The United States has tax treaties (income-tax agreements) with numerous other nations. These treaties, which are extremely important to multinational corporations, are designed to (1) avoid or reduce double corporate taxation situations and (2) improve the flow of tax-related information among tax-enforcement officials. An example of how double corporate taxation might occur for a specific expenditure is if neither the United States tax law nor British tax law allowed a deduction for that portion of research and development costs incurred by a U.S. parent but allocated to its British subsidiary.

In this appendix, we discuss double corporate taxation in the broader context of whether a foreign subsidiary’s reported pretax income is taxed not only overseas but by the Internal Revenue Service as well.

I. THE POSSIBLE TAXATION OF A FOREIGN SUBSIDIARY’S EARNINGS AT THE PARENT LEVEL IN ADDITION TO TAXATION AT THE SUBSIDIARY LEVEL

As discussed in the appendix to Chapter 3, the intent of the Internal Revenue Code is to tax earnings of subsidiaries (domestic or foreign) only once in the United States at the corporate level. Recall further from that appendix that (1) a foreign subsidiary cannot file a consolidated income tax return with its U.S. parent and (2) the “dividend received deduction” applies only to dividends received from domestic subsidiaries. (Also recall from Chapter 1 that the earnings of a foreign subsidiary are generally taxed in the United States only when dividends are received.) Because of these two limitations, a domestic parent’s dividend income from a foreign subsidiary is taxed at the corporate level in the United States. Thus without some comparable special tax provisions for foreign subsidiaries, a double corporate tax (from a worldwide perspective) would result—something that is easily avoided for domestic subsidiaries.

Due to the heavy double corporate tax that would result on a foreign subsidiary’s earnings (which would border on a system of “confiscation” rather than taxation), the Internal Revenue Code provisions allow the parent-level tax to be either (1) entirely avoided or (2) substantially lessened, as explained in detail shortly.

Differences in Income Tax Rates

For all practical purposes, the parent-level tax on dividend income received from a foreign subsidiary is paid only when the subsidiary pays income-related taxes to the foreign government at a

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1 Some exceptions exist (most notably on foreign income characterized as passive), and such foreign income is taxed as it is earned—whether or not it is distributed. Such income is referred to as a deemed dividend or deemed distribution by the IRS. In financial reporting, it is merely the income earned under the equity method of accounting.

The ability of the parent to choose when a foreign subsidiary’s earnings become taxable in the United States allows the parent to have a planning strategy at its disposal if it becomes necessary to report taxable income to prevent certain net operating losses or tax credit carryforwards from expiring.
lower tax rate than the U.S. tax rate. Thus the parent-level tax becomes a problem only when a parent has a subsidiary in a low tax-bracket country (relative to the United States), such as Ireland, which has a 10% income tax rate, or Singapore, which often grants a zero tax rate. The statutory corporate income tax rates of the major trading countries range from 34% [France] to 42% [Germany].

Thus the parent-level tax does not result in fully taxing the same income twice (once abroad and once domestically). Instead, it merely makes up for income taxes that otherwise would have been paid if the income had been earned in the United States. Keep in mind that the U.S. income tax system—unlike the tax system of most foreign countries—taxes worldwide income, not just income earned within the United States.

Avoiding the Parent-Level Tax on a Foreign Subsidiary’s Earnings: Instructing the Subsidiary to Reinvest Rather Than Distribute Its Earnings

Because the parent-level tax is paid only if the foreign subsidiary pays dividends, the parent-level tax can be entirely avoided merely by instructing the foreign subsidiary to reinvest rather than distribute its earnings. As of December 31, 2003, the undistributed foreign earnings of U.S. companies is estimated at roughly $600 billion.

The Critical Financial Reporting Issue—If and When to Record the Parent-Level Taxes

Even if a foreign subsidiary’s earnings are reinvested rather than distributed, whether deferred income tax expense and deferred income taxes payable should be recorded for financial reporting purposes is an issue. The concern is that at some point the foreign subsidiary’s accumulated earnings may be partially or fully distributed to the parent, thus triggering the payment of the parent-level taxes. After all, the parent controls the foreign subsidiary’s dividend policy, and changed economic conditions could cause a reversal of the “pay no dividends policy.” Thus the issue is whether the parent-level taxes should be recorded (1) in any event, (2) only if it is reasonably expected that the taxes will actually have to be paid, or (3) only when actually paid. This issue is addressed in APB Opinion 23.

II. THE REQUIREMENTS OF APB OPINION NO. 23

APBO 23, “Accounting for Income Taxes—Special Areas,” is the governing pronouncement on recording parent-level taxes on a subsidiary’s earnings, and it requires that the parent-level income taxes be recorded when the subsidiary’s earnings are earned (consistent with the accrual basis) not when the earnings are distributed (consistent with the cash basis). (FAS 109, “Accounting for Income Taxes,” did not supersede this pronouncement.) However, if a certain reinvestment condition is met (discussed shortly), the parent-level income taxes need not be recorded. Accordingly, APBO 23’s approach is not fully consistent with either the accrual basis or the cash basis. Instead, APBO 23 takes a pragmatic in-between approach of recording the parent-level taxes only to the extent that they are reasonably expected to be paid. APBO 23 sets forth a specific condition in this regard. If the condition is met, the parent-level tax must be recorded when the subsidiary earnings are earned even though some or all of such taxes may be deferred income taxes.

2 In contrast, many foreign countries (such as Britain, Germany, and the Netherlands) tax only income earned in their country—not worldwide income.

3 Note that the accumulated earnings tax does not apply to foreign subsidiaries.

4 In 2004, Congress passed tax legislation that gave a one-year window to repatriate foreign earnings at a reduced income tax rate of 5.25% instead of 35%. (Procedurally, an 85% special deduction [in lieu of foreign tax credits] is allowed. Thus 15% × 35% tax rate = 5.25%).
The Specific Condition: Indefinite Investment of Undistributed Earnings

If evidence shows that some or all of the undistributed earnings have been or will be invested indefinitely, parent companies do not have to record parent-level income taxes on their share of their subsidiaries’ undistributed earnings. Indefinitely does not mean permanently. Thus parent companies are not required to invest the undistributed earnings of their subsidiaries forever but only for the foreseeable future.

Examples of Evidence

Two examples of evidence to satisfy this “invested indefinitely” condition are (1) historical experience and (2) planned future programs of operations.

The Final Analysis

In effect, the parent records income taxes only to the extent that their payment is reasonably expected to be made. Possible scenarios include:

1. **Total reinvestment.** The intention is to reinvest indefinitely 100% of the foreign subsidiary’s earnings (no parent-level taxes need be recorded).
2. **Partial reinvestment.** The intention is to reinvest less than 100% of the foreign subsidiary’s earnings indefinitely (some parent-level taxes must be recorded).
3. **No reinvestment.** The intention is to distribute in the foreseeable future 100% of the foreign subsidiary’s earnings (full parent-level taxes must be recorded).

What If Circumstances Change?

With respect to changing circumstances, APBO 23 requires that income tax expense for the current year be adjusted to reflect any change in such estimated taxes payable. This manner of reporting is a change in accounting estimate treatment, as opposed to either (1) a correction of an error treatment (for which prior period statements would be restated) or (2) a change in accounting principle treatment. Two changed-circumstance scenarios are possible:

1. **Undistributed earnings are no longer planned to be reinvested indefinitely.** Income taxes that in retrospect should have been accrued in prior periods must now be accrued. The Income Tax Expense account is debited (restatement of the prior period financial statements is not allowed).
2. **Undistributed earnings are no longer planned to be distributed.** Previously recorded accrued income taxes payable must now be adjusted downward. The offsetting credit is to the Income Tax Expense account. Restatement of the prior period financial statements is not allowed—nor can the offsetting credit be reported as an extraordinary item.

Rationale of APB Opinion 23

The rationale of APBO 23 is that a subsidiary may not distribute all of its earnings because the capital is needed to finance internal growth. Thus the parent views all or a large portion of the subsidiary’s retained earnings as permanent capital. From this viewpoint, no U.S. income taxes would ever be paid on the amount deemed permanent capital because it would never be distributed as dividends. Consequently, it would not be sensible to record parent-level taxes on that portion of a subsidiary’s earnings that is invested in the subsidiary indefinitely.

Observation

Not recording parent-level income taxes on a foreign subsidiary’s undistributed earnings is an implicit form of discounting—if the parent-level taxes will not be paid until far into the future, the present value of the deferred tax liability is effectively zero.
III. Calculating Parent-Level Taxes on Foreign Subsidiaries’ Earnings

A foreign subsidiary files an income tax return in the country in which it is domiciled (that is, incorporated). Although a U.S. parent must report as dividend income on its tax return any dividends received from its foreign subsidiary, no income taxes may be owed at the parent level on this dividend income if the subsidiary paid taxes at a rate equal to or higher than the U.S. tax rate. To determine whether taxes should be recorded at the parent level for financial reporting purposes, the following procedures are used:

1. Determine how much of the subsidiary’s earnings do not qualify for the special condition of APBO 23.
2. Gross up these “nonqualifying” earnings to a pretax income amount.
3. Apply the U.S. statutory income tax rate to this pretax income. This is in the nature of a pro forma calculation—it shows what income taxes would have been owed had these foreign earnings been earned in the United States.
4. Subtract from these pro forma income taxes any available foreign tax credits allowed. If a positive balance exists, record that amount as the parent-level taxes on the subsidiary’s “nonqualifying” earnings. If a zero or negative balance exists, no parent-level taxes need be recorded. Two kinds of foreign tax credits exist:
   a. Foreign income taxes.
   b. Dividend withholding taxes. The foreign government withholds these taxes when a dividend is remitted. One of the avowed purposes of this tax is to collect taxes that otherwise would have been collected at the individual taxpayer level had local citizens owned the corporation. (The dividend withholding tax rates of most of the major trading countries range from 5% to 15%.)

The Internal Revenue Code has limitations on the credit amount allowable against the pro forma income taxes. The limitations are based on (1) the type of foreign source income and (2) the overall amount of foreign source income. The specific limitations are beyond the scope of this text, but you should be aware that they exist.

Why Is It Also Necessary to Record the Dividend Withholding Taxes on the Parent’s Books?

In addition to the parent-level income taxes, the parent must record on its books the dividend withholding tax payable. The dividend withholding tax is a tax to the recipient; accordingly, it is never recorded as an expense on the foreign subsidiary’s books.

Required Disclosures

When a deferred tax liability has not been recognized because the “invested indefinitely” assumption is used, FAS 109 requires disclosure of either (1) the amount of the unrecognized deferred tax liability if that amount is determined to be practicable or (2) a statement that determination is not practicable. See the Case in Point on the following page for an example of such disclosure.

Illustrations 16A-1 and 16A-2 show how to calculate and record parent-level taxes on “nonqualifying” earnings of foreign subsidiaries under differing assumptions.

Parco’s journal entries shown in Illustration 16A-1 are presented in T-account fashion:

<table>
<thead>
<tr>
<th>Investment in Subsidiary</th>
<th>Equity in Net Income (of Subsidiary)</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) 800,000</td>
<td>800,000 (3)</td>
<td></td>
</tr>
<tr>
<td>800,000 (1)</td>
<td></td>
<td>(3) 760,000</td>
</tr>
</tbody>
</table>
CASE IN POINT

ChevronTexaco Corporation’s 2003 Annual Report

“Undistributed earnings of international consolidated subsidiaries and affiliates for which no deferred income tax provision has been made for possible future remittances totaled approximately $10.5 billion at December 31, 2003. Substantially all of this amount represents earnings reinvested as part of the company’s ongoing business. It is not practical to estimate the amount of taxes that might be payable on the eventual remittance of such earnings.

On remittance, certain countries impose withholding taxes that, subject to certain limitations, are then available for use as tax credits against a U.S. tax liability, if any.

ILLUSTRATION 16A-1 CALCULATING AND RECORDING U.S. INCOME TAXES ON A 100%-OWNED FOREIGN SUBSIDIARY’S EARNINGS: 100% OF EARNINGS DISTRIBUTED

I. Assumed Information Regarding Parco Inc’s 100%-Owned Foreign Subsidiary, Subco Inc., for 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income Tax Rate</td>
<td>20%</td>
</tr>
<tr>
<td>Dividend Withholding Tax Rate</td>
<td>5%</td>
</tr>
<tr>
<td>Percentage of 2006 Net Income Distributed as Dividends in 2006</td>
<td>100%</td>
</tr>
<tr>
<td>Income before Income Taxes (pretax income)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Income tax expense @ 20%</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Net Income</td>
<td>$800,000</td>
</tr>
<tr>
<td>Less-Dividend withholding taxes at 5%</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Cash Received by Parco</td>
<td>$760,000</td>
</tr>
</tbody>
</table>

Taxes Recorded versus Taxes Owed

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes Recorded on Subco’s Books in 2006</td>
<td>$200,000</td>
</tr>
<tr>
<td>Taxes Owed to the Foreign Government for 2006</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

II. Calculation of Income Taxes to Be Recorded by Parco in 2006 That Pertain to Subco’s 2006 Earnings

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subco’s 2006 pretax income</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>U.S. income tax rate</td>
<td>35%</td>
</tr>
<tr>
<td>Pro Forma U.S. Income Taxes</td>
<td>$350,000</td>
</tr>
<tr>
<td>Less allowable foreign tax credits:</td>
<td></td>
</tr>
<tr>
<td>Foreign income taxes ($1,000,000 x 20%)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Dividend withholding taxes ($800,000 x 5%)</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Taxes Owed to the U.S. Government</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

Taxes Recorded versus Taxes Owed

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes Recorded on Parco’s Books in 2006</td>
<td>$150,000</td>
</tr>
<tr>
<td>Taxes Owed to the U.S. Government for 2006</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

III. Parco’s 2006 Entries Relating to Subco’s 2006 Earnings

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Investment in Subsidiary</td>
<td>800,000</td>
</tr>
<tr>
<td>To apply the equity method of accounting</td>
<td>800,000</td>
</tr>
<tr>
<td>(2) Income Tax Expense</td>
<td>150,000</td>
</tr>
<tr>
<td>Current Income Taxes Payable—IRS</td>
<td>110,000</td>
</tr>
<tr>
<td>Current Income Taxes Payable—Foreign</td>
<td>40,000</td>
</tr>
<tr>
<td>To record income taxes on Subco’s 2006 earnings (100% currently payable because 100% of the 2006 net income was distributed in 2006)</td>
<td></td>
</tr>
<tr>
<td>(3) Cash</td>
<td>760,000</td>
</tr>
<tr>
<td>Current Income Taxes Payable—Foreign</td>
<td>40,000</td>
</tr>
<tr>
<td>Investment in Subsidiary</td>
<td>800,000</td>
</tr>
<tr>
<td>To record receipt of dividend</td>
<td></td>
</tr>
</tbody>
</table>
ILLUSTRATION 16A-2  CALCULATING AND RECORDING U.S. INCOME TAXES ON A 100%-OWNED FOREIGN SUBSIDIARY’S EARNINGS: 20% OF EARNINGS EXPECTED TO BE REINVESTED INDEFINITELY

I. Assumed Information Regarding Parco Inc’s 100%-Owned Foreign Subsidiary, Subco Inc., for 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income Tax Rate</td>
<td>20%</td>
</tr>
<tr>
<td>Dividend Withholding Tax Rate</td>
<td>5%</td>
</tr>
<tr>
<td>Income before Income Taxes (pretax income)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Income tax expense @ 20%</td>
<td>$200,000</td>
</tr>
<tr>
<td>Net Income</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

**BREAKDOWN OF 2006 EARNINGS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Pretax Income</th>
<th>Income Taxes @ 20%</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subco’s Pretax Income</td>
<td>$200,000</td>
<td>($40,000)</td>
<td>$160,000</td>
</tr>
<tr>
<td>Income taxes @ 20%</td>
<td>(40,000)</td>
<td>(60,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Net Income</td>
<td>$160,000</td>
<td>$240,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

II. Calculation of Income Taxes to Be Recorded by Parco in 2006 That Pertain to Subco’s 2006 Earnings

<table>
<thead>
<tr>
<th>Description</th>
<th>Pretax Income</th>
<th>Income Taxes</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. income tax rate</td>
<td>35%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pro Forma U.S. Income Taxes</td>
<td>$105,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less allowable foreign tax credits:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign income taxes @ 20% of Subco’s pre-tax income</td>
<td>(60,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend withholding taxes @ 5% of Subco’s net income</td>
<td>(12,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes Owed to the U.S. Government</td>
<td>$33,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Taxes Recorded versus Taxes Owed

- **Taxes Recorded on Parco’s Books in 2006**
  \[($12,000 + $20,000 + $33,000 + $55,000)\]
  \[= $120,000\]

- **Taxes Owed to the U.S. Government for 2006**
  \[($33,000 + $55,000)\]
  \[= $88,000\]

Note: Observe that these amounts are 80% of the comparable amounts shown in Illustration 16A-1.

(continued)
SUMMARY OF KEY POINTS FOR APPENDIX 16A

1. Under APBO 23, the parent-level tax must be recorded in the year in which the subsidiary earns the income—not when the dividends are paid. To the extent that the income taxes are not expected to be paid, however, they need not be recorded.

2. The condition that allow the parent-level tax not to be recorded is the indefinite investment (supported by history or planned programs of operations).

3. In computing the parent-level taxes on a foreign subsidiary’s earnings, a pro forma calculation is made as if the earnings had been earned and then taxed in the United States. Foreign tax credits and dividend withholding taxes can be used to reduce the amount of parent-level taxes otherwise payable to the IRS.

SELF-STUDY QUESTIONS FOR APPENDIX 16A

(The answers are at the end of these questions.)

1. For financial reporting purposes, under what circumstances must parent companies record income taxes on earnings of foreign subsidiaries?
   a. If a tax-free liquidation is planned.
   b. If the earnings have been or will be invested indefinitely.
c. If a consolidated income tax return cannot be filed.

d. If the dividend received deduction is not applicable.

e. If some or all of the earnings are expected to be distributed.

2. Paxe Inc. owns 100% of the common stock of Saxe Inc., a foreign subsidiary located in a country that has a 20% corporate income tax rate and a 10% dividend withholding tax. The U.S. income tax rate is 35%. Saxe reported net income of $400,000 for 2006 and remitted $250,000 of these earnings as dividends to Paxe in 2006. The remaining earnings are expected to be remitted in 2007. What is the total amount of income taxes relating to Saxe that Paxe should record on its books for 2006?

a. $-0–

b. $25,000

c. $35,000

d. $40,000

e. $75,000

3. Use the information in Question 2. What amount of parent-level income taxes will eventually be paid to the IRS?

a. $-0–

b. $25,000

c. $35,000

d. $40,000

e. $75,000

4. Use the information in Question 2. What will be the total taxes eventually paid to the foreign government?

a. $100,000

b. $125,000

c. $135,000

d. $140,000

e. $175,000

Answers to Appendix Self-Study Questions

1. e  2. e  3. c  4. d

(Interactive Quizzes containing these questions and answers can be found at the website: http://pahler.swlearning.com)

**Review Questions for Appendix 16A**

1. When and to what extent does APBO 23 require the parent-level taxes on a foreign subsidiary’s earnings to be recorded?

2. What conditions allow for not recording the parent-level taxes?

3. What are two examples of evidence to support the invested indefinitely condition?

4. What are the general procedures used to calculate the parent-level tax on a foreign subsidiary’s earnings?

5. What two types of foreign tax credits exist?

6. Which entity records as an expense the dividend withholding tax paid or payable? Why?

7. How is the effect of a change in assumption regarding indefinite investment of a foreign subsidiary’s undistributed earnings reported?
EXERCISES FOR APPENDIX 16A

E 16A-1 100% Reinvestment of Earnings  Pikee Inc. owns 100% of the outstanding common stock of Sikee Inc., a foreign subsidiary that consistently does not declare dividends on its common stock because the earnings are used each year for internal expansion, which is expected to continue into the foreseeable future. For 2006, Sikee had net income of $140,000. Assume a 30% foreign income tax rate, a 5% dividend withholding tax rate, and a 40% U.S. income tax rate.

Required Prepare the 2006 entries relating to Pikee’s investment in Sikee assuming that Pikee uses the equity method.

E 16A-2 No Dividends Declared—Intended Liquidation  Probco Inc. owns 100% of the outstanding common stock of Solvco Inc., a foreign subsidiary domiciled in a country that has a 25% corporate income tax and a 5% dividend withholding tax. Probco expects Solvco to be operational for 8 years, after which (1) it will be liquidated and (2) its undistributed earnings will be remitted to Probco. For 2006, Solvco (1) reported net income of $300,000 and (2) declared no dividends. Assume a 40% U.S. income tax rate.

Required Prepare the 2006 entries related to Probco’s investment in Solvco assuming that Probco uses the equity method.

PROBLEMS FOR APPENDIX 16A

P 16A-1 Dividends Declared  Putco Inc. owns 100% of the outstanding common stock of Sutco Inc., a foreign subsidiary domiciled in a country that has a 25% corporate income tax and a 15% dividend withholding tax. Putco expects Sutco to be operational for 10 years, after which (1) it will be liquidated and (2) its undistributed earnings will be remitted to Putco. For 2006, Sutco (1) reported net income of $450,000 and (2) declared and paid cash dividends of $240,000. Assume a 40% U.S. income tax rate.

Required 1. Prepare the 2006 entries related to Putco’s investment in Sutco assuming that Putco uses the equity method.
2. What amount is reported on Putco’s 2006 federal corporate income tax return relating to the investment in Sutco?

P 16A-2 Temporary Partial Reinvestment of Earnings  Pavco Inc. owns 100% of the outstanding common stock of Savco Inc., a foreign subsidiary domiciled in a country that imposes a 20% corporate income tax and a 5% dividend withholding tax. For 2006, Savco (1) reported net income of $200,000 and (2) declared and paid cash dividends of $120,000. Savco’s $80,000 of undistributed 2006 earnings are expected to be distributed within 5 years. Assume a 40% U.S. income tax rate.

Required 1. Prepare the 2006 entries relating to Pavco’s investment in Savco assuming that Pavco uses the equity method.
2. What amount is reported on Pavco’s 2006 federal corporate income tax return relating to the investment in Savco?

P 16A-3 Temporary Partial Reinvestment of Earnings  Ponex Inc. owns 100% of the outstanding common stock of Sonex Inc., a foreign subsidiary domiciled in a country that imposes a 25% corporate income tax and a 15% dividend withholding tax. For 2006, Sonex (1) reported net income of $600,000 and (2) declared and paid cash dividends of $420,000. The remaining $180,000 of 2006
net income is expected to be distributed as soon as cash becomes available. Assume a 40% U.S. income tax rate.

Required

1. Prepare the 2006 entries related to Ponex’s investment in Sonex assuming that Ponex uses the equity method.
2. What amount is reported on Ponex’s 2006 federal corporate income tax return relating to the investment in Sonex?

P 16A-4

Indefinite Partial Reinvestment of Earnings Punco Inc. owns 100% of the outstanding common stock of Sunco Inc., a foreign subsidiary domiciled in a country that imposes a 30% corporate income tax and a 10% dividend withholding tax. For 2006, Sunco (1) reported net income of $350,000 and (2) declared and paid cash dividends of $140,000. For the remaining 2006 net income of $210,000, $70,000 is expected to be distributed as dividends in late 2007, and $140,000 is expected to be used for internal expansion. Assume a 40% U.S. income tax rate.

Required

1. Prepare the 2006 entries related to Punco’s investment in Sunco assuming that Punco uses the equity method.
2. What amount is reported on Punco’s 2006 federal corporate income tax return relating to the investment in Sunco?

P 16A-5

Indexing the Tax Basis of Foreign Fixed Assets—LCU Is the Functional Currency Subcorr is a 100%-owned foreign subsidiary located in a country that annually allows the tax basis of fixed assets to be partially adjusted upward for local inflation. The local currency financial statements, however, are prepared without any indexing for inflation.

Additional information

1. On 1/1/06, Subcorr acquired land at a cost of 400,000 LCU.
2. The foreign government, which has a 40% income tax rate, will allow the tax basis of fixed assets to be restated by 25% for 2006.
3. Local GAAP and U.S. GAAP are identical.
4. Subcorr’s functional currency is the local currency.

Required

1. Under FAS 109, what entry should Subcorr make at 12/31/06 relating to the allowed 25% increase in tax basis of the land?
2. What entry(ies) would Subcorr make in 2007 if the land were sold for 520,000 LCU on 1/2/07? Prepare a partial income statement for 2007 in LCU.

P 16A-6

Indexing the Tax Basis of Foreign Fixed Assets—U.S. Dollar Is the Functional Currency Use the information in Problem 16A-5, but assume that Subcorr’s functional currency is the U.S. dollar.