



## Accounting for the Tax Effects of Repatriated Earnings and Income from Domestic Production Activities

Companies that qualify for the recent tax law's deduction for domestic production activities must account for it as a special deduction under Statement 109 and reduce their tax expense in the period or periods the amounts are deductible on the tax return, according to a new FASB Staff Position.<sup>1</sup> Another staff position allows companies additional time to evaluate whether foreign earnings will be repatriated under the repatriation provisions of the new tax law and requires specified disclosures for companies needing the additional time to complete the evaluation.<sup>2</sup>

### Income from Domestic Production Activities

Staff Position FAS 109-1 clarifies Statement 109's guidance that applies to the new deduction for qualified domestic production activities. When fully phased-in, the deduction will be up to nine percent of the *lesser* of "qualified production activities income" or taxable income. The staff position clarifies that the deduction should be accounted for as a special deduction under Statement 109, not as a tax-rate reduction, because the deduction is contingent on performing activities identified in the new tax law.

The tax benefits of the special deductions should be recognized no earlier than the year in which they are reported on the tax return. As a result, companies qualifying for the special deduction generally would not have a one-time adjustment of deferred tax assets and liabilities in the period the law was enacted. Deferred tax assets and liabilities generally should not reflect the special deductions to be taken in future years, so the tax rate used to calculate deferred tax assets and liabilities generally would not change.

Income from Domestic  
Production Activities

1

Unremitted Foreign Earnings

2

<sup>1</sup> FASB Staff Position FAS 109-1, Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004, December 21, 2004. FASB Statement No. 109, *Accounting for Income Taxes*, February 1992. The recent tax law is the American Jobs Creation Act of 2004, October 22, 2004.

<sup>2</sup> FASB Staff Position FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*, December 21, 2004.

The future tax effects of special deductions might affect the calculation of deferred tax assets and liabilities in limited situations. The deductions could make it necessary for some companies to adjust their deferred tax assets and liabilities to reflect a different average graduated tax rate or to increase a valuation allowance for deferred tax assets. This could occur because special deductions reduce taxable income, and future taxable income is considered in determining both the need for a valuation allowance and the average graduated tax

rate used to record deferred taxes when graduated rates are “a significant factor.”

If the effect of the special deduction is significant, it should be included in the company’s reconciliation of its reported tax expense to the amount of tax expense that would result from using the statutory tax rate.

The staff position’s provisions are effective immediately. Companies that previously recognized the deduction as a tax-rate reduction must restate their previously-issued financial statements to reflect the provisions of the staff position.

## Unremitted Foreign Earnings

Staff Position FAS 109-2 addresses the effect of the new tax law’s one-time deduction for qualifying repatriations of foreign earnings. The law’s one-time 85 percent dividends-received deduction applies to a company’s qualified cash dividends received from controlled foreign corporations if the funds are reinvested in the United States. The deduction can result in an effective tax rate of 5.25 percent (before consideration of any available foreign tax credits) on the repatriation of those foreign earnings, a rate much lower than the normal statutory 35 percent rate. The deduction is available for dividends received either during the company’s last tax year beginning before October 22, 2004, or during the company’s first tax year that begins during the one-year period beginning October 22, 2004.

The staff position allows additional time for companies to determine whether any foreign earnings will be repatriated under the new tax law’s one-time deduction for repatriated earnings and how the law affects whether undistributed earnings continue to qualify for Statement 109’s exception from recognizing deferred tax liabilities. Companies that take the additional time are required to provide disclosures about the status of the company’s evaluation and the potential effects of its decision. The staff position calls its guidance “a practical exception” made necessary because some of the new law’s provisions are unclear and the law was enacted late in the year.

## Scope and Calculation of the Deduction for Domestic Production Activities

The new tax law provides a deduction that is generally available to activities in which “qualifying production property” is manufactured, produced, grown, or extracted in whole or in significant part within the United States. The deduction is equal to a percentage (3 percent in tax year 2005 and increasing to 9 percent after tax year 2009) of the lesser of the company’s “qualified production activities income” (QPAI) for the tax year or its taxable income for the tax year (determined without regard to the new deduction).

The amount of the deduction is limited to 50 percent of the W-2 wages, as defined by the new tax law, paid by the company during the tax year.

**Repeal and Replacement of the Exclusion for Extraterritorial Income.** The new deduction replaces some benefits of the repealed exclusion for extraterritorial income by providing tax relief to U.S.-based manufacturing. The deduction applies to all companies deriving income from “qualified domestic production activities.”

**The QPAI Calculation.** QPAI is equal to “domestic production gross receipts,” reduced by the

sum of (1) the cost of good sold that are allocable to the receipts, (2) other deductions, expenses, or losses directly allocable to the receipts, and (3) a ratable share of other deductions, expenses, and losses that are not directly allocable either to the receipts or to another class of income.

“Domestic production gross receipts” generally include the gross receipts of the company that are derived from “qualifying production property” that was manufactured, produced, grown, or extracted in whole or in significant part by the company within the United States. “Qualifying production property” includes certain tangible property, computer software, and sound recordings. Some other activities, such as production of qualified film, electricity, natural gas, or water, certain construction activity, and engineering and architectural services, also qualify for the deduction. However, certain other activities, such as the sale of food or beverages prepared by the company at a retail establishment, the transmission or distribution of electricity, natural gas, or water, and the lease or license of property to a related party, do not qualify for the deduction.

Under U.S. tax law, certain earnings of controlled foreign corporations are not taxed in the U.S. until the earnings are repatriated. The Statement 109 exception to recognizing deferred tax liabilities on undistributed foreign earnings applies when a company plans to indefinitely reinvest some or all of the company's foreign earnings in the foreign tax jurisdiction. Until a company completes its assessment of the effect of the one-time deduction on its plans for reinvestment, the company's repatriation and reinvestment plans may be uncertain. The uncertainty about whether some or all foreign earnings will be repatriated that exists while the company is completing its evaluation could call into question the assumption underlying the indefinite-reinvestment exception. Without the additional time provided by the staff position, Statement 109 would require that the effect of the change in the tax law be recognized in the period that includes the enactment date.

The grant of additional time to decide whether any foreign earnings will be repatriated under the provisions and to re-evaluate the indefinite-reinvestment determination applies only to companies that have not yet completed the evaluation of the effect of the new tax law on their plans for reinvestment or repatriation of foreign earnings. A company that has decided to remit foreign earnings must record deferred tax liabilities on the earnings that will be remitted. A company that has not completed the evaluation, but has decided to remit a portion of its undistributed foreign earnings, must record deferred tax liabilities on the portion it has decided to remit. If the company subsequently decides to remit additional amounts of foreign earnings, additional tax liabilities would be recorded at the time the subsequent decision is made.

A company might complete its evaluation of the effect of the new tax law subsequent to the date of its financial statements, but prior to their issuance. This could occur, for example, if clarifying language on key elements of the repatriation provision is released subsequent to the date of the financial statements. In addition, a company may not decide to repatriate earnings until after the date of the financial statements because it needs time to calculate the amount of undistributed foreign earnings that will qualify for the one-time deduction under the new tax law and the

related income-tax effects, and then to decide whether to repatriate or reinvest those earnings.

However, according to the staff position, companies should record deferred tax liabilities attributable to foreign earnings to be remitted as a result of the new tax law in the period that the decision is made to remit those earnings. For example, the impact of a decision made in January 2005 by a company with a December 31 year-end to repatriate earnings under the provision is to be recorded in 2005 (the period the decision is made),

## Limitations to the 85 Percent Dividends Received Deduction

The amount of repatriations available for the 85 percent dividends received deduction is limited and must meet requirements regarding the use of the funds in the United States.

**Ceiling Limit.** The amount of dividends eligible for the 85 percent deduction is limited to the *greater* of:

- \$500 million, or
- The amount of foreign earnings for which deferred tax liabilities have not been recorded based on the Statement 109 exception as shown in the company's "applicable financial statement." In cases where the "applicable financial statement" does not show a specific amount of such earnings, but discloses the tax liability attributable to such earnings, the amount of the tax liability divided by 0.35 (i.e., gross up the tax liability at a 35 percent rate).

Except for companies that are required to file financial statements with the SEC, "applicable financial statement" means the most recently audited financial statements that are certified on or before June 30, 2003. For companies that are required to file financial statements with the SEC, "applicable financial statement" means the most recent statement filed with the SEC on or before June 30, 2003.

Companies that did not disclose the amount of earnings permanently reinvested outside of the United States or the related tax liability in the "applicable financial statement" are limited to a ceiling of \$500 million.

The amount of dividends eligible for the 85 percent deduction is reduced by specified increases in related-party indebtedness on the part of a controlled foreign corporation.

**Base Period Average.** Repatriated amounts eligible for the 85 percent deduction generally represent the dividends received in the tax year to which the election applies *over* an average of dividends received from controlled foreign corporations in the base period (as defined in the statute).

**Domestic Reinvestment Plan.** To qualify for the 85 percent deduction, the dividends must be invested in the United States pursuant to an appropriate domestic reinvestment plan approved by the company's senior management (president, CEO, or comparable official) before the dividend is paid, and subsequently approved by the company's board of directors, management committee, executive committee, or similar body. The plan must provide, in the law's words, "for the reinvestment of the dividend in the United States (other than as payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation."

There are a number of questions on the proper interpretation of provisions of the new law pertaining to the 85 percent deduction. Clarifying guidance is expected.



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not as of December 31, 2004, even if the 2004 financial statements have not been issued. That impact would be recorded in the interim period the decision is made. It would not be included as part of the estimated annual effective tax rate used for interim financial reporting.

Companies may also need to evaluate other ramifications of repatriation on their financial reporting, such as hedging the foreign-currency exposure of the net investment where the value of the subsidiary changes significantly.

**Disclosure Requirements.** Companies that have not completed the evaluation of the repatriation provisions as of the balance-sheet date are required to include in the financial statements the following disclosures:

- A summary of how the repatriation provision applies to the company, including the status of the company's evaluation of the repatriation provision's effects and the expected completion date of the evaluation.
- If the company makes the decision in stages, the effect on tax expense or benefit of amounts recognized under the repatriation provision. Annual financial statements should show any effects as a separate component of the disclosures of current and deferred taxes for the period.
- The range of reasonably possible amounts of undistributed earnings being evaluated for repatriation and the potential range of additional income-tax effects. If the range of income-tax effects cannot be reasonably estimated at the time the financial statements are issued, a statement to that effect should be provided.
- Pro forma financial data showing the potential effect of a decision to reinvest or repatriate foreign earnings subsequent to the date of its financial statements but prior to their issuance. The pro forma financial data must include, at a minimum, the effect on income-tax expense or benefit.

Companies reporting on the period during which they complete their evaluation of the effects of the repatriation provision should disclose the effect on income-tax expense or benefit for the period. Annual financial statements should show the effects as a separate component of the disclosures of current and deferred taxes for the period.

Staff Position FAS 109-2 is effective immediately.

The descriptive and summary statements in this presentation are not intended to substitute for the text of the FASB Staff Positions or for the text of the American Jobs Creation Act of 2004 or for related guidance that may be issued. Reporting entities complying with the tax legislation and any FASB requirements should apply the texts of the law and the accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.