suggests that there was more than mere tax deferral or avoidance motivation at work. More particularly, it has been posited that a financial reporting objective—namely, the ability to avert tax expense recognition—actually inspired both the foreign reinvestments and then the flood of repatriations during the tax holiday.

Inasmuch as deferred taxes had not been provided on foreign earnings that had been asserted to have been indefinitely reinvested abroad (and because AJCA required that only earnings that had been so designated qualified for the one-time-only, tax-favored, repatriation), opportunistic repatriation in 2005 did indeed permanently avoid tax expense recognition. This financial reporting conduct can be distinguished from sound corporate economic decision-making, although it would hardly have been prohibited behavior, *per se*.²⁸ This hypothesis is consistent with the finding that repatriated funds were used overwhelmingly to facilitate share repurchases and dividend payments, and not for job-creating capital investment purposes.

The AJCA restricted repatriations subject to the tax holiday provision to foreign earnings previously described in GAAP financial statements as being indefinitely reinvested overseas. This was done to stimulate *incremental* repatriations of earnings and investable cash. By repatriating those earnings, on which deferred taxes had not been provided, the corporations risked suggesting to investors—and, more importantly, to their outside auditors—that previous expressions of intentions to not remit earnings to domestic parents may have been less than

sincere. However, the authors are not aware that these repatriations triggered disputes with auditors (which, had they occurred, could have resulted in restatements of prior periods' financial statements, or in demands that provisions for deferred taxes be made on any remaining unremitted foreign earnings). In any event, in contrast with certain other requirements under GAAP, APB 23 does not include any explicit proviso regarding the “tainting” of remaining unremitted foreign earnings.²⁹

It should be noted that the tax rate to be applied to unremitted foreign earnings under GAAP, if the “indefinitely reinvested” criterion is not satisfied, would depend upon management's intention regarding the means by which such earnings would eventually be realized—*i.e.*, whether by means of dividends, or via the disposal of the entity and the realization of capital gains. Accordingly, the amount of such deferred income taxes, if they must be provided, would be dependent upon the anticipated means of realization, which of course could change over time. If the law provides a mechanism under which the parent can recover its investment tax-free, deferred income taxes are not provided.³⁰ Additionally, a change made to equalize the top corporate tax rate, instead of declaring a tax holiday, would eliminate the need for the U.S. corporation to show evidence of how it has used repatriated cash.

In other cases, the minimization or avoidance of income taxes can be achieved only if the parent company owns a stipulated share of the subsidiary's stock. A parent owning less than this threshold level of its subsidiary may express its intent to utilize a tax planning strategy to acquire the necessary additional shares to realize this benefit. In evaluating this strategy, the cost of acquiring the additional shares must be considered, and the benefits to be recognized (*i.e.*, a reduced deferred income tax liability) must be offset by the cost of implementing the strategy as discussed earlier in this chapter. In general, it would be more challenging to justify non-recognition of deferred taxes on unremitted foreign earnings in such circumstances.

Additionally, a distinction exists in the application of APB 23 between differences in income tax and financial reporting bases that are considered “inside basis differences” versus “outside basis differences,” and this was clarified by consensus of the FASB's Emerging Issues Task Force.³¹ Certain countries' income tax laws allow periodic revaluation of long-lived assets to reflect the effects of inflation, with the

offsetting credit recorded as equity for income tax purposes. Because this is an internal adjustment that does not result from a transaction with third parties, the additional basis is referred to as “inside basis.” The cited consensuses indicate that the APB 23 indefinite reversal criteria only apply to “outside basis differences,” and not to “inside basis differences” arising in connection with ownership of foreign subsidiaries. Therefore, a deferred income tax liability is to be provided on the amount of the increased inside basis in all cases.

Certain foreign countries tax corporate income at rates that differ depending on whether the income is distributed as dividends or retained by the corporation. Upon subsequent distribution of the accumulated earnings, the taxpayer receives a tax credit or refund for the difference between the two rates. In the consolidated financial statements of a parent company, the future income tax credit and the deferred income tax effects related to dividends that will be paid in the future are recognized based on the distributed rate if the parent provided for deferred income taxes because it did not invoke the indefinite reversal criteria of APB 23. If the parent did not provide for deferred income taxes as a result of applying the APB 23 criterion, the undistributed rate is to be used. Again, parallel tax rates would go a long way to resolving this issue.

To summarize the foregoing, under U.S. GAAP, strictly interpreted, there should be a relatively high hurdle for the nonrecognition of the tax effects of the earnings of foreign subsidiaries of domestic corporations, whatever the tax laws might otherwise provide regarding current tax payment obligations. In other words, it would be incumbent upon the reporting entity to demonstrate, by reference to its historical actions and its current, documented plans, that foreign earnings will be reinvested abroad indefinitely, with no realistic intent to repatriate those earnings. For the entity’s independent accountants, of course, the challenge will be to audit management’s intentions—always among the more difficult of undertakings, fraught with risks of later second-guessing and possible litigation.

Accounting for Deferred Taxes on Foreign Earnings Under IFRS

The basic concept set forth under APB 23, that deferred taxes are to be provided on all timing differences, including those arising from unremitted earnings of foreign subsidiaries that remain untaxed in the parent

company’s jurisdiction until repatriated, also is subscribed to by IFRS. Likewise, IFRS provides an exception that supports the nonrecognition of the tax effects of the unremitted foreign earnings, under limited circumstances. However, the criteria for nonrecognition differ as between these two financial reporting regimes, and this difference could well affect management behavior in ways that investors, auditors and others would be well-advised to become familiar with.

Under the pertinent international accounting standard, IAS 12, the reporting entity is to recognize a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that *both* of the following conditions are satisfied:

1. the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; *and*
2. it is probable that the temporary difference will not reverse in the foreseeable future.³²

It should be noted that two terms in the foregoing rule could be subject to some degree of definitional debate. These are *probable* and *foreseeable future*. Reasonable preparers, auditors, and users of the financial statements could be expected to occasionally disagree over the meanings of these terms, and given different perspectives and the general litigiousness of our culture, these disagreements could lead to serious contention, including litigation, particularly if investors believe management committed misrepresentations in the financial statements relied upon for investment decisions.

Under IFRS, the term “probable” is generally defined as being a likelihood of greater than 50 percent, which is formally expressed as being “more likely than not” to occur.³³ However, that definition is found in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, which states that the “more likely than not” interpretation therein does not necessarily also apply to the same term when used in other IFRS standards. Remarkably, although the term “probable” is used some 28 times in IAS 12, it is never given a formal or operationalizable definition, adding to the likely frustration of preparers, users and auditors.

For purposes of the present discussion, however, it will be asserted that “probable,” when used as a threshold condition for the nonrecognition of the tax effects of unremitted foreign earnings, will be taken to mean “more likely than not,” consistent with the term’s use in IAS 37. This provides a much lower

threshold criterion than the corresponding one under U.S. GAAP, which demands a firm management assertion that foreign earnings are to be indefinitely reinvested abroad and thus shielded from U.S. corporate income taxes indefinitely.

Similarly, the standard does not define “foreseeable future,” and thus this will remain a matter of subjective judgment. Nevertheless, the *foreseeable future* implies a more proximate horizon than is suggested by the corresponding U.S. GAAP term, *indefinite*. Put another way, in the authors’ view, it would be easier for management to assert that any repatriation of foreign earnings is not expected in the foreseeable future (the IFRS guideline) than it would be to assert an absolute intention to indefinitely reinvest those earnings abroad (the U.S. GAAP criterion).

As a historical note, it can be observed that the criteria set forth by the current version of IAS 12, while subjective, are less ambiguous than under the predecessor standard (also denoted as IAS 12), which permitted nonrecognition of a deferred tax liability whenever it was “reasonable to assume that (the associate’s) profits will not be distributed.” That former criterion granted even greater discretion to management, presumably to many auditors’ consternation.

Taken together, the terms *probable* and *foreseeable future* as used by IAS 12 suggest that it would be much more feasible for corporations reporting under IFRS to justify not providing deferred taxes on unremitted foreign earnings, where (as for U.S. corporations) those taxes will not become payable until there is repatriation to the parent company. As the United States now permits the optional use of IFRS for financial reporting by U.S. corporations—and may eventually mandate use of IFRS as the successor to U.S. GAAP—this would suggest that deferred taxes

on unremitted foreign earnings will increasingly go unreported until, and if, repatriation occurs.

Finally, it should be noted that IASB had determined that the exception to the required recognition of deferred taxes, in those circumstances in which the parent or investor or venturer entity is both able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future, should be removed from IAS 12. However, this suggestion met with significant opposition, and the IASB has more recently concluded that this exception will be continued, but in a somewhat restricted form (essentially only eliminating the possibility of nonrecognition with regard to “associates,” as equity method investees are known under IFRS). As of late 2010, amendment of IAS 12 remains under active debate, but no final action is anticipated until other IASB-FASB convergence matters have been resolved.

Conclusions

In conclusion, instead of legislating another tax holiday, which could easily fail to meet its intentions, we would propose bringing U.S. tax rates and accounting rules close to an international parity. The level playing field would initially benefit some nations more than others, but in the long run would provide a flatter and fairer surface for business competition. In the short run, the U.S. economy would likely be an enormous beneficiary with lower tax rates spurring corporations to open their checkbooks with the benefits of both repatriated dollars and tax savings. As Americans, we should welcome the competition and look forward to fully and fairly participating in a bigger game on a global arena.

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¹ To obtain this benefit, the American-owned foreign affiliates must be separately incorporated as subsidiaries in foreign countries. The profits of unincorporated foreign businesses such as American-owned branches in other countries are not eligible for this deferral.

² U.S. corporations receive a U.S. tax credit for corporate taxes paid overseas, but only up to the U.S. tax rate. Studies have found that, given the foreign taxes paid credit and the proclivity to not repatriate foreign earnings, U.S. corporations have paid only about a 2.3-percent effective rate in U.S. income taxes on foreign earnings in recent years. (White House Office of the Press Secretary, 2009, addressing the effective rate paid in

2004.) Government data suggests that large U.S. corporations with positive income paid a weighted-average effective worldwide tax rate of only 16.1 percent on foreign source income, as compared to 25.2 percent on domestic income. (United States Government Accountability Office, 2008.)

³ It has been noted that there are copious opportunities for “cross-crediting” foreign earnings, so as a practical matter there may be little in the way of lost foreign tax credits against U.S. corporate taxes.

⁴ Net of foreign tax credits, this amount would obviously be smaller, but since foreign corporate tax rates are widely acknowledged to be much lower than the 35-percent U.S.

rate, on average, there would still be substantial incremental receipts of such a comprehensive wave of repatriations. (Among developed nations, only France, Germany, Japan, and a few other nations have rates equal to or greater than that of the United States.) Such remittances obviously will not occur in the absence of a tax holiday or other incentive program; if the 2004 holiday were replicated, maximum receipts before credits would be about \$75 billion.

⁵ Arguably, the fact of the 2004 tax holiday has served to encourage nonrepatriation in the years since that program expired, in the hope that another such plan might be enacted, as has indeed been urged by

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- several noted economists since the start of the current recession.
- ⁶ DANIEL SHAVIRO, *FIXING THE U.S. INTERNATIONAL TAX RULES*, Ch. 2 (draft).
- ⁷ Shaviro observes that current rules “smack more of gratuitously self-imposed harm, and are hard to defend other than as Rube Goldberg devices for navigating to a particular point on the spectrum between purely worldwide and purely territorial taxation.” (SHAVIRO, *id.*)
- ⁸ The acceptable uses of these tax-favored repatriations included job creation, capital investment, and other growth-producing expenditures. In addition, the credit was limited to those foreign earnings that had been described (and accounted for) in the entity’s financial statements as having been permanently invested abroad.
- ⁹ Proponents of the AJCA expected, *inter alia*, the creation of from 500,000 to 600,000 new American jobs (based, respectively, on 2003 study by Allen Sinai of Decision Economics, Inc., and estimate by J.P. Morgan Securities. However, many experts, including the White House’s own Council of Economic Advisers, foresaw that this would not happen. (See, e.g., *Tax Windfall May Not Boost Hiring Despite Claims; Some Companies Plan to Use New Break on Foreign Profits for Debt and Other Needs*, WALL ST. J., Oct. 13, 2004, at A1.)
- ¹⁰ One such calculation determined that U.S. multinationals repatriated about \$362 billion under the provisions of the AJCA, exceeding most predictions and translating into an average of \$370 million of qualifying repatriations for each of the 843 corporations that took advantage of the tax holiday. (Melissa Redmiles, *The One-Time Received Dividend Deduction*, STATISTICS OF INCOME BULLETIN, Spring 2008, at 102-114.)
- ¹¹ Permitted and prohibited uses were set forth by IRS Notice 2005-10. In the authors’ view, it is hardly surprising that self-reported uses of tax-favored repatriated funds would fall within the officially sanctioned categories. As discussed in this article, other, empirical research does not support such self-serving professions by corporate executives.
- ¹² This apparent violation of the applicable regulations was possible because funds are fungible, and the permitted uses may have otherwise been planned expenditures which were then nominally financed by repatriated funds, while the otherwise earmarked funds were redeployed to accomplish share repurchases or dividends that otherwise would not have been effected.
- ¹³ Dharmapala, D., Foley, C. F., and Forbes, K. J., *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act*, April 2010.
- ¹⁴ Arguably, this was at variance to the explicit requirements of AJCA, and in any event further suggests that U.S. corporations were not capital constrained, undermining the logic of the tax holiday.
- ¹⁵ Increased executive compensation was explicitly banned under AJCA, but, as noted with regard to share repurchases, which was also a prohibited use of repatriated funds under the program, the fungibility of cash makes it almost impossible to actually trace the use of these funds. This was clearly a weakness of the 2004 program, and thus of any renewed tax holiday scheme that would be similarly structured.
- ¹⁶ See, e.g., Allen Sinai, *Macroeconomic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment*, a study performed by Decision Economics, Inc. for the American Council for Capital Formation, Nov. 2008 (revised Jan. 30, 2009). This paper cites other research that purports to find that earnings repatriated under AJCA in fact were deployed for U.S. capital investment, employee training, R&D and other legitimate and intended purposes. (Graham, J., Hanlon, M., and Shevlin, T., *Barriers to Mobility: The Lock-out Effect of U.S. Taxation of Worldwide Corporate Profits*, Oct. 27, 2008.) Mr. Sinai acknowledges, however, that even if the AJCA had salutary effects, replication in the current economic environment would not be likely to occur.
- ¹⁷ Faulkender, M. and Petersen, M., *Investment and Capital Constraints: Repatriations Under the American Jobs Creation Act*, July 2009.
- ¹⁸ Faulkender and Petersen found, using Form 10-K analyses, that “permanently reinvested” foreign earnings fell by only about \$106 billion from 2004 to 2005, or only about one-third the amount reported as being repatriated under AJCA, which dramatically suggests that various schemes were employed to exaggerate the benefits received from the tax holiday, further emphasizing the apparent hopelessness of successfully implementing the intended policy objectives of the Act.
- ¹⁹ The Modigliani-Miller capital structure theory, also known as the capital structure irrelevancy principle, was set forth by Franco Modigliani and Merton Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, AMERICAN ECONOMIC REVIEW, 48 (3): 261-297 (1958).
- ²⁰ Research has shown that from 60 percent to over 91 percent of the net repatriations were used for dividend payments or, more commonly, for share repurchases. (See, e.g., Dharmapala, D., Foley, C. F., and Forbes, K. J., *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act*, April 2010.) Although some tax receipts would flow from such actions (particularly dividends paid to individual shareholders), this clearly would not be consonant with the stated purpose of the tax holiday, and probably would not even recover the cost incurred by the Treasury. It clearly would not achieve the job creation purpose cited. Furthermore, the fact that repatriated funds were used in this manner suggests strongly that these corporations were not capital constrained (*i.e.*, the absence of investments in the United States was not due to a lack of investable funds, but rather was due to a dearth of worthy investment options), making it even less likely that the tax holiday could spur domestic economic growth.
- ²¹ Arguably, entities which would keep idle funds abroad in order to delay the 35-percent tax on repatriated earnings even in the face of profitable investment opportunities in the United States, possibly to distort (thanks to the APB 23 “indefinite reinvestment” exception) the effective tax rate and other performance indicators, could be seen as ill-governed, raising other concerns beyond the scope of this article.
- ²² While exceptions certainly could exist, holding cash, which in recent interest rate environments yield little or no return, would appear to be dysfunctional in the face of profitable investment opportunities in, e.g., plant and equipment. A typical alternative use of the cash, to reacquire outstanding shares (thus boosting EPS, a key measure of performance), would have required that the subsidiary first transfer the cash to the parent company, which would have triggered tax on repatriated earnings.
- ²³ The “matching concept” approach was established by Accounting Principles Board (APB) Opinion No. 11, which became effective in 1968. The APB was superseded by the Financial Accounting Standards Board in 1973, which signaled a change in basic accounting theory to a balance sheet orientation with the promulgation of its Conceptual Framework, beginning in the late 1970s, which (regarding accounting for income taxes) reached a natural culmination with the issuance of FASB Statement of Financial Accounting Standards No. 109, effective for periods beginning after late 1992. Subsequent refinements have not altered this approach, which requires that reporting entities essentially inventory all unreversed temporary differences, and their expected tax effects, as of each balance sheet date, making tax expense reported on each period’s income statement an amalgamation of taxes currently due, changes affecting previously deferred tax effects, and other elements that may or may not be strictly correlated with income and expense reported in that period’s income statement. A more complete explanation of these financial reporting concerns is beyond the

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scope of the current paper, but can be found in various resources, including *Wiley GAAP 2010*, by Barry J. Epstein, Ralph Nach, and Steven M. Bragg.

²⁴ APB 23, *Accounting for Income Taxes – Special Areas*, at para. 9. Under the FASB's Accounting Standards Codification, which superseded all previously issued literature in 2009, this is now designated as ASC 740-30. Since many readers have yet to become familiar with the ASC, the original technical references will be used in this article.

²⁵ APB 23, *Accounting for Income Taxes – Special Areas*, at para. 10.

²⁶ APB 23, *Accounting for Income Taxes – Special Areas*, at para. 12.

²⁷ Footnote disclosures of taxes that would be due on unremitted foreign earnings are required. However, it is widely held that investors, analysts, and other users of financial statements give less attention to footnote disclosures than they do to amounts actually reported in the bodies of the financial statements.

²⁸ While it may be disappointing that "earnings management" continues to be practiced,

this behavior must be distinguished from financial reporting fraud, which involved, e.g., improper revenue recognition, use of so-called "cookie jar reserves," and other forbidden accounting actions. However, even this more innocuous form of earnings management raises corporate governance and other concerns, which are beyond the scope of this article. Indeed, there appears to be evidence that financial reporting considerations rank in importance equal to actual tax payments in managements' eyes. (See Graham, J., Hanlon, M., and Shevlin, T., *Corporate Decisions Regarding the Location of Operations and Dividend Repatriations: Does Financial Accounting Expense Deferral Matter?* Unpublished working paper, 2008.)

²⁹ This contrasts with the requirement under SFAS 115 pertaining to accounting for so-called "held-to-maturity" investments. SFAS 115 allows such investments to be carried at amortized historical cost, which is an exception to the general rule that investments be carried at fair value. If the reporting entity in fact disposes of such

investments prior to maturity, that action precludes further classifications of investments as "held-to-maturity," thus necessitating mark-to-market reporting of any remaining portion of that portfolio.

³⁰ For example, under Code Sec. 332, a parent corporation can liquidate an 80-percent-or-more-owned subsidiary without recognizing gain or loss for income tax purposes. Also, under Code Sec. 368, a parent can effect a statutory merger or consolidation with its 80-percent-or-more-owned subsidiary, under which no taxable gain or loss would be recognized.

³¹ EITF 92-08, *Accounting for Income Tax Effects* under FASB Statement No. 109 of a Change in Functional Currency when an Economy Ceases to Be Considered Highly Inflationary, and EITF 93-09, *Application of FASB Statement No. 109 in Foreign Financial Statements Restated for General Price-Level Changes*.

³² IAS 12, para. 39.

³³ IAS 37, para. 23.

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