



Tax Reform: Repatriation of Foreign Earnings

A 2016 report released by the U.S. Public Interest Research Group, Citizens for Tax Justice, and the Institute on Taxation and Economic Policy estimated that Fortune 500 companies held nearly \$2.5 trillion in accumulated profits offshore for tax purposes. Taxing these offshore profits has been discussed as a means to pay for several policy goals—including infrastructure investment and lowering corporate statutory rates.

Brief Summary of Current Law

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 paying 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 the firm's 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 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.

Repatriation Holiday in the American Jobs Creation Act

The American Jobs Creation Act (P.L. 108-357) permitted 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%. Credits for foreign taxes paid were reduced by a corresponding amount.

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

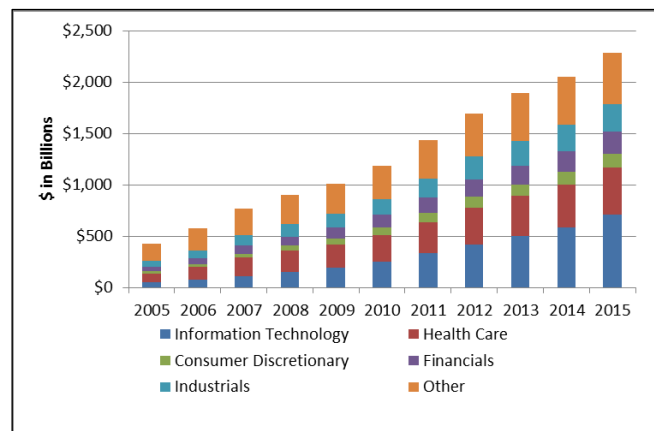
United States in a firm's books of accounts certified before June 30, 2003.

According to an IRS study of the provision, 843 of the roughly 9,700 eligible corporations took advantage of the deduction. 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.

The same IRS study also 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.

As shown in **Figure 1**, the accumulation of funds that could be repatriated since the 2004 repatriation holiday has been concentrated in the health care and information technology industries. Together these industries account for over 50% of the total funds overseas according to a Credit Suisse report.

Figure 1. Permanently Reinvested Foreign Earnings, 2005-2015



Source: David Zion et al., *Parking Lots of Cash and Earnings Overseas*, Credit Suisse Equity Research, March 11, 2016.

Selected Proposals

Stand-Alone Voluntary Proposals: Proposals were made in the 114th Congress that would have provided corporations the option to voluntarily repatriate previously untaxed earnings; apply reduced tax rates to these repatriations; and use the tax revenue to fund infrastructure

investment (S. 981), replenish the Highway Trust Fund (H.R. 625), reduce the national debt (H.R. 2225), or for other purposes (H.R. 3083 and H.R. 5158).

Mandatory Proposals as Part of Business Tax Reform:

The House- and Senate-passed versions of the “Tax Cuts and Jobs Act” would each impose a mandatory tax on deemed repatriations. The House-passed version would tax cash or cash equivalents at 14% and illiquid assets at 7%. The Senate-passed version would apply rates of 14.5% and 7.5%, respectively, and recapture the benefits of the reduced rates for any company that inverts within 10 years of the bill’s enactment.

Past proposals would have used a tax on unrepatriated foreign earnings as part of the transition associated with business tax reform. Both the Better Way (House Republican plan) released in June 2016 and the Tax Reform Act of 2014 (H.R. 1 in the 113th Congress) would have used a mandatory or deemed tax on unrepatriated earnings to assist the transition to new tax systems which would not tax overseas corporate profits. Under both proposals, existing unrepatriated earnings of U.S. firms’ foreign subsidiaries held in cash would be taxed at 8.75% and other earnings at 3.5%. The liability for this one-time tax would be payable over eight years.

Budgetary and Economic Issues

Budgetary Issues: Voluntary repatriation proposals have been scored by the Joint Committee on Taxation as reducing federal revenue. This loss occurs because some of the repatriated funds would have been repatriated normally within the budgetary window, but would have been taxed at the statutory rate of 35%. Each repatriated dollar that fits in this category generates a revenue loss equal to the difference between the statutory and reduced tax rate. According to a 2014 Joint Committee on Taxation estimate, a two-year repatriation holiday was estimated to reduce federal revenue by \$95 billion over 10 years. Voluntary holidays also may reduce revenue as they produce an incentive for companies to delay future repatriations in anticipation of future repatriation holidays.

Deemed repatriation proposals may raise revenue depending on how the provision is designed. Overseas earnings can be broken into two categories: those held in cash and those physically reinvested in overseas plant and equipment. According to Credit Suisse, the share held as cash could be as high as 45%. As a result, it is unlikely a deemed repatriation will raise significant revenue unless physically reinvested earnings are also taxed.

Economic Issues: Regardless of whether a tax on repatriated earnings is voluntary or mandatory, an

examination of the American Jobs Creation Act suggests any short-term stimulus would be limited. According to the CBO, an upper-bound estimate suggests a stimulus effect of 40 cents of GDP per tax dollar not received. This upper-bound estimate would be reduced to the extent that companies are not cash constrained and by flexible exchange rates.

A tax on repatriated earnings is also unlikely to significantly improve long-run economic growth. To see why, remember that economic growth can arise from growth in labor supply and/or growth in the capital stock. As a result, growth effects depend upon the degree that the tax would alter firm’s decisions to hire employees and invest. However, a report from the Heritage Foundation found that a

repatriation holiday would have little or no effect on investment and job creation... simply because the repatriating companies are not capital-constrained today. Any investment, any action that they would deem worthwhile today can be and is being financed by current and accumulated earnings.

Empirical analyses have found little to no discernible economic effects from the provisions in the American Jobs Creation Act. Studies using publicly available data sources—such as annual reports and press releases—to report the subsequent actions of participants in the American Jobs Creation Act generally concluded that much of the repatriated earnings were used for cash-flow purposes and found little evidence that new investment was spurred. Similarly, empirical econometric studies found the repatriation provisions to be an ineffective means of increasing economic growth (for example see Dhammika Dharmapala, C. Fritz Foley and Kristin J. Forbes, 2011. “Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act,” *Journal of Finance*, American Finance Association, vol. 66(3) and Mitchell A. Petersen and Michael Faulkender, 2012, *Investment and Capital Constraints: Repatriations Under the American Jobs Creation Act*, *Review of Financial Studies*, 25(11)).

This In Focus is part of a series of short CRS products on tax reform. For more information, congressional clients may visit the “Taxes, Budget, & the Economy” Issue Area Page at www.crs.gov.

Donald J. Marples, Specialist in Public Finance

IF10640

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.