



fei

financial executives
international

Letter of Comment No: 1A
File Reference: 1202-ITU

June 14, 2004

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: IASB Convergence Project on Accounting for Income Taxes

Dear Sir David:

The Committees on Corporate Reporting ("CCR") and Taxation ("COT") of Financial Executives International ("FEI") are writing to express their concerns regarding tentative decisions related to the International Accounting Standards Board's ("IASB") convergence project on accounting for income taxes. 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 view of CCR and COT and not necessarily those of FEI. For convenience and simplicity, our comments address the issues primarily from the perspective of the U.S. authoritative literature.

Our specific concerns relate to potential changes to the deferred tax exception for permanently reinvested earnings. Currently, U.S. GAAP provides that deferred taxes are not provided on the basis difference in foreign subsidiaries if the difference is "essentially permanent in duration" (FAS 109 paragraph 31). However, as part of the deliberation on the conformity project, the IASB has tentatively concluded that, "in principle, no exception should exist for temporary differences on investments in subsidiaries and associations or interests in joint ventures-domestic or foreign," and has asked the IASB staff to analyze the "practical difficulties" related to foreign subsidiaries and joint ventures.

We ask the Board to drop this proposal prior to issuing an exposure draft. We believe that the proposed change does not advance the Board's objectives related to convergence efforts. Specifically, it does not improve comparability of financial reports of U.S. preparers and non-U.S. preparers subject to IAS; it will cause financial reports to diverge from economic reality; and it adds significant computational complexity that will in turn require arbitrary and complex rules. We also question the technical and conceptual merit of the proposal. Our reasoning follows:

The Exception is Not a Convergence Issue

We do not believe that this meets the minimum criteria that should apply to issues to be included in a convergence project. FAS 109 and IAS 12 are not in conflict with respect to permanently reinvested foreign earnings. Both standards provide exceptions for outside basis differences. The current IAS 12 standard provides a general exception to deferred taxes on investments in subsidiaries, branches and associations. The FAS 109 exception is somewhat more limited. For foreign entities, the investment must be essentially permanent in duration. For domestic subsidiaries, tax law must provide a means of tax-free recovery and the entity must expect to utilize this means. With respect to investments in foreign entities, the FAS 109 and IAS 12 exceptions are essentially the same. The boards of both FASB and the IASB have agreed that the general approach to convergence will be to focus on areas of difference between the accounting standards. Since investment in foreign subsidiaries is not an area of difference, it should not be addressed as part of this project.

In addition, we note that the exception to deferred shareholder taxes on basis differences of foreign subsidiaries is a long-standing aspect of financial reporting. Both the FASB and IASB have "agreed not to do a fundamental rethink of the basic principle as part of the short-term convergence project." While the treatment of shareholder taxes for foreign subsidiaries may technically constitute an exception rather than a "basic principle," the impact is so potentially profound to global businesses it would be as significant as a change in basic principle. A project on short-term convergence is not the right forum to consider such a significant change to financial reporting as it does not offer interested parties an appropriate forum to debate the significant issues implicated by such a change.

Proposed Change Does Not Mirror Economic Reality

We strongly believe that the current financial reporting better reflects economic reality. The basis difference associated with permanently reinvested earnings will not result in a tax liability until the investment is liquidated which typically would be in the very distant future (largely only at the ultimate wind-up of the business). FAS 109 as currently written would require provision of a tax once a reversal becomes apparent. Accordingly, only long-lived basis differences avoid the provision of taxes. As an economic matter, the liability on long-lived basis differences is essentially zero on a present value basis. Since discounting of deferred taxes is not permitted, recording an undiscounted liability for taxes to be paid in the indefinite future will result in a significant disconnect between the financial statements and economic reality.

Comparability of Financial Reports Will Suffer

The proposed change would adversely affect the comparability of financial reports. Many countries, including most European countries, have territorial tax systems. If the parent company operates in a country with a territorial tax system, there would be no incremental tax recorded on an investment in a foreign subsidiary if the exception for permanent reinvestment were eliminated. The U.S., on the other hand, has a worldwide tax system; but, in order to foster international competitiveness, the U.S. defers tax until earnings are repatriated. The U.S. tax system attempts to put companies in the same economic position as foreign counterparts through deferral. If deferred taxes on permanently reinvested earnings were recorded for a U.S.-based company, earnings could be significantly affected relative to the foreign-based company when the companies are actually in essentially the same economic position. Comparability would diverge rather than converge.

Change Would Impose an Unacceptable Level of Complexity

Significant complexity and cost would result from a change in the standard. The calculation of the residual shareholder tax that will not be paid until many years in the future will often be extremely difficult and will require estimates and hypothetical assumptions that would be susceptible to error or manipulation. FAS 109 requires the calculation of this amount for footnote disclosure unless it is "not practicable" to compute the amount. Virtually all large corporations with global operations disclose that it is not practicable to compute this amount, suggesting how difficult it would be. The calculation of this deferred tax is an exercise that could require significant new systems and thousands of hours of work each quarter for even relatively small enterprises.

The calculation of residual shareholder tax involves the rules of numerous tax jurisdictions and would require a multi-tier computation. For each step of the computation there would need to be a determination, among other things, about the availability of tax exemptions and the amount of any foreign tax credits. In order to determine whether an exemption was available or the amount of an available foreign tax credit, planning alternatives would need to be considered (the U.S. tax system provides credit for foreign taxes paid, subject to complex statutory limitations). This determination is significantly complicated by facts about global operations:

- It is not uncommon for a business group to have hundreds of foreign subsidiaries in multiple tiers of ownership.
- Some entities may be profitable while others are unprofitable.
- There may be joint venture partners in various entities that would affect the implementation of certain tax planning techniques.
- Countries have widely different tax and legal rules that would affect the ability to pay and timing of distributions, as well as the availability and practicality of tax planning strategies. Such rules can and do change on a frequent basis.
- Many countries allow some form of tax consolidation, but the mechanics vary widely. The specific mechanics can affect the availability and amount of tax net of foreign tax credit at the shareholder level.
- The U.S. foreign tax credit is subject to a limitation calculation that would become subject to varying assumptions if distributions that will not be actually made are deemed to be made. The calculation required would be so hypothetical in nature that there could never be any comparability in the assumptions regarding availability and computation of foreign tax credits that different companies would be using to compute the residual U.S. tax. The alternative would be to have fixed assumptions, which would almost certainly be contrary to what many if not most companies would actually do. In order to calculate the deferred residual shareholder tax, assumptions would need to be made about the operations of the business not just for a few years into the future, but potentially for many decades into the future.

Systems would need to be developed to gather the data for each legal entity, perform shareholder tax calculations and calculate the impact of the multitude of planning possibilities. All of the effort spent on planning for and calculating the theoretical residual tax would be of no economic value to the enterprise since there is no intention to ever pay this tax. This vast

increase in the impact of tax planning assumptions reflected in the financial statements would require extensive audit resources to review. Since the computation is only theoretical, its accuracy will never be verified by audit of a taxing authority.

The rationale for retaining the APB 23 provisions for foreign earnings when FAS 109 was adopted remains valid. When adopting FAS 109, the FASB was convinced by information it received from constituents that the calculation of a deferred tax liability for undistributed earnings permanently invested in a foreign entity could sometimes be extremely complex. The FASB noted the hypothetical nature of the calculations, in deciding not to require recognition of a deferred tax liability for those earnings. In fact, based on the complexity of the calculations, the FASB actually extended the exception from providing deferred taxes beyond undistributed earnings to include any other difference between the book and tax basis in a foreign subsidiary that is essentially permanent in duration regardless of the underlying reason for the existence of that difference. These underlying considerations have not changed since FAS 109 was adopted in 1992. In fact, changes in the regulatory environment have likely magnified the complexity and hypothetical nature of the calculations. We believe that the rationale for exempting undistributed earnings that are permanently invested in a foreign entity is more valid today than it was in 1992.

Our objective in bringing these issues to the Board's attention now is to avoid significant expenditures of time and effort on the part of both the IASB and constituents through the normal due process when the merits of the position do not warrant it. The Board's tentative decision has already garnered significant attention among U.S. tax professionals and accountants, even though the FASB has yet to reach a tentative conclusion on the issue. We expect the level of interest, and related angst, to grow significantly as word of the decision spreads. We do not want to see this highly controversial issue taint the views of preparers on the Board's other convergence projects. We therefore believe that it is in the best interests of the Board and its constituents not to proceed with this issue. We welcome the opportunity to discuss our concerns with you further. Please contact Frank Brod at 989-636-1541 with any questions.

Sincerely,



Frank H. Brod
Chair, Committee on Corporate Reporting
Financial Executives International

Joe Luby

Joseph O. Luby
Chair, Committee on Taxation
Financial Executives International

cc: Robert Garnett, Member, International Accounting Standards Board
Robert Herz, Chairman, Financial Accounting Standards Board
Donald Nicolaisen, Chief Accountant, Securities and Exchange Commission