

September 13, 2004

Robert Herz, Chairman  
Financial Accounting Standards Board  
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**Letter of Comment No: 2**  
**File Reference: 1202-ITU**

Dear Bob:

This letter sets forth Citigroup's comments on the proposal (the Proposal) to revoke the exception from recording deferred US taxes on indefinitely invested earnings of foreign subsidiaries (the APB 23 Exemption) as part of FASB's short-term convergence project on accounting for income taxes.

Citigroup believes that the deferred tax liability that would be recorded would provide little useful information to investors and may, in fact, be confusing and misleading. Consequently, we focus on these factors in our letter. In addition, we note that the calculation of the deferred tax liability will be complicated and time consuming, and will likely lead back to the type of detailed scheduling requirement that ultimately led to the demise of FAS 96.

#### **SUMMARY OF MAIN POINTS**

The main points the letter makes are:

1. The APB 23 Exemption leads to sensible results that are broadly consistent with the principles of FAS 109.
2. The deferred taxes that will be recorded under the Proposal will yield little useful information to investors and may be more misleading than helpful to them.
3. The APB 23 Exemption for indefinitely invested overseas earnings was exhaustively debated by FASB when it was adopted and should not now be changed in the convergence project or otherwise.

#### **DISCUSSION**

##### **The APB 23 Exemption Is Sensible and Broadly Consistent With the Treatment of Similar Temporary Differences Under FAS 109.**

Today, Citigroup records deferred taxes on the temporary differences of its domestic corporations and on the basis differences on its foreign corporations where the earnings of these corporations are to be repatriated in the foreseeable future.

**Comparison with other deferred taxes** - Deferred taxes of domestic companies relate largely to only one taxing jurisdiction, the Federal government. Dealing as they do with one set of tax rules and most often on shorter dated items, the computations involved are relatively simple compared to the calculations that would be required for indefinitely invested overseas earnings. Deferred taxes for state and local taxes also are required. However, FAS 109 provides that the form of realization of earnings by a parent company drives their tax treatment at the parent company level. Therefore, management can control whether deferred state and local taxes are booked on domestic subsidiary earnings based on an assumption about the future treatment of the earnings (FAS 109, para. 33). For example, if state and local taxes can be avoided by liquidating a subsidiary (versus paying a dividend from it), management can properly not book a deferred state and local tax liability if it adopts this as a distant, albeit realistic, tax plan.

As for deferred taxes on earnings of foreign subsidiaries not being indefinitely invested overseas, these earnings, by definition, are to be repatriated in the foreseeable future, and the calculations relating to them will be simpler because of this fact. Typically, these earnings cannot be effectively redeployed overseas or consist of high taxed earnings. In the latter case, domestic companies will want to claim the foreign tax credits (FTC's) on the foreign taxes in excess of 35% (the marginal Federal tax rate) because these credits can reduce the company's Federal tax burden. In cases where high taxed earnings cannot be brought back to the US in "the foreseeable future," the deferred tax asset typically associated with such earnings cannot be booked (FAS 109, para. 34).

**Earnings covered by the APB 23 Exemption** - In light of the foregoing, Citigroup feels that the potential deferred tax liabilities on earnings covered by the APB 23 Exemption are materially different from those recorded for other temporary differences and, for the reasons expressed in the next section, deserve distinct treatment. However, we note that the treatment of these potential liabilities is generally consistent with the resulting effect under FAS 109 today of (i) potential deferred tax liabilities for state and local taxes on earnings in domestic subsidiaries, and (ii) long dated deferred tax assets relating to foreign subsidiary earnings.

There have been suggestions that the APB 23 Exemption can lead to the management of earnings.<sup>1</sup> We do not see how this is likely. To satisfy the exemption, the earnings must be indefinitely invested overseas. Consequently, there is little likelihood that earnings may be temporarily "parked" in a foreign subsidiary in order to avoid a deferred tax expense until a more propitious time. If this likelihood was felt to be real, the answer is to require reporting companies to have realistic plans in place to indefinitely invest their APB 23 earnings overseas and to insure that these plans are followed. Since Citigroup elected to treat certain of its foreign earnings under APB 23, it has not repatriated any of these earnings to the US.

#### **The Deferred Taxes that Will Be Recorded Under the Proposal Will Yield Little Useful Information to Investors and May Be Misleading to Them.**

Under the Proposal, deferred US taxes would be recorded on indefinitely invested foreign earnings in an amount equal to the amount of US taxes that will be paid (net of FTC's) on them when they are realized in the US.

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<sup>1</sup> See Jack T. Ciesielski, *Untaxed Foreign Earnings: Endangered Profit Pump?*, The Analyst's Accounting Observer, Vol. 13, No. 12 (August 19, 2004).

In determining US deferred taxes, a determination must be made of how these earnings will be realized in the US. Realization may come from a dividend distribution to the US, a liquidation of the foreign company or a sale of it. While the US tax consequences for the three will often be the same, there may be situations where the results will differ materially. The focus in the comments that follow principally relates to dividend distributions.

**Distortion of true tax burden** - For earnings covered by the APB 23 Exemption, since there has been no dividend and the subsidiary has no intention of paying a dividend, there is no actual US tax liability nor any near term prospect of there being a real liability. Accordingly, if a deferred tax liability is booked, it will not be paid until the distant future. To record deferred taxes in such a situation will greatly overstate the true tax burden facing an effected company. While there have been varied arguments about discounting deferred taxes,<sup>2</sup> we believe that the reader of financial statements will be better informed if long-dated deferred taxes (if they must be recorded) are recorded on a discounted basis. Discounting will appropriately reveal the operating cash flow advantages of deferring taxes and properly disclose the true economic tax burden a company faces over time.

**Deferred tax figures will be confusing and misleading** - Under FAS 109, a reporting company cannot take future events into account in calculating its deferred taxes. To a degree unlikely with other deferred tax liabilities, the deferred tax figure relating to indefinitely invested foreign earnings will almost certainly change materially over time.

Under the US tax law, in calculating the amount of a FTC, foreign taxes are translated into US dollars at the average exchange rates in effect for the years in which the taxes were incurred. However, dividends are translated into US dollars at exchange rates in effect on the date the dividends are paid. Consequently, the effective tax rate on the subsidiary earnings probably will change many times over the years. Under FAS 52, for non-hyperinflationary currencies, these changes will run through other comprehensive income (OCI) (FAS 52, para. 13) and so may not be discerned or, if discerned, understood by many readers of an issuer's financial statements.

The calculation of the FTC available to a US parent company is based on a "pooling concept" for post 1986 years. (A "layering concept" applies to earlier years.) All of the undistributed, post-1986 earnings and profits of the foreign corporation are combined into a single pool, and all of the foreign taxes paid in post-1986 years relate to that pool (separate "baskets" are maintained for different types of income, but for purposes of this discussion the baskets are ignored). A dividend back to the US is considered as coming pro-rata out of the pool and it brings with it a pro-rata share of taxes. Because of this pooling rule, events happening years later can affect the tax rate in the pool. For example, the tax laws and rules in the different countries involved (the US, the home country of the subsidiary and the home country of any foreign holding company(ies)) may change, and these changes will often impact the effective tax rate on the earnings or on the company's ability to use these earnings as FTC's in the US. Acquisitions (and tax elections relating to stepping up the basis of assets or leaving them on an historic basis), dispositions and reorganizations are likely, and they too can impact the pool of taxes and earnings.

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<sup>2</sup> See FASB Research Report, *Accounting for Income Taxes: A Review of Alternatives* (1983), Chapter 7 and the source materials cited at the end of the chapter.

The result of all this is that the effective foreign tax rate on the earnings when they are finally realized in the US is likely to be dramatically different than when the earnings were first realized. And, each of these changes in the effective foreign tax rate will have a corresponding impact on the US deferred tax liability. Indeed, as noted, even the form of the ultimate realization of the earnings (dividend, liquidation or sale of the subsidiary) may profoundly impact the amount of US tax payable. Of course, there will be some trail of the changes to the deferred tax liability over the years, both through OCI and through net income, but even a sophisticated investor's ability to understand these changes is likely to be limited.

As we pointed out in the first section of this discussion, we feel the deferred taxes relating to the APB 23 Exemption are materially different than other types of deferred taxes. Given the factors detailed above, we do not feel that recording these deferred taxes would give investors additional meaningful information. Indeed, the movements in the accounts are likely to be confusing to most of them.

**Comparability of earnings** - Most investors want financial information that permits them to make investment decisions based on the relative worth of the earnings of different corporations. If the APB 23 Exemption is revoked, reporting companies will need to make numerous assumptions in making their deferred US tax liability calculations on indefinitely invested foreign earnings. The assumptions that are made could have a significant impact on the liability amounts. Consequently, under the Proposal, the results of different companies may not be comparable because of the likely differences in assumptions that are made.

Moreover, the comparison with foreign companies operating under territorial systems of taxation (foreign subsidiary dividends are not subject to home tax) will be even more difficult. These foreign companies will not need to accrue deferred taxes on the earnings of their foreign subsidiaries indefinitely invested overseas. Hence, even though on an economic basis a US and a foreign company are comparable, their tax expense and balance sheet deferred tax accounts may look vastly different.

### **The APB 23 Exemptions was Exhaustively Debated by FASB when Adopted and Should Not Now Be Changed.**

In the years leading up to the adoption of FAS 96, many accountants and academics debated what the accounting treatment of taxes should be. There was a respectable group of commentators that felt that partial (versus comprehensive) interperiod tax allocation was the correct accounting treatment for taxes.<sup>3</sup> This argument was picked up in the debate that culminated in the adoption of FAS 96. Looking at the debate underlying the preservation of APB 23 in FAS 96, it is not clear that comprehensive interperiod tax allocation would have been adopted in it had the rules in APB 23 not been carried forward.<sup>4</sup> The exception for APB 23 seems to have been carried forward into FAS 109 without considerable further discussion.

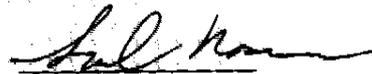
Since the process pursuant to which the APB 23 Exemption was preserved appears to have been a thorough and thoughtful one, we do not believe that the exemption should

<sup>3</sup> See e.g., Dennis R. Beresford, *Deferred Tax Accounting Should Be Changed*, The CPA Journal, June 1982.

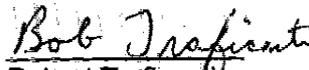
<sup>4</sup> See FAS 96, dissenting opinion of Mr. Mosso, p. 22 ("Without discounting, recognizing Opinion 23 differences would have grossly overstated the amount of tax liabilities and that was a factor in the Board's decision to continue those anomalous exceptions to deferred tax recognition.").

be revoked. If revocation is to be considered, it must be done with due deliberation and input by all affected parties, and the short-term convergence project is not the correct place for this analysis to take place.

Respectfully submitted,



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