Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis

Donald J. Marples
Specialist in Public Finance

Jane G. Gravelle
Senior Specialist in Economic Policy

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Summary

At the beginning of the 111th Congress, economic stimulus proposals have dominated the legislative agenda, with a broad recognition that business tax incentives are among the policy options to consider. Two prominent proposals, H.R. 1 and S. 1, both titled the American Recovery and Reinvestment Act of 2009, have thus far been the focus of this debate. Both proposals include business tax incentives which would increase the after-tax rate of return on domestic investment. In contrast, little attention has been given to international policy options. An exception to this is a plan to reduce the tax rate on repatriated dividends that has received some consideration. Under such a plan, the U.S. tax that U.S. firms pay when their overseas operations remit ("repatriate") their foreign earnings as dividends to their U.S. parent corporations would be reduced. This provision was considered, but not adopted, as a floor amendment to a Senate version of the American Recovery and Reinvestment Act of 2009.

A conceptually similar proposal was enacted as part of the American Jobs Creation Act (P.L. 108-357). The provision provided a temporary reduced rate for repatriated earnings, with the condition that the repatriated earnings be used for domestic investment. While empirical evidence is clear that this provision resulted in a significant increase in repatriated earnings, empirical evidence is unable to show a corresponding increase in domestic investment or employment.

Viewed in the current debate on how to most efficiently stimulate the economy, economic theory suggests that the simulative effect of a temporary tax cut for repatriations may be partially offset by exchange rate adjustments that would reduce net exports. In addition, how businesses use repatriated earnings will impact the stimulative effect of a tax cut for repatriations. For example, repatriated earnings will have a larger stimulative effect if they are used to increase current investment. A smaller stimulative effect will result, in contrast, if the repatriated earnings are used to shore up "cash-flow" issues. This report will be updated as legislative events warrant.

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The legislative agenda at the start of the 111th Congress has been dominated by efforts aimed at stimulating the U.S. economy. Two prominent proposals, H.R. 1 and S. 1, both titled the American Recovery and Reinvestment Act of 2009, have thus far been the focus of this debate. Both proposals include business tax incentives which would increase the after-tax rate of return on some domestic investment. In contrast, little attention has been given to international policy options. One international option that has received some consideration is a plan to reduce a tax cut for repatriated dividends. Under this option, the U.S. tax that a U.S. parent corporation pays when its overseas operations repatriate foreign earnings to its U.S. parent, as dividends, would be reduced. This provision was considered, but not adopted, as a floor amendment to a Senate version of the American Recovery and Reinvestment Act of 2009.

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In the context of the current debate on stimulus, the use of the repatriations and not the magnitude of repatriations stimulated are likely to be the key to the proposal's effect on U.S. economic growth. This follows from two points. First, even if sizeable repatriations occur, the rate of return on U.S. investment will be unaffected by the repatriations. Assuming firms are not liquidity-constrained, it is possible that the bulk of the repatriations will be used as dividends to stockholders or used to pay down corporate debt. This scenario is especially likely for large firms.[1] Second, when the repatriations occur, those that are denominated in foreign currencies will be converted to dollars. The corresponding increase in the demand for dollars may drive up the price of the dollar in world currency markets. As a result, U.S. net exports may decline from levels that would otherwise occur, and the stimulative impact of the repatriations on the U.S. economy would be lessened.

The U.S. International Tax System

The United States bases its jurisdiction to tax international income on residence. As a result, U.S.-chartered corporations are taxed on their worldwide income, but foreign corporations are taxed only on their U.S.-source income. Accordingly, a U.S. firm with overseas operations can indefinitely postpone its U.S. tax on its foreign income by operating through a foreign subsidiary. Using the same principle, U.S. taxes are deferred as long as its foreign earnings remain in the control of its foreign subsidiary and are reinvested abroad. The U.S. firm pays taxes on its overseas earnings only when they are paid to the U.S. parent corporation as intra-firm dividends or other income.

Another prominent feature of the U.S. tax system is the foreign tax credit. The foreign tax credit is designed to alleviate double taxation where U.S. and foreign governments' tax jurisdictions overlap ─ that is the U.S. firm pays taxes at the higher of the U.S. or foreign tax rate. With respect to repatriated dividends, U.S. firms can claim foreign tax credits for foreign taxes paid by

[1] See CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle, for a more detailed discussion.

their subsidiaries on the earnings used to pay the repatriated dividends. The ability to defer U.S. tax, thus, poses an incentive for U.S. firms to invest abroad in countries with low tax rates. Proposals to cut taxes on repatriations are based on the premise that even this deferred tax on intra-firm dividends discourages repatriations and encourages firms to reinvest foreign earnings abroad and that a cut in the tax would stimulate repatriations.

Repatriated Earnings Provisions in the American Jobs Creation Act

The repatriated earnings provision included in the American Jobs Creation Act (P.L. 108-357) reduced the taxes due on repatriated earnings. In particular, the provision provided a deduction equal to 85% of the increase in foreign-source earnings repatriated. For a firm paying taxes at the 35% corporate tax rate, this reduced the tax rate on repatriated earnings to the equivalent of 5.25%.

The act required firms to adopt domestic investment plans for qualifying repatriations and limited the maximum deduction allowed. The maximum allowable deduction was set equal to the greater of $500 million or the amount of earnings shown to be permanently reinvested outside the United States in a firm's books of accounts certified before June 30, 2003.

The deduction was designed and intended to be available for one year. At the taxpayer's option, the year would be the first tax year beginning on or after the date of enactment of P.L. 108-357 or the last tax year beginning before that date. The conference report for the act stated the "conferees emphasize that this is a temporary economic stimulus measure, and that there is no intent to make this measure permanent, or to 'extend' or enact it again in the future."[2]

Impacts of a Reduction in the Tax on Repatriated Earnings

A number of researchers have studied the impact of the reduction in the tax on repatriated earnings that came out of the American Jobs Creation Act. The studies have generally focused on two particular responses: the level of repatriations and the impact on economic growth. In short, the studies generally conclude that the reduction in the tax rate on repatriated earnings led to a sharp increase in the level of repatriated earnings, but that the repatriations did not increase domestic investment or employment. They further conclude that much of the repatriations were returned to shareholders through stock repurchases.

[2] U.S. Congress, Conference Committees, 2004, *American Jobs Creation Act of 2004*, conference report to accompany H.R. 4520, H.Rept. 108-755, 108th Cong., 2nd sess. (Washington: GPO, 2004), p. 314.

Impact on Repatriated Earnings

The impact of a reduction in the tax on repatriated earnings depends on whether the reduction is permanent or temporary. As mentioned above, the provision enacted in P.L. 108-357 was envisioned as being a temporary and one-time reduction.

A permanent reduction in the tax on repatriated earnings is not likely to result in an increase in repatriations. According to the "new view" of dividends, once a firm invests equity capital in a foreign subsidiary, the payment of home-country taxes is inevitable.[3] Given this inevitability, once the capital is abroad, repatriation taxes have no impact on the firm's decision whether to repatriate foreign earnings in the present or to instead reinvest them abroad. Instead, repatriations will follow a life-cycle model, unaffected by repatriation taxes, where young foreign subsidiaries will receive capital from their U.S. parent so long as there are profitable foreign investment opportunities, followed by a period of self-financing of foreign investment by the foreign subsidiary, and ending with a period of repatriations made by mature foreign subsidiaries.

In contrast, a temporary reduction in the tax on repatriated earnings is likely to result in an increase in repatriations in the short-run. Note that the long-run result, above, depended upon the tax on repatriated earnings being the same in the present and the future. This no longer holds for a temporary reduction, and thus repatriation taxes may affect the level of repatriations. This is not to say that all firms will increase repatriations in response to the tax reduction. It is expected that a young firm's repatriation decisions would still be unaffected by repatriation taxes, as long as the reduction expires prior to the firm intending to repatriate profits. In addition, any short-term increase in repatriations may be offset by a decrease in repatriations in later years. This is especially likely to occur if corporations view a temporary rate reduction as likely to recur.

The actual pattern of repatriations observed after enactment of the American Jobs Creation Act validated the short-run economic prediction. According to the Internal Revenue Service, 843 of the roughly 9,700 eligible corporations took advantage of the deduction.[4] This sub-set of eligible corporations repatriated $312 billion in qualified earnings and created total deductions of $265 billion. Using the most recent year of data available, the data suggest that approximately one-third of all offshore earnings were repatriated in the tax year after enactment. As way of comparison, base dividends for the same corporations total approximately $34 billion and suggest a normal repatriation rate of little more than 4%. Thus, not controlling for other factors, the rate reduction resulted in a greater-than eight-fold increase in repatriations.

The IRS study of the provision, cited above, provided information on the recipients. The benefits of the repatriation provision are not evenly spread across industries. The pharmaceutical and medicine industry accounted for $99 billion in repatriations or 32% of the total. The computer and electronic equipment industry accounted for $58 billion or 18% of the total. Thus these two industries accounted for half of the repatriations. Most of the dividends were repatriated from low tax countries or tax havens.

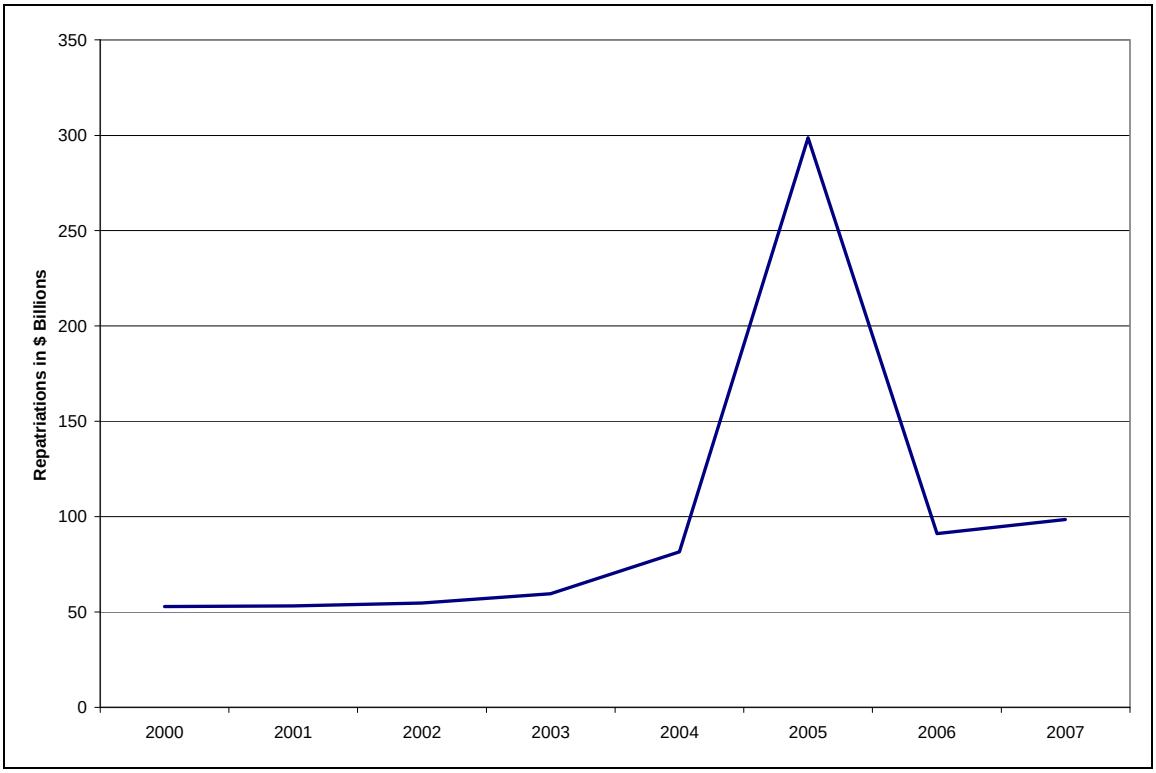
[3] Jane Gravelle, "Federal Corporate Income Tax," in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (Washington, DC: The Urban Institute, 1999), p. 175.

[4] Melissa Redmiles, *The One-Time Recieved Dividends Deduction*, Internal Revenue Service, Statistics of Income Bulletin, Washington, DC, Spring 2008, http://www.irs.gov/pub/irs-soi/08codivdeductbul.pdf.

The benefits were also highly concentrated in a few firms. According to a recent study, five firms (Pfizer, Merck, Hewlett-Packard, Johnson & Johnson, and IBM) are responsible for $88 billion, over a quarter (28%) of total repatriations.[5] The top 10 firms (adding Schering-Plough, Du Pont, Bristol-Myers Squibb, Eli Lilly, and PepsiCo) accounted for 42%. The top 15 (adding Procter and Gamble, Intel, Coca-Cola, Altria, and Motorola), accounted for over half (52%).

Using an alternative measure of repatriations also shows a large "spike" in repatriations resulting from the American Jobs Creation Act. As seen in **Figure 1**, U.S. Multinationals increased their repatriations by approximately 266% from the prior year.

Figure 1. Repatriations by U.S. Multinational Corporations, 2000-2007



Source: Bureau of Economic Analysis, International Transactions, Table 7a.

The empirical evidence also suggests that corporations expect the temporary rate reduction to recur. According to several researchers, unrepatriated earnings have rapidly grown since 2005.[6] In fact, since the last repatriation rate reduction, unrepatriated earnings for all corporations have grown by 72% to $958 billion and by 81% to $639 billion for firms that repatriated under the American Jobs Creation Act.

[5] Rodney P. Mock and Andreas Simon, "Permanently Reinvested Earnings: Priceless," *Tax Notes*, November 17, 2008, pp. 835-848.

[6] Allen Sinai, *Macro Economic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment*, Decisions Economics, Inc, Economic Studies Series, Dec. 11, 2008, http://www.accf.org/media/dynamic/3/media_304.pdf; and Lee A. Shepard and Martin A. Sullivan, "Multinationals Accumulate to Repatriate," *Tax Notes*, January 19, 2009, pp. 295-298.

Impact on Economic Growth

Given the empirical evidence that a temporary reduction in taxes on repatriated earnings leads to an increase in repatriated earnings, how does this affect economic growth? Two factors that will impact the answer are how the repatriated earning are used and the role of flexible exchange rates. Simply put, the more the repatriated earnings are used to shore up a corporation's balance sheet or paid to shareholders the less the simulative effect of the repatriations. On top of that, flexible exchange rates will likely further depress the simulative impact of the repatriations.

Use of Repatriated Earnings and Economic Stimulus

Fiscal policy, such as a reduction in the tax rate on repatriated earnings, boosts economic activity by increasing the short-run demand for goods and services. Put bluntly, the earning must be spent, in order to stimulate the economy. With this in mind, the American Jobs Creation Act required that corporations have an approved plan to reinvest the repatriated earnings prior to claiming the 85% deduction. The main criticism of the reinvestment plan provision was that it allowed an overly generous range of reinvestment options ─ all but executive compensation and stock repurchase programs ─ and that it was not explicitly linked to specific uses. Proponents of the reinvestment plan argue that the range of options allowed reflects a recognition of the fungibility of money.

Economic theory finds that changes in the after-tax cost of new investment are most likely to induce new investment. In contrast, incentives which increase after-tax profits (and benefit mainly cash-flow) without changing the incentive for new investment do not generally induce much new hiring or production, because these types of incentives do not alter the conditions of the pre-incentive investment equilibrium.

Two studies have attempted to quantify the impact of cash-flow incentives. According to the Sinai study, instituting repatriation provisions similar to those in the American Jobs Creation Act would improve the net cash-flow of participating companies by approximately $535 billion in 2009. The Congressional Budget Office (CBO) estimates that the stimulative impact (or multiplier) of a specific cash-flow proposal, for loss carrybacks, at between 0 and 40 cents of GDP per tax dollar not received.[7] This range of the stimulative effect for loss carrybacks should likely be viewed as an upper-bound estimate for the cash-flow effect of a repatriation rate reduction. This follows from the observation that corporations with current losses─ and thus having losses to carryback─ are more likely to be cash constrained and able to benefit from a cash-flow provision than the relatively large multination corporations that are likely to have a better cash-flow position. (By contrast, CBO sets the multiplier for federal spending at 1 to 2.5, for transfer payments at 0.8 to 2.2, and for individual tax cuts at 0.5 to 1.7.)[8]

Which category of incentive a reduction in the tax on repatriated earnings belongs in depends upon the degree to which repatriated earnings change the incentive for new investment. This in turn depends upon the degree to which the reinvestment plan compels investment. Given a weak

[7] U.S. Congress, House Committee on the Budget, *The State of the Economy and Issues in Developing an Effective Policy Response*, The Economic Outlook and Budget Challenges, 111th Cong., 1st sess., January 27, 2009.

[8] The CBO multipliers are similar to those used by other forecasters. See CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte for a complete discussion on multiplier effects.

focus of the reinvestment plan, economic theory suggests that it is likely that a reduction in the tax on repatriated earnings falls into the less stimulative category.[9]

Empirical analyses of the stimulative effects of the repatriation provisions in the American Jobs Creation Act also suggests a limited stimulative impact from the provisions. They conclude that much of the repatriated earnings were used for cash-flow purposes and little evidence exists that new investment was spurred.

Several analysts have used public data sources, such as annual reports and press releases, to report the subsequent actions of participants in the American Jobs Creation Act, primarily firms that repatriated but also reduced employment, a sign that the scale of domestic operations was not increasing. In **Table 1** we summarize selected information from these reports for these firms. Taken together, the firms identified in **Table 1** account for nearly one-third of all repatriations under the American Jobs Creation Act. In general, two trends emerge from these analyses: (1) corporations that utilized the repatriation provisions were unable to expand domestic operations and (2) corporations in several industries appear to have increased their rate of repatriations after the expiration of the repatriation provisions. These event studies, while informative, are not able to imply any causal relationship between use of the repatriation provisions and subsequent firm responses, since they are unable to compare the response with an alternative response in the absence of utilization of the repatriation provisions. They also cannot be generalized to other firms.

Table 1. Selected Information on 12 Corporations that Utilized the Repatriation Provisions in the American Jobs Creation Act

Company	JOBS Act Repatriation Amount ($ Billions)	Jobs Lost in 2005-2006	Pre-JOBS Act Accumulation of Foreign Earnings (two years, $ Billions)	Post-JOBS Act Accumulated Foreign Earnings ($ Billions)
Pfizer	37	10,000	67	101
CitiGroup	3.2	n/a	9	35.8
Merck	15.9	7,000	33	29.7
Hewlett-Packard	14.5	14,500	28.9	23.7
Proctor & Gamble	10.7	unspecified # lost	24.7	54
IBM	9.5	n/a	34.7	33
PepsiCo	7.5	200-250	16.3	25.5
Motorola	4.4	unspecified # lost	13.7	8.1
Honeywell	2.7	2,000	5.5	7
Ford	0.9	30,000-40,000	n/a	n/a

[9] Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, "The Unintended Consequences of the Homeland Investment Act: Implications for Financial Constraints, Governance, and International Tax Policy," unpublished working paper, September 2008; Roy Clemons and Michael R. Kinney," An Analysis of the Tax Holiday for Repatriations Under the Jobs Act," *Tax Notes*, August 25, 2008, pp. 759-768; and Jennifer Blouin and Linda Krull, "Bringing it Home: A Study of the Incentives Surrounding the Repatriations of Foreign Earnings Under the Jobs Creation Act of 2004," Unpublished Working Paper, Wharton School and University of Oregon, July 2008.

Company	JOBS Act Repatriation Amount ($ Billions)	Jobs Lost in 2005-2006	Pre-JOBS Act Accumulation of Foreign Earnings (two years, $ Billions)	Post-JOBS Act Accumulated Foreign Earnings ($ Billions)
National Semiconductor	0.5	5 percent of workforce	n/a	n/a
Colgate-Palmolive	0.8	4,000	n/a	n/a

Sources: Columns 2 and 3: Lee A. Sheppard and Martin A. Sullivan, "Multinationals Accumulate to Repatriate," *Tax Notes*, January 19, 2009, pp. 295-298; and various media reports; Column 4: Sheppard and Sullivan .

Building upon the event study literature, a series of empirical econometric studies have concluded that the American Jobs Creation Act repatriation provisions did not increase domestic economic activity. Dharmapala et al. find that repatriations had a small and statistically insignificant impact both on domestic capital expenditures and employment.[10] Clemons and Kinney, similarly, are unable to find evidence that investment expenditures increased in corporations that utilized the repatriation provisions of the JOBS Act.[11] In summary, these studies both found the repatriation provisions to be an ineffective means of increasing economic growth.

There is some empirical evidence, however, that the repatriations were used to return money to shareholders though stock repurchase programs.[12] Dharmapala et al. found that a $1 increase in repatriations increased stock repurchases by $0.91, a use prohibited under the American Jobs Creation Act. (Note that because of the fungibility of money, firms that use part of the repatriation to repurchase shares may not violate the law). Clemmons and Kinney also concluded that the only significant increase in expenditures for participating corporations was on stock repurchases. Another study found similar results, estimating that 20% of the repatriation was used for stock repurchases.[13]

In contrast to these empirical studies, the simulations conducted in the Sinai study find that a temporary reduction in the tax on repatriated earnings would increase domestic economic activity in the 2009-2013 time period.[14] According to the simulation results, the reduction in the tax on repatriated earnings would increase gross domestic product (GDP) by an average of $62 billion per year, and business capital spending and research and development by an average of $7 billion per year. The study also finds an increase in employment that peaks at 614,000 additional jobs in 2011.

[10] Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, "The Unintended Consequences of the Homeland Investment Act: Implications for Financial Constraints, Governance, and International Tax Policy," unpublished working paper, September 2008.

[11] Roy Clemons and Michael R. Kinney, "An Analysis of the Tax Holiday for Repatriations Under the Jobs Act," *Tax Notes*, August 25, 2008, pp. 759-768.

[12] In addition to stock repurchases, increasing dividends are a way of returning money to shareholders. Given the temporary nature of the repatriation provisions, however, stock repurchases would be the expected vehicle to return money to shareholders, since they represent less of a commitment to ongoing distributions.

[13] Jennifer Blouin and Linda Krull, "Bringing it Home: A Study of the Incentives Surrounding the Repatriations of Foreign Earnings Under the Jobs Creation Act of 2004," Unpublished Working Paper, Wharton School and University of Oregon, July 2008.

[14] Allen Sinai, *Macro Economic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment*, Decisions Economics, Inc, Economic Studies Series, Dec. 11, 2008, http://www.accf.org/media/dynamic/3/media_304.pdf.

Exchange Rate Adjustments and Economic Stimulus

The stimulative effect of the reduced tax rate on repatriated earnings is expected to be muted by the international system of flexible exchange rates and, subsequently, by trade. This effect will occur, because as foreign denominated earnings of foreign subsidiaries are repatriated they are also converted to U.S. dollars. This result increases the demand for dollars which leads to an appreciation, or increase, in the price of the dollar in foreign exchange markets. This stronger dollar makes U.S.-made exports more expensive and foreign imports less expensive. As a result, U.S. exports would temporarily decline, further straining the economy and at least partially offsetting any stimulative effect of the repatriated earnings.

Author Contact Information

Donald J. Marples
Specialist in Public Finance
dmarples@crs.loc.gov, 7-3739

Jane G. Gravelle
Senior Specialist in Economic Policy
jgravelle@crs.loc.gov, 7-7829