

Letter of Comment No: | File Reference: 1202-ITU

September 24, 2004

Robert Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, CT 06856-5116

Dear Bob:

The Committees on Corporate Reporting ("CCR") and Taxation ("COT") of Financial Executives International ("FEI") are writing to provide the Board with further information regarding the complexity associated with computing incremental deferred U.S. taxes on earnings of foreign subsidiaries that are deemed to be permanently reinvested. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR and COT are technical committees of FEI, which review and respond to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and COT and not necessarily those of FEI.

This supplements our prior correspondence to Sir David Tweedie with a copy to you dated June 14, 2004, which explained why we did not think it was appropriate to eliminate the exception for earnings permanently reinvested as provided for in FAS 109. As explained in that letter, we strongly believe the lack of relevance of the measurement by itself provides sufficient justification for not eliminating the exception. By choosing to focus exclusively on complexity, we trust that the Boards have not lost sight of this fundamental issue. We strongly encourage the Boards to consider explicitly the usefulness of the specious financial information that would be reported if companies were to recognize liabilities based on these hypothetical calculations. We recommend that members of the Board speak directly with analysts and portfolio managers to understand how the change would affect their analysis and decision-making. When this additional research is combined with the data that is currently being gathered on complexity, we believe the cost/benefit argument in favor of retaining the exception will be compelling and persuasive.

We also wish to reiterate our view that inclusion of this issue in the Short-Term International Convergence project is inappropriate. The stated objective of this project is to identify and harmonize GAAP and IFRS accounting standards when a high-quality solution can be achieved in the near term. The exception is a fundamental principle of existing tax accounting standards and consideration of its elimination is not something that can be quickly or easily resolved. Moreover, we believe that the information we have shared through letters and field visits demonstrate that elimination of the exception is not a high quality solution.

In addition to the information in the body of this letter, to assist the Boards in their research on the issue of complexity we have provided the following supplemental information: a more detailed discussion of the U.S. tax model as it applies to taxation of foreign earnings and a comparison of the U.S. tax model with other tax jurisdictions.

Overview

The calculation of incremental deferred U.S. taxes on earnings of a foreign subsidiary for book purposes would be inherently difficult because of the extensive and complex U.S. tax rules regarding the taxation of foreign earnings and the crediting of foreign taxes. These difficulties would manifest primarily in two ways: (1) the number of assumptions that must be made concerning when and how the repatriations occur and their related consequences on modeling for purposes of computing deferred taxes, and (2) the operational complexities of developing and maintaining deferred tax accounts on a quarterly basis. Because U.S. tax on the earnings of foreign subsidiaries generally may be deferred indefinitely at the shareholder's option and the fact that there often are severe economic penalties associated with repatriations, the calculations are entirely hypothetical in nature. While the Board may choose to provide additional guidance targeted at eliminating some aspects of the complexity, we believe that such changes would likely result in a material change to the hypothetical deferred tax amount that would otherwise be reported for many companies and would be unlikely to improve comparability. The combination of these considerations strongly indicates that the financial information produced would be neither reliable nor verifiable.

Summary of U.S. Tax System

Unlike the tax systems of many other countries, the U.S. tax system provides that domestic corporations are subject to tax on their worldwide income, whether domestic or foreign. However, to avoid international double taxation, the U.S. allows a credit for foreign taxes paid on income earned abroad. If the amount of the foreign tax credit is less than the pre-credit U.S. tax on the foreign income, residual U.S. tax is incurred.

U.S. corporations are generally not taxed on the earnings of foreign subsidiaries until a dividend distribution is received from the subsidiary. This provision, often referred to as "deferral," means that if the foreign subsidiary retains any of its earnings for investment or other uses, the U.S. tax on such undistributed earnings will be deferred indefinitely. The earnings may also be "deemed" repatriated to the U.S. under a variety of rules. When repatriations of foreign earnings are made, the calculation of the U.S. foreign tax credit against U.S. taxes on those earnings works as follows:

- In the year of distribution, a credit can be claimed for foreign taxes paid on the earnings from which the dividend is distributed ("indirect" or "deemed paid" foreign tax credit).
- The calculation of the credit is based on a "pooling" approach established by the Tax Reform Act of 1986, which generally provides that:
 - All of the undistributed, post-1986 earnings and profits ("E&P"), computed under U.S. rules, of the foreign corporation are combined into a single pool,
 - All of the foreign taxes paid in post-1986 years are combined into a single pool,

- A dividend by the foreign corporation to a U.S. shareholder is considered to come prorata out of the pool of undistributed E&P and will bring with it a pro-rata share of the pool of taxes not previously distributed.
- The U.S. system requires that the foreign tax credit be separately calculated for each of nine foreign tax credit "baskets." Within each basket, excess foreign tax credits (e.g., taxes from countries having an effective tax rate of greater than 35%) can be used to offset U.S. tax that would otherwise be due on income in that basket. Excess FTC's from one basket cannot be applied against residual tax in another basket.
- Detailed expense allocation requirements and rules related to reallocation of losses (and subsequent recapture) also apply.
- Excess credits, by basket, can be carried back two years and carried forward five years.

The principles described above provide only a glimpse of the complexity of the tax code in this area (the IRS form alone related to reporting the foreign tax credit is 8 pages long). A more detailed analysis of the key provisions of the U.S. tax model is provided in Appendix A.

Complexities in Modeling the Deferred Tax Calculation

Before corporations can attempt to calculate the residual deferred taxes on permanently reinvested foreign earnings they will need to make assumptions as to when the hypothetical repatriations will occur and how they will be effected. A large multi-national corporation will typically have thousands of Controlled Foreign Corporations (CFCs) and other entities organized into ownership chains, usually with multiple levels. Accordingly, these assumptions would need to be performed for the earnings of each legal entity and at each ownership level in a multi-tier structure as the earnings move through the levels. The specific assumptions that are the sources of the complexity will vary by company and will depend on the company's particular circumstances (such as whether it is a manufacturing company or financial services company). After applying the assumptions about when and how earnings would be repatriated, foreign deferred income and withholding taxes would also need to be computed under the local country tax system for any higher-tier subsidiary in a multi-country ownership chain to reflect the impact of those assumptions. These additional impacts on the higher tier entities would need to be considered in computing the ultimate deferred U.S. taxes.

In a large multi-national corporation, a typical tax department will have dozens of skilled professionals involved in repatriation planning for the current year. Once the timing of an actual repatriation is determined, a majority of their time is spent exploring the most tax efficient alternatives available under the tax law for getting those earnings to the U.S. This involves thousands of hours per year working through the planning intricacies of foreign and U.S. rules related to just one year's repatriation. This effort is entirely focused on countries where earnings are not deemed to be permanently reinvested. Forecasting hypothetical repatriations and associated tax planning strategies, scenarios for which could number in the thousands, would dramatically expand the time and effort involved.

Timing of Repatriation – The specific assumptions that are made concerning the timing of repatriations could significantly change the effect on the overall amount of U.S. deferred tax

reported. This is because assumptions about timing will determine how the reversal of temporary differences for both U.S. E&P and local (foreign) tax affect the distribution or deemed distribution and the resulting tax amount. In certain cases, for each legal entity, scheduling year-by-year the timing of local deferred tax reversals may be necessary to determine the shareholder tax consequence of hypothetical distributions. In addition, in various group taxation regimes, the actual taxpayers of a group liability wouldn't be known until the local return is finalized. Accordingly, assumptions would need to be made about group filings to determine the hypothetical group taxpayer of deferred taxes.

We note that for CFCs that have never repatriated earnings, there are a large number of "one-time" tax accounting elections that must be made for U.S. tax purposes for the hypothetical repatriation. Each of these elections affects the timing of recognition of income or expenses for tax purposes. In addition, until the CFC actually repatriates earnings, or otherwise triggers actual U.S. tax, any hypothetical tax election would be non-binding such that a completely new set of tax elections might be assumed each year, depending on the specific tax circumstances.

Method of Repatriation—Repatriation can take a number of different forms, including dividends, "deemed" dividends such as 956 loans, liquidations, etc. The form of the repatriation will determine the actual path of the earnings. A dividend will go through the ownership chain before reaching the U.S., while a deemed dividend may skip levels in the ownership chain and thereby result in a different amount of taxable distribution and U.S. tax. In addition, the way in which the earnings associated with a dividend are assumed to pass through the ownership chain requires careful analysis of deficits and other potential factors (e.g., legal or contractual restrictions on dividends) that may have the effect of limiting recovery of losses and/or "trapping" taxes at lower levels in the ownership chain.

How Income/Expense are Basketed—Under U.S. tax law the amount of foreign tax credit can be limited depending on the amount and character of the foreign source income in each basket. In addition to evaluating which baskets current E&P falls into, assumptions will have to be made about which basket un-repatriated earnings fall into (something which is not currently done for earnings that are permanently reinvested). Further, one must also evaluate which baskets any temporary differences would fall into. Depending upon the nature of income in a future year, this exercise would be complicated by the possibility that a source of income or expense could switch baskets in a future year as circumstances change (e.g., from the financial services to the passive basket).

Disconnects Between Earnings and Taxes – Earnings and taxes of a CFC are not directly connected to each other under U.S. tax law. As a result, foreign income and associated taxes may not always be repatriated in the same pattern that they were earned for book purposes: earnings are sometimes repatriated without the associated foreign taxes and vice versa. These discontinuities can result in the foreign taxes being trapped outside the U.S. or being repatriated in a year when they cannot be credited. This complicates estimation of the deferred tax liability because the amount of foreign tax that is creditable is not known until fixed by an actual repatriation. Sources of such disconnects include: (1) differences between local country tax rules for recognizing earnings compared with U.S. tax law, resulting in foreign taxes being paid either before or after the income is recognized for U.S. tax purposes. (2) Losses in foreign subsidiaries in one year followed by income in later years that cannot be offset under U.S. tax law by the

earlier loss.

Determining a Valuation Allowance – If there are excess foreign tax credits in a particular basket in a particular year one must consider the need for a valuation allowance. This often requires estimation, projection and allocation of expense items (such as interest and other allocable costs) and non-dividend foreign source income (such as cross-border interest, export sales and royalties) to determine the foreign tax credit limitation by basket. Such an exercise would require numerous assumptions about the future. For example, if fair market value has been elected as the basis for the interest allocation, in addition to having to estimate future interest rates and debt levels, one has to make assumptions about future fair market values of assets and the equity of the total company. In another instance, an overall loss from foreign operations in a given year could prevent foreign taxes on income repatriations that year from being credited. In addition, the overall foreign loss would cause future foreign source income to be re-characterized as domestic income thereby further limiting the recognition of foreign tax credits. Finally, the reversal of U.S. temporary differences may produce a "domestic source" loss in a particular year, which would be reallocated to foreign source income (by basket). This would reduce the foreign tax credit limitation and increase the required valuation allowance. As a result, detailed scheduling of the reversal of U.S. temporary differences would be required if there is a possibility of an interaction with a potential excess foreign tax credit situation.

Complexities in Operationalizing the Required Accounting

Elimination of the exception would significantly expand the application of FAS 109 to the most complex aspects of the tax law. This will adversely affect the ability of companies to prepare their quarterly income tax accrual calculations at a time when the time frame for reporting interim financial results is being further compressed. The aspects that contribute most significantly to operational complexity include:

Analysis of E&P/Tax Balances – For non-dividend paying CFCs, an analysis of pre-1987 and post-1986 balances for both E&P and taxes would be required to establish the pools required under the tax law. A multi-decade E&P study would have to be conducted by legal entity. In addition, the underlying sources of differences between U.S. tax E&P and the associated book investment would need to be analyzed. This would need to be split between permanent differences, temporary differences and Other Comprehensive Income (OCI) related items. Depending on the outcome of this analysis and the timing of dividends, scheduling out the reversal of temporary items by legal entity by year may be necessary.

E&P/Tax Baskets – In addition to determining the basket of all existing earnings and tax amounts, the basket of all differences between a CFC's book investment and tax earnings amount would need to be determined.

Tiering-up Through Chains of CFCs – Foreign currency exchange effects on differences between U.S. tax E&P and book investment must be carried through all repatriation plans (by year tiering-up through the ownership chain) to determine the ultimate impact on deferred tax liability. In a similar vein, hypothetical repatriations treated as dividend repatriations must be tiered up and the consequences to each higher tier CFC's local tax and withholding tax must be analyzed and recorded.

Valuation Allowances – If there is potential that a valuation allowance will be necessary, one would need to calculate the effect (positive or negative) of OCI-related basis differences (tiered-up through hypothetical repatriations) on the potential valuation allowance and allocate that portion of impact of recording valuation allowance to OCI. For any year in which there is a possible excess foreign tax credit in any basket (considering the potential impact of a reallocation of domestic source loss discussed previously), one would need to project other foreign source income and allocate expenses by basket. This would require significant resources even if reasonable assumptions could be made to estimate the future amounts.

Validating Tax Treatments – Determining the appropriate tax consequences of hypothetical repatriations may require taking and supporting positions on the local or U.S. tax treatment of items in the hypothetical computation in order to assess "probable" tax treatment for purposes of computation. Since this exercise would only be performed for purposes of the hypothetical calculation, there is no tax or economic reason to devote significant resources to determining the probable tax treatment. However, not doing so further lessens the relevance and credibility of the resulting amount that would be recorded.

Foreign Currency Effects – On an ongoing basis the estimation, tracking and rollforward of the deferred tax would be affected by movements in foreign currency exchange rates, since the rates applicable to foreign taxes paid are frozen and would differ from the rates used to translate future dividends. This may require even more complex and intricate calculations in order to allocate the change in deferred tax balance, including changes in required valuation allowances, between current operations and OCI.

Cost-Benefit Considerations

All of the effort spent on planning for and calculating the theoretical residual tax would require a tremendous investment in highly skilled resources to perform the work. Moreover, the result will be of no economic value since the projection does not take into account future earnings or future foreign taxes and the calculated remittances will likely never actually occur. This vast increase in the impact of tax planning assumptions also would require extensive audit resources to review. Since the computation is only theoretical, its accuracy would never be verified by audit of a tax authority. Even if we were persuaded that the difficulties discussed above could be overcome through simplification, the resulting measurements would likely have no relevance. Finally, since any residual obligation could be deferred indefinitely (e.g. through reinvestment of unremitted earnings) the present value of the calculated taxes would be close to zero in most cases.

We believe that the vagaries of calculating residual shareholder taxes on the earnings of foreign subsidiaries described above provide persuasive evidence that elimination of the exception would result in excessive modeling and operational complexity. If enacted, the new requirement would result in accrual of additional tax that will likely vary significantly, and essentially permanently, from the true economic cost of the tax and provides minimal benefit to users of financial statements. We strongly believe that a change to require the computation of residual shareholder taxes would not improve the reporting of income taxes over the current accounting embodied in FAS 109 and APB 23 and does not justify the cost that would be incurred. We are hopeful that the additional information we have provided will resolve any remaining questions

the Board may have. If not, representatives of COT and CCR will be pleased to meet with the Board and Staff at your earliest convenience to address any remaining questions.

Sincerely,

Frank H. Brod

Chair, Committee on Corporate Reporting

Financial Executives International

Michael Reilly

Chair, Committee on Taxation

Financial Executives International

cc: Sir David Tweedie, Chairman, IASB

Robert Garnett, Member, IASB (CCR Liaison Member)

James Leisenring, Member, IASB (FASB Liaison Member)

APPENDIX A

Tax and Accounting Treatment of Foreign Subsidiary Earnings.

Key Principles of U.S. Tax Code

- 1. U.S. domestic corporations are subject to tax on all of their income, whether domestic or foreign. To avoid international double taxation, the U.S. allows a credit for foreign income taxes paid on income earned abroad.
- 2. If the amount of a foreign tax credit is less than the pre-credit U.S. tax on the foreign income, residual U.S. tax is incurred on the foreign income. Conversely, if the amount of the foreign tax credit is greater than the pre-credit U.S. tax on the foreign income, the excess foreign tax can be absorbed as a credit against other U.S. taxes provided the taxpayer has sufficient capacity under its foreign tax credit limitation to do so.
- 3. The concept of taxing a U.S. parent corporation on the earnings of a foreign subsidiary only upon a dividend distribution is referred to as "deferral". If the foreign subsidiary retains any of its earnings for reinvestment or for other uses, the U.S. tax on such undistributed earnings will be deferred until there is a dividend distribution.
- 4. While deferral of foreign subsidiary earnings is the general rule, the U.S. tax law makes certain types of income (generally, "passive" income) subject to immediate U.S. tax under the provisions of Subpart F.

Calculation of Indirect Foreign Tax Credit

- 1. In the year of distribution of foreign earnings to the U.S., a credit can be claimed for foreign taxes paid on the earnings from which the dividend is distributed (an "indirect" or "deemed-paid" foreign tax credit).
- 2. The calculation of the credit is based on a "pooling approach" established by the Tax Reform Act of 1986. (An entirely different set of rules apply to earnings in pre-1987 years.) All of the undistributed, post-1986 earnings and profits ("E&P") of the foreign corporation are combined into a single pool, and all of the foreign taxes paid in post-1986 years are combined into a single pool. A dividend by the foreign corporation to its U.S. shareholders is considered to come pro-rata out of its pool of undistributed E&P and will bring with it the same pro-rata share of taxes out of the same pool.
- 3. In calculating the amount of a foreign tax credit, foreign taxes are translated in U.S. dollars at the average exchange rates in effect in the years in which the taxes were incurred. However, dividends are translated into U.S. dollars at exchange rates in effect on the date the dividends are paid.
- 4. The IRS requires that the foreign tax credit be separately calculated for each of nine

- foreign tax credit "baskets". Within each basket, excess foreign tax credits from countries having effective tax rates of greater than 35% can be used to offset U.S. tax that would otherwise be due (subject to foreign tax credit limitation capacity to do so).
- 5. A U.S. tax group will be entitled to claim foreign tax credits associated with dividends passed up through as many as six levels of foreign subsidiaries before reaching the U.S. However, as the dividends go through each new company, the amount of the dividend enters into the E&P pool and relevant basket of the recipient company and the foreign tax credits associated with the dividend enter into the relevant tax pool of the recipient company.
- 6. Excess credits can be carried back two years and carried forward five years.

Deferred Tax Accounting

- 1. Absent the provisions in APB 23 exempting the booking of deferred taxes on earnings indefinitely reinvested overseas, a deferred tax asset or liability will need to be calculated on all earnings of foreign subsidiaries.
- 2. The calculation of the deferred tax amount will begin with the foreign subsidiary earning the income. For this company, current and deferred local taxes must be calculated using U.S. GAAP rules. These calculations will be influenced by timing differences arising in the ordinary course of business, and by differences arising from acquisitions, dispositions and reorganizations.
- 3. In determining U.S. deferred taxes on these foreign earnings, a determination must be made on how the benefit of these earnings will be realized in the U.S. Realization may come from a dividend distribution to the U.S., a liquidation of the foreign company, or a sale of it. While the U.S. tax consequences for the three frequently will be the same, there may be situations where the results differ materially. For simplicity, the focus in the balance of this appendix is on dividend distributions. However, it should be noted that the alternative mechanisms for repatriations for a particular group of entities may be more appropriate for purposes of determining deferred taxes and therefore cannot be ignored.
- 4. In the cases involving dividends, the dividend must be traced through each intermediary foreign company back to the first U.S. company in the chain. As it passes through each foreign company, a determination of the tax and accounting treatment in that company must be made. For example, a dividend frequently, will be taxable under the recipient country's tax law, so a new calculation per the rules set out in the second paragraph must again be made. This calculation often will involve a determination of the extent to which a credit for the underlying taxes paid by the distributing company will be allowed.

- 5. Assumptions must be made as to the amount and timing of the dividends¹. Assumptions must also be made about originating and reversing timing differences in relation to the timing of dividend payments. While foreign exchange movements and un-enacted changes in laws or regulations cannot be anticipated, known changes that will take effect at future dates must be taken into account.
- 6. Once the dividend is traced to a U.S. company, the effective tax rate on it must be determined. If it is less than 35% for the global basket of income, a deferred tax liability must be recorded for the difference. If it is greater that 35%, a deferred tax asset generally should be recorded. In the latter instance, a further determination must be made to insure that the asset can be realized in a reasonable time period.

Where the foreign subsidiary will not indefinitely invest its earnings off-shore and the expectation is that a dividend will be paid in the foreseeable future, the calculations will be far easier to make since fewer assumptions will need to be made.

Appendix B PriceWaterhouseCoopers Comparative Summary of U.S. and Foreign Tax Rules Relating to Foreign Subsidiary Earnings

For purposes of comparing and contrasting the tax complexities associated with requiring recognition of deferred tax liabilities on all undistributed foreign subsidiary earnings, tax rules employed by the United States are compared with some of our major trading partners in taxing dividends from foreign subsidiaries.

U.S. laws relating to the taxation of earnings of foreign subsidiaries generally are viewed as the most complex when compared to the tax laws of our major trading partners.² Tax rules that apply to foreign subsidiary dividends in the following countries are compared: Canada, France, Germany, Japan, the Netherlands, the United Kingdom, and the United States. These seven countries are home to 80 percent of the 2004 Financial Times 500 list of the world's largest corporations. The chart in Appendix B highlights selected aspects of the taxation of foreign earnings in these seven countries as of January 1, 2004.

In general, the United States taxes earnings of a foreign subsidiary only when the subsidiary distributes the earnings to a U.S. shareholder in the form of a dividend. To prevent the earnings from being taxed twice (once by the foreign country in which the profits were earned and a second time by the United States), the United States allows a credit for foreign taxes paid against the U.S. tax on the foreign dividend, subject to numerous limitations. As described below, the U.S. foreign tax credit regime is governed by highly detailed and extremely complex rules and regulations. Thus, to record a deferred tax liability for all undistributed foreign subsidiary earnings, a U.S. company would need to compute the residual U.S. tax, if any, on all of its foreign subsidiaries' earnings taking into account hypothetical foreign tax credit calculations under the applicable rules and regulations.

The United Kingdom and Japan also employ foreign tax credit systems to prevent or eliminate the double taxation of foreign subsidiary earnings. As described below, these two countries' foreign tax credit rules contain some complex features, but neither approaches the overall level of complexity of the U.S. tax rules.

The other countries (i.e., Canada, France, Germany and the Netherlands) generally exempt all or substantially all foreign subsidiary dividends from tax. Thus, the proposal to record deferred taxes on undistributed foreign subsidiary earnings would impose little, if any, financial statement impact or compliance burdens for companies headquartered in these countries.

Canada, France, Germany and the Netherlands have the simplest regimes for taxing foreign subsidiary earnings since they employ full or partial dividend tax exemptions. The United Kingdom and Japan tax foreign dividends; however, both of these countries' foreign tax credit rules lack many of the complexities of the U.S. rules. The U.S. foreign tax credit rules that increase complexity and compliance burdens as compared to other countries include:

² See, e.g., The NFTC Foreign Income Project: International Tax Policy for the 21st Century, National Foreign Trade Council, Inc. (2001)

- limits the foreign tax credit within nine categories of income. The other countries examined do not have similarly complex foreign tax credit limitation rules. While the United Kingdom and Japan apply the foreign tax credit limitation on a subsidiary-by-subsidiary basis, the calculations generally can be made with figures extracted directly from financial accounting results or from subsidiaries' foreign tax returns. Thus, for example, before computing a deferred tax liability for all foreign subsidiary earnings, a U.S. company would need to separately determine the various categories of income in all of the foreign subsidiaries and apply the foreign tax credit limitation separately to each category of income.
- Expense allocation rules: To compute the U.S. foreign tax credit limitation, it is necessary to apply detailed and complex rules for allocating various expenses against foreign earnings. The most complex rules in this area involve the allocation of expenses for interest (allocated based on relative asset values) and research and development (allocated based on product lines). None of the other countries examined requires similar detailed expense allocations.
- Credit carryover rules: Countries that use a foreign tax credit system, including the
 United States, the United Kingdom and Japan, permit carryovers and/or carrybacks of
 unused foreign tax credits. U.S. tax rules, however, require that carryovers and
 carrybacks be computed separately for each of the nine separate categories of income
 referred to above.
- Credit for taxes paid by foreign subsidiaries (indirect credits): The United States, the United Kingdom, and Japan permit indirect foreign tax credits (i.e., credits for the foreign income tax imposed on the income from which dividends are paid). The foreign tax credit computations are more complicated when indirect foreign tax credits are permitted for several tiers of foreign subsidiaries. Japan permits indirect credits for up to two tiers of foreign subsidiaries, and the United Kingdom permits indirect credits for all foreign subsidiaries, regardless of the number of intermediate companies. In the United States, indirect credits may be claimed for up to six tiers of foreign subsidiaries. Unlike the United Kingdom or Japan, the U.S. tax rules require that each subsidiary's income be segregated into each of the nine separate categories of income referred to above, while the United Kingdom and Japan do not require any similar complex computations. Thus, for example, to record a deferred U.S. tax liability on undistributed earnings of a sixthtier foreign subsidiary, a U.S. company would need to consider the tax results as if the earnings in each prescribed category of income were paid through six levels of companies.
- Loss resourcing rules: Under U.S. tax rules, foreign losses generally are recaptured in later years by recharacterizing subsequent foreign income as U.S. income for purposes of determining allowable foreign tax credits. Significant complexity is added by requiring similar recapture rules for the nine foreign tax credit limitation categories of income. No such recapture rules are required in the other countries examined.

- Measurement of repatriated earnings in determining parent tax liabilities: In all countries except the United States, the amount of a distribution from a foreign subsidiary that constitutes a dividend for tax purposes generally is determined based on the subsidiaries' book income or local country taxable income. For U.S. tax purposes, however, a separate and detailed calculation of "earnings and profits" under U.S. tax principles is required in order to determine the amount of dividends from the foreign subsidiaries. This additional burden is not found in the other countries examined.
- Alternative tax computations: The U.S. tax rules apply a complex, alternative minimum tax (AMT) computation to ensure that a minimum level of U.S. tax is paid on a broad measure of income (i.e., alternative minimum taxable income). To compute AMT liability, taxpayers must make parallel tax calculations, including a separate set of foreign tax credit computations under the alternative system. Moreover, the AMT system imposes an additional limitation that prevents foreign tax credits from reducing tax before credits by more than 90 percent. No other country requires such a parallel foreign tax credit computation.

Appendix C

	Genera	al rules	Taxation of Foreign Source Income, Selected Countries, January 1, 2004 Foreign tax credit system for taxable dividends							
Country	Basic method of taxation	Types of double taxation relief available	General limitations Imposed on double tax rellef	Interest allocation rules	Loss re- sourcing rules	Credit carryover rules	Allocation of expenses other than interest (e.g., R&D)	Number of tiers through which indirect (subsidiary) foreign tax credit is allowed	Measurement of repatriated earnings in determining parent tax liabilities	Alternative Minimum Tax
Canada	Worldwide income except income from treaty countries, which is exempt.	exemption system.	Per country credit ilmitation with business and non-business baskets. Exemption limited to active business income earned in treaty countries.	No.	equivalent	Limited application. Unused business credits may be carried back three years and forward seven.	Broad principles require allocation of expenses that relate to foreign income.	0	Foreign tax rules, except for investment income.	No.
France	Generally taxed only on French source income.	limited use of	Exemption limited to active	No.	No.	No.	No.	0	Domestic accounting rules,	No.
Germany	Worldwide income except income from treaty countries, which is exempt.	Mixed credit and exemption system.	No.	No.	No.	No.	No.	0	Domestic accounting rules.	No.
Japan	Worldwide income regardless of geographic origin.	Credit system.	Overall credit limitation. Taxes in excess of 50% may not be creditable. Two-thirds of untaxed income excluded from numerator of calculation. Credit use limited if company's worldwide income is more than 90% foreign.	Broad principles require allocation of expenses that relate to foreign income.	No.	No carryback. Unused credits can be carried forward three years.	Broad principles require allocation of expenses that relate to foreign income.	2	Foreign tax and domestic tax rules. High degree of conformity between domestic tax and accounting rules.	No.
Netherlands	Worldwide income.	Primarily exemption system with limited use of credit system.	not eligible for exemption, withholding	No	No.	Limited application. Unused credits can be carried over indefinitely.	No.	D	Domestic accounting rules.	No.
United Kingdom	Worldwide income regardless of geographic origin.	Credit system.	Item-by-item credit limitation, but excess credits can be used against dividends with insufficient credits through the use of onshore pooling regime.		No.	Unused credits can generally be carried back three years, forward indefinitely, and surrendered to other group companies.	No.	Unilimited provided ownership rules are met.	Foreign accounting rules.	No.
United States	Worldwide income regardless of geographic origin.	Credit system		Detailed rutes requiring allocation of interest on a water's edge basis using adjusted bases or fair market values of assets.	require only resourcing of foreign source income subsequent to an overall foreign loss.	forward five years.	apportionmen		Domestic tax law.	Yes. Foreign tax credit ilmited to 90% of Alternative Minimum Taxable Income. Requires duplicate computation of foreign tax credits with all limitations and allocations modified using alternative minimum tax rules.