Case 16-7
Show Me the Money

Harbor Solutions Inc. (HSI) is a U.S. publicly traded company with headquarters in Boston, MA, and a June 30 year-end. HSI provides insurance claims processing solutions to businesses. In addition to its U.S. locations, HSI also has subsidiaries in several regions around the world. HSI has historically provided evidence that all undistributed earnings of its European subsidiaries are indefinitely reinvested, and thus, no deferred taxes have been recognized for the excess of the financial reporting amounts of HSI's investment in the stock of those subsidiaries over the tax basis of those investments. These undistributed earnings include earnings in high-tax rate countries that under U.S. federal tax law would generate significant foreign tax credits (FTCs) when distributed to HSI.

20X2 Event

In the fourth quarter of fiscal year 20X2, a cash distribution was made from the European subsidiaries to HSI, the U.S. parent entity. The decision to make this distribution was in anticipation of a proposed change in U.S. tax law expected to be enacted later in the 20X2 calendar year that would limit certain FTCs that were available in the event of a distribution from its foreign subsidiaries; if passed, the new law would negatively affect HSI's ability to utilize these FTCs. The proposed change in U.S. tax law was enacted shortly after HSI's fiscal 20X2 year end.

After the 20X2 cash distribution, management reevaluated its assertion about whether all undistributed earnings of the European subsidiaries were indefinitely reinvested. Management concluded that all historical undistributed earnings of the European subsidiaries will be indefinitely reinvested, in part because the change in U.S. tax laws resulted in a lower FTC benefit than was available under the prior law. In addition, management provided evidence through a specific documented plan for reinvestment of all historical undistributed earnings (i.e., those earnings that remained undistributed at the end of 20X2) of these European subsidiaries. Historically, management has complied with its specific documented plan for reinvestment of undistributed foreign earnings, investing the earnings to both expand its European operations and to acquire European-based entities operating in similar lines of business. In the last 10 years, no other distributions of foreign earnings from the European subsidiaries have taken place.

Therefore, HSI did not recognize deferred tax liabilities for the excess of the amounts for financial reporting over the tax bases in its investments in the European subsidiaries.

20X3 Event

On March 1, 20X3, HSI entered into an agreement to purchase an unrelated U.S. entity for a cash payment of $640 million. To fund the purchase, HSI used the following sources:

1. $100 million of available cash in the United States.
2. $400 million of cash obtained through a private placement offer of debt issued by HSI.

3. A distribution of $140 million from the European subsidiaries to the U.S. parent.

The distribution from the European subsidiaries occurred before the private placement debt was issued. The debt issuance was originally planned for $400 million as documented in the financing proposal presented and approved by the board of directors, which included an outside investment banker's analysis of expected demand for the proposed private placement. Because of the unexpectedly strong investor interest in the private placement, HSI subsequently increased the amount of the debt offering to $550 million and received approval from the board of directors for the $150 million increase. Management stated that if the positive response to the debt offering was known before the distribution was made from the European subsidiaries, management would not have directed the subsidiaries to make the distribution.

After the 20X3 distribution, management reevaluated its assertion about whether all undistributed earnings of the European subsidiaries were indefinitely reinvested. Before the acquisition in 20X3, HSI had acquired five companies. All but one of these acquisitions was outside the United States. HSI currently has no plans to acquire additional U.S. entities and has no expectation that a further distribution of foreign earnings to fund acquisitions will be required.

Further, management assessed its ongoing domestic cash flow needs. This cash flow analysis incorporated existing term loans that are set to mature in May 20X4 and the private placement debt issued in 20X3 that will mature in 20X8. Management provided for two scenarios: the refinancing of the term loans and the repayment of the term loans in 20X4. On the basis of the cash flow analysis performed, management noted that future domestic cash needs, including covering debt maturities as they become due, would be satisfied from operating cash flows in the U.S.

Required:

- Do you agree with HSI's conclusion that the indefinite investment exception under ASC 740-30 should continue to be applied?

Additional Facts

For the European subsidiaries to aggregate the funds that were distributed in the 20X3 earnings repatriation to the U.S. parent, intercompany loans were executed among various HSI subsidiaries around the world. This resulted in intercompany loans payable at various European subsidiaries, including Harbor Europe Holdings Inc. (HEH), an international holding entity with no operations of its own. To service its intercompany debt, HEH will receive dividends from its subsidiaries.

HSI expects that the subsidiary dividends it receives will be taxable in the United States as Subpart F income under IRS Code Section 954(c) because the "look through" rules in IRS Code Section 954(c)(6) that historically excluded foreign subsidiary dividends from Subpart F income were scheduled to expire at the end of 20X3. Therefore, such amounts are expected to become taxable to HSI in the United States even though they are not distributed to HSI.

Management has stated that interest expense owed by HEH, and the dividends it will receive from its subsidiaries, are not expected to exceed the future earnings of those subsidiaries. Management prepared an analysis showing that the level of historical earnings of HEH's subsidiaries provide evidence that the future earnings of the subsidiaries will be sufficient to cover the necessary dividends to HEH to service the intercompany debt. Further, HSI will provide capital contributions to HEH to cover any interest expense owed by HEH that is greater than its current-year earnings (i.e., dividends from its subsidiaries). Therefore, management does not believe that any historical undistributed earnings would become taxable in the United States, and thus, those earnings are indefinitely reinvested. Management has included this information within its specific documented plan for reinvestment of the historical undistributed earnings.

Required:

- After considering the Additional Facts, do you agree with HSI's conclusion that the indefinite investment exception under ASC 740-30 should continue to be applied to historical undistributed earnings at the end of 20X3?