

## Downsizing the international tax deferral: What it could mean for US business

President Obama's 2010 budget proposes the biggest changes to the taxation of US multinational companies since the Kennedy Administration. Since the founding of the US income tax, US multinational companies have been able to defer paying US tax on their foreign subsidiaries' earnings, as long as the parent companies continue to reinvest the earnings in those foreign operations. The proposed tax legislation would minimize the benefits of deferral, increasing the tax burden for US companies with foreign operations.

A main objective of the proposal is to reduce the incentives for companies to offshore jobs. Taken as a whole, the proposed changes are expected to raise at least \$150 billion over the next decade, potentially helping to offset the cost of healthcare reform and other initiatives. But the proposed legislation could also have the unintended consequence of putting US businesses at a competitive disadvantage in the global marketplace, by increasing their tax burden. Our major trading partners (including all OECD member countries) either exempt business income earned by their domestic companies' foreign subsidiaries or defer taxes on that income until it's repatriated. Thus, going forward, US companies would generally face higher taxes than their foreign competitors when competing in a given locale.

The proposal does not call for an outright repeal of tax deferral, but its enactment would substantially minimize the benefits of deferral. How? It would

- **Limit certain tax deductions:** US multinationals with overseas operations would no longer get tax deductions for the entire expenditure on items such as interest expense or head-office salaries, unless foreign earnings were fully remitted to the United States.
- **Restrict credits:** The US foreign tax credit for repatriated foreign earnings would be reduced to reflect the average tax rate across all countries where a company has operations. US companies would therefore lose a portion of their foreign tax credits from higher-tax countries, consequently subjecting their foreign earnings in those countries to double taxation.

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Big tax changes may be coming for US companies that have international operations. If key pieces of the Administration's tax proposal get through Congress, benefits US companies have long enjoyed could dwindle, possibly leading to tough decisions for US multinationals and their boards.

#### Convertible debt: New consequences

Recent changes in the way companies report certain types of convertible debt could impact how they contemplate financing options. Find out what directors should know.

#### Intersecting the comp & audit committees

As the link between risk and executive compensation continues to elicit public and governmental concern, some lawmakers are contemplating legislative action. And what action should directors take? A starting point is active collaboration between audit and compensation committees.

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## Convertible debt: New consequences

Greater ease in accessing the credit markets over recent months has been accompanied by a surge in convertible debt offerings. Companies issuing convertible debt securities (i.e., debt instruments that the holder may convert into cash, stock, or a combination of the two at or before maturity) need to be aware that the financial reporting for many of these instruments has changed substantially. Businesses may, in particular, be surprised by the size of the increase in their recorded interest expense.

Why? Because new guidance from the FASB requires companies to report as interest expense the economic cost of certain convertible debt securities—including the value of the embedded equity feature. Until now, companies largely were able to avoid doing this by using specially engineered debt instruments (directors may have heard these referred to as Instruments B, C and X). These instruments allowed companies to report interest expense at the lower notional (or cash) interest rate. Some of these instruments also had a less dilutive effect on earnings per share, making them all the more attractive to the companies issuing them.

Companies will have to begin recording higher interest expense on these instruments in 2009 (calendar-year companies have been doing so since the first quarter). An added wrinkle is that companies must apply the new accounting retrospectively, dating back to when the securities were issued. So even if a company has no plans to issue convertible debt in the future, it will still have to apply the new guidance to such instruments that are currently on its books.

What should directors be thinking about if their companies have considerable convertible debt?

- Whether management is contemplating how the new guidance will affect future convertible debt transactions and is assessing the ongoing suitability of security structures that the company used in the past
- Whether the company's treasury function is reconsidering various financing options, and what those options are, given that convertible debt will have a greater impact on the bottom line going forward

- How much additional interest expense the company will have to report and the implications this will have for meeting debt covenants, as well as for performance targets tied to incentive compensation
- Whether management is consulting experts as needed, given the valuation requirements, the accompanying new disclosures, the complexity of the new guidance, and the fact that other newly effective accounting literature also impacts this area:

Because companies must apply the guidance retrospectively, any company intending to prepare a new or amended registration statement, proxy statement, or private offering memorandum will need to revise previously filed annual financial statements if the change resulting from the new convertible debt guidance is material to the company (since most companies didn't recast and refile their annual statements in their regular quarterly filings), in order to reflect the impact of this change in accounting principle.

## Committee intersection: Where audit and compensation cross paths

The economic crisis has prompted a wide range of stakeholders to put tough questions to directors. One at the forefront has been whether executive compensation programs promote excessive risk-taking.

Lawmakers and regulators especially have been focused on this issue as they try to determine how best to regulate financial institutions. But public officials aren't just looking at the financial services sector: They're looking across all industries, asking whether tying annual and equity-based incentives to metrics such as revenue and business volume implicitly encourages executives to take risks that may pay off in the short term, at the expense of companies' long-term health.

Washington is contemplating ways to prevent or minimize such short-sighted behavior. For its part, the SEC is actively considering having companies disclose how compensation impacts risk-taking—not just compensation for executives, but for employees generally. And though legislative action hasn't focused specifically on the link between risk and compensation, both houses of Congress have introduced bills that would give shareholders a vote on executive pay (and shareholders *are* looking at the risk-compensation link). If policymakers are not satisfied that companies are adhering to principles that align their compensation structures with sound

risk management practices, the current initiatives could come to fruition, with further measures possibly following.

### Mutual concerns

The intersection of risk and executive compensation suggests the need for greater dialogue between a company's audit committee and compensation committee. Why? One reason is that many audit committees are tasked with reviewing management's policies for assessing and managing risk. Audit committees might therefore benefit from discussing with their colleagues on the compensation committee the degree to which compensation structures may be promoting and rewarding an inappropriate level of risk-taking by executives.

Another reason for coordination is that the better the audit committee understands the performance metrics the compensation committee tags to incentive pay, the better the audit committee can monitor the integrity of those metrics—in particular, by focusing on whether the ability to achieve performance targets significantly affects management's financial reporting judgments.

Plus, given that the audit committee generally has a bird's-eye view of the company's risk considerations, it is better positioned to identify any potential disconnect between

management's view of risk and the compensation committee's view. Sharing this broader picture with the compensation committee could increase the likelihood that compensation programs promote behaviors that are aligned with the risk appetite that management and the board as a whole have agreed on. Of course, companies need to take risks to make money; regular discussion between the audit and compensation committees will help ensure a mutual understanding of where those risks figure in the risk-compensation equation.

### Making the conversation happen

Despite the clear benefits of collaboration, regular interaction between the two committees can be challenging to orchestrate. This is especially true at companies where the two committees meet simultaneously, preventing cross-committee membership. Those companies may want to consider alternatives, such as regular discussions between the two committee chairs, annual joint meetings of the committees, or a policy of reviewing each other's agendas and minutes. Such efforts would clearly demonstrate that directors have registered shareholders' concerns about risk and compensation and are doing something about it.

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- **Curtail tax-free transfers of cash earnings between overseas operations:** Related foreign operations of US companies would no longer be able to make loans to or invest in one another without their US parent paying current US tax on income earned from these transactions.

How likely is Congress to pass the proposal? With a burgeoning federal deficit and costly items on the legislative agenda, Washington is hard-pressed to find funding sources. In addition to fiscal pressure, there is political pressure. As former Ways and Means Committee Chairman Bill Archer, now a senior tax advisor at PricewaterhouseCoopers, notes, “The President has placed his personal endorsement behind these proposals. As a result, Congress is compelled to give them serious consideration, and it significantly raises the hurdle for those who will oppose them.”

Despite uncertainty about Congressional approval, the impact of potential tax changes (individually or taken as a whole) is too great for companies to ignore. Directors—particularly those at companies

earning substantial income from overseas operations—should discuss possible implications with management. That discussion might cover

- How the company’s tax liability (both US and foreign) could change, and the potential effect on earnings and cash flow
- Any operational changes that could offset some of the tax increase, or, if the tax increase is significant, fundamental restructuring options the company might consider
- The possible impact on treasury and capital structuring if the US parent can no longer deduct the full cost of company debt
- The extent to which management intends to engage with Administration officials and members of Congress to share perspectives on the business effects of the proposed legislation

The bottom line: Thinking about the Administration’s proposal now will better enable companies to respond strategically if some or all of the proposed tax changes come to pass.

### How PwC can help

To have a deeper discussion about how these subjects might affect your business, please contact:

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Tell us how you like **To the Point** and what topics you want to hear more about. Just send an email to [us.assurance@us.pwc.com](mailto:us.assurance@us.pwc.com).

### You may also want to read

*2009 Current Developments for Directors*—This annual publication captures important developments and the critical governance issues directors and executives face. The 2009 edition addresses key business issues such as the implications of the economic crisis, trends in governance, and key financial reporting developments (e.g., around business combinations and fair value accounting).

This and our other corporate governance publications—including previous issues of **To the Point**—are available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

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