Backgrounder

No. 2610
October 3, 2011

Published by The Heritage Foundation

Would Another Repatriation Tax Holiday Create Jobs?

J.D. Foster, Ph.D., and Curtis S. Dubay

Abstract: *U.S. companies that own foreign subsidiaries pay taxes abroad—and they often pay taxes again when the companies bring the earnings home—known as repatriation. This double taxation naturally hurts competitiveness at home and abroad, and encourages U.S. companies to leave these earnings abroad. A proposal to reduce the U.S. tax on profits previously earned—a repatriation tax holiday—is gaining momentum in Congress. This sequel to a similar 2004 holiday would, like its predecessor, have a minuscule effect on domestic investment and thus have a minuscule effect on the U.S. economy and job creation. Heritage Foundation tax policy experts J.D. Foster and Curtis S. Dubay explain why this tax cut would not be a step toward the sound policy of territoriality, and suggest a more useful step toward territoriality and fundamental reform that would strengthen U.S. competitiveness at home and abroad.*

A proposal for another repatriation tax holiday—reducing U.S. tax owed by U.S. companies on the accumulated earnings of their foreign subsidiaries for one year—is gaining congressional support. Keeping taxes low is a sound goal, but as with any policy the details matter. Congress passed a similar tax holiday in 2004, and produced the expected immediate results—the return of a significant amount of foreign earnings to the United States. This demonstrated, once again, the responsiveness of taxpayers, in this case multinational businesses, to changes in tax policies. However, the evidence is clear that these repatriations did not

Talking Points

- U.S. foreign tax policy diminishes American competitiveness at home and abroad, and encourages firms to leave earnings abroad after paying foreign tax rather than being subjected to additional U.S. tax.
- The repatriation tax holiday would provide relief to certain U.S. multinational companies on their accumulated foreign earnings and existing deferred tax liability in the hope of increasing domestic investment, and thus job creation.
- Repatriations would certainly follow, but, as a similar 2004 exercise demonstrated, the increase in domestic investment would very likely not. These companies are generally not capital-constrained and can already invest as much domestically as they choose.
- Congress should instead enact at least a partial exemption for future foreign earnings, thereby improving the competitiveness of U.S. companies at home and abroad and improving economic performance and job creation at home.

This paper, in its entirety, can be found at: *http://report.heritage.org/bg2610*

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

produce the hoped-for subsequent surge in domestic investment.

The current proposal would cut taxes, which is generally a good thing, but if another repatriation tax holiday were enacted, one should expect a similar result as last time; specifically, a surge in repatriations and little appreciable increase in domestic investment or job creation. The repatriation holiday would have little or no effect on investment and job creation, the key to the whole issue, 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. For those rare instances in which outside financing is needed, interest rates remain at historic lows and few if any of these repatriating companies are constrained. Adding to their financing abilities will not increase the opportunities for investment.

There is much that can and should be done to improve the domestic economy and the international competitiveness of America's multinational corporations. What is most needed is for Washington to adopt a policy of "do less harm," allowing families and businesses a respite from the uncertainties arising from constant policy shifts and the natural politician's need to "do something," even if that something only adds to business uncertainty. Thus, policies like stopping the regulatory onslaught and cutting budget deficits by cutting spending would be an important step restoring confidence in the private sector and allowing the economy to begin to grow again.

One positive action Congress could take would be to enact a substantial corporate tax rate reduction as part of a narrowly focused fundamental reform. Permanently improving the investment environment in the United States and making firms more competitive internationally would encourage more investment and would invigorate the recovery and strengthen the economy for the long run.

Another important reform would be to shift how the U.S. taxes its businesses operating abroad. Pending fundamental reform, policymakers should consider a more productive, intermediate step, such as a permanent partial exemption for future foreign-source earnings of all U.S. businesses. A forward-looking step toward territoriality—a system in which companies pay taxes at home only on profits earned at home—would have a far greater effect on U.S. domestic investment and the U.S. economy than a backward-looking tax holiday.

What is a Repatriation Tax Holiday?

A repatriation tax holiday waives some or all of the residual U.S. tax owed on the income earned abroad at some point in the past by U.S. companies' foreign subsidiaries. Under a system known as "worldwide taxation" this income is subject to tax first in the foreign jurisdiction and again in the United States if and when the earnings are returned via a dividend payment from the foreign subsidiary to the U.S. parent company. U.S. rules on international taxes are highly complex, but the essential issue is that additional U.S. tax is due on these repatriated earnings if the tax levied abroad is less than the tax levied in the United States.

In effect, under worldwide taxation the U.S. ensures that the income from foreign investment by U.S. corporations is taxed at least as heavily as the income from domestic investment. This longstanding and misguided policy is designed specifically to discourage foreign investment by U.S. firms in favor of domestic investment. Ostensibly intended to preserve U.S. jobs, worldwide taxation amounts to a tax-based form of protectionism that preserves neither jobs nor competitiveness.

One effect of worldwide taxation is that it discourages U.S. companies from bringing income earned abroad back to the United States. The payment of U.S. tax is deferred as long as the earnings belong to a foreign subsidiary and remain abroad, so, naturally, companies leave the earnings abroad if they can.[1] Certainly, in many, perhaps most, instances the U.S. parent company chooses to leave earnings overseas to finance overseas opportuni-

1. The earnings of other business forms, such as company branches, are subject to current U.S. tax whether the income is returned home or not. The deferral of U.S. tax is available only to U.S.-owned corporations operating abroad, known as controlled foreign corporations (CFCs).

ties anyway. In some instances, however, the parent company would bring these foreign earnings home were it not for the additional U.S. tax that would immediately be owed.

Ostensibly intended to preserve U.S. jobs, worldwide taxation amounts to a tax-based form of protectionism that preserves neither jobs nor competitiveness.

Faced with substantial demands for overseas financing and substantial U.S. tax owed if earnings are repatriated, a substantial pool of foreign earnings has built up over time. A repatriation tax holiday would deal with the United States' short-sighted worldwide taxation scheme with a one-time waiver of a portion of the residual U.S. tax. For example, the 2004 repatriation tax holiday allowed U.S. companies to deduct 85 percent of the earnings received from their foreign subsidiaries from their U.S. taxable income. Allowing this deduction effectively lowered the U.S. federal corporate tax rate on those earnings from a maximum of 35 percent to 5.25 percent.

One would certainly expect a large portion of these accumulated foreign earnings to be repatriated if the U.S. were to offer a tax holiday. Repatriating the earnings allows the company to reduce an accrued tax liability carried on the balance sheet, instantly improving the company's financial strength. Companies repatriated earnings with gusto in response to the 2004 repatriation tax holiday, and would do so again if offered the opportunity. Tax incentives matter. The policy question is which benefits to the economy might be expected to follow.

Would a Repatriation Tax Holiday Foreshadow True Territoriality?

One argument offered in support of a repatriation tax holiday is that it represents a step toward a better overall tax policy based on territorial tax principles rather than on the worldwide tax principles presently guiding U.S. tax policy.

A territorial tax system simply means a country only taxes income earned at home, leaving foreign governments to tax income earned in their countries. Territoriality would allow U.S. companies to compete on an even footing in foreign markets, not having to carry the combined burdens of the foreign tax and the residual U.S. tax.

Worldwide taxation was common among industrial nations for many years. Increasingly, other nations realized they had created an artificial barrier to the flow of capital, a barrier that harms their own companies and workers, much as an artificial barrier to the flow of goods and services harms their own companies and workers. Thus, just as they have moved toward freer trade in goods and services, many foreign countries have moved toward a more growth-friendly territorial approach to the taxation of foreign investment.

A common misconception surrounding worldwide taxation is that it protects the level of domestic investment by discouraging foreign investment by U.S. companies. In a global economy with globally integrated companies, this concept is badly antiquated. Domestic investment rarely competes with foreign investment opportunities. Rather, domestic companies compete with foreign companies in pursuit of foreign market opportunities. To the extent that a U.S. company is successful in a foreign market, it raises the competitiveness of the entire enterprise. Reflecting this economic synergy, a recent article in the *American Economic Review* found that a 10 percent increase in foreign investment is associated with a 2.6 percent increase in domestic investment.[2]

The movement toward territoriality is one of two instances in which foreign practice is clearly a good guide for U.S. policy (the other being the global drive toward lower corporate tax rates). The United States should follow the international lead in this case and adopt a territorial system in which foreign earnings are taxed solely in the foreign jurisdiction.

2. Mihir A. Desai, Fritz C. Foley, and James R. Hines, "Domestic Effects of the Foreign Activities of US Multinationals," *American Economic Journal: Economic Policy*, Vol. 1, No. 1 (February 2009), at *http://www.ingentaconnect.com/content/aea/aejep/2009/00000001/00000001/art00008* (September 27, 2011).

In this sense, a repatriation tax holiday highlights a true flaw in U.S. international tax policy.

But, eliminating the tax on already-earned foreign income under a repatriation tax holiday is quite different from eliminating U.S. tax on future foreign income of U.S. companies—adopting a territorial system. Territoriality eliminates a tax bias influencing *future* economic decisions primarily regarding international investment. A repatriation tax holiday is tax relief for the consequences of *past* decisions. Time travels in only one direction: Reducing the tax today cannot affect past decisions. The key to improving economic performance lies with future decisions, not past consequences.

Capital Constraints Necessary for Repatriation Holiday to Raise Investment

Though a repatriation tax holiday is not a step toward territoriality, aside from cutting taxes for the sake of cutting taxes the policy might make sense if it were to produce sufficiently powerful economic benefits, such as substantial increases in domestic investment. The U.S. economic recovery remains very weak and threatens to stall entirely, job growth is non-existent, and unemployment is still high and threatens to rise. The moment is propitious for sound policies that could give the economy a real boost. The repatriation tax holiday produced little if any such effects last time and promises little if repeated because money is fungible, capital is plentiful, and domestic investment incentives remain unchanged.

The unstated assumption behind the domestic investment argument for a repatriation tax holiday is that the companies in question are somehow capital-constrained—that, for some reason, they have inadequate access to capital. Indeed, one analytical study proponents often cite in support of a repatriation tax holiday includes this idea of a credit constraint in its title: "Macroeconomic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a *Credit- and Liquidity-Constrained Environment*" (emphasis added).[3]

One might have argued the U.S. companies in question were liquidity- or credit-constrained during the height of the past financial crisis when credit markets were functioning poorly, but not today. Credit markets are operating reasonably normally, providing credit and equity as needed to companies in search of capital.

Territoriality eliminates a tax bias influencing future economic decisions primarily regarding international investment. A tax holiday is tax relief for the consequences of past decisions.

In fact, few if any such companies are looking for substantial additional capital to invest in new production facilities, since they have substantial domestic earnings (over $1.5 trillion in after-tax net profits in the second quarter at an annualized rate),[4] even greater accumulations of cash balances and short-term security holdings, and relatively modest investment demands (business investment remains 12 percent below the pre-recession peak)[5] because the economy continues—and is expected to continue—to operate with substantial excess capacity for years to come. (Capacity utilization stood at 75.5 percent in July of 2011 compared to 81 percent in 2007, while the unemployment rate remains above

3. Allen Sinai, "Macroeconomic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment," Decision Economics, Inc., January 30, 2009, at *http://www.accf.org/media/dynamic/3/media_316.pdf* (September 27, 2011).
4. See "National Income and Product Accounts," Table 11 ("Corporate Profits: Level and Percent Change"), Bureau of Economic Analysis, Department of Commerce, August 26, 2011, at *http://www.bea.gov/newsreleases/national/gdp/2011/pdf/gdp2q11_2nd.pdf* (September 27, 2011).
5. "National Income and Product Accounts," Table 3 ("Gross Domestic Product and Related Measures: Level and Change From Preceding Period"), Bureau of Economic Analysis, Department of Commerce, August 26, 2011, at *http://www.bea.gov/newsreleases/national/gdp/2011/pdf/gdp2q11_2nd.pdf* (September 27, 2011).

9 percent compared to a full employment rate of between 5 percent and 5.5 percent.)[6]

Healthy companies in need of external capital have ready access to capital at very low cost. Sufficient, cheap supply and a limited demand for additional investment capital is not the environment in which an influx of capital from abroad would remedy a capital constraint or lead to a surge of domestic investment.

What Corporate Supporters Say

Corporate supporters of the repatriation tax holiday have rallied behind an organized campaign appealingly called "WinAmerica," complete with Web site.[7] The Web site presents a number of arguments and an extensive list of examples purportedly demonstrating how some companies were able to undertake economically beneficial action after bringing foreign earnings home following the last repatriation tax holiday. The list is extensive, and impressive, but under inspection it falls far short of convincing because, in each case, the proponents cannot argue the company in question was capital-constrained.

The first example cites Oracle, a Fortune 100 business software company based in California that was able to use repatriated funds "to outbid foreign competitors to acquire two companies." The two purchased companies were both based in the United States. The statement on the WinAmerica Web site concludes that Oracle's acquisition led to increased hiring and kept its intellectual property at home.

The first element of this example argues that Oracle used repatriated funds to acquire the U.S. companies. But if these purchases were worthwhile, would Oracle have been unable to acquire the companies using domestic earnings, perhaps combined with other external capital sources? Was, or is, Oracle today capital-constrained? No. In fact, Oracle reported $4.7 billion cash on hand at the end of 2003 with total expenses of $6 billion, and was paying a modest 3.38 percent in interest on notes payable three years later.

Certainly, the acquisitions were made, but no evidence is presented that Oracle could not have completed the transaction without the financing made possible by repatriating foreign earnings. Such evidence would have to begin by demonstrating how Oracle was otherwise capital-constrained because of inadequate domestically generated free cash flow and an inability to raise funds in capital markets on reasonable terms. With nearly $5 billion cash on hand at the time, this would be a tough argument to sell.

The second element of the Oracle example attempts to assert that the acquisitions by Oracle had economic benefits. Oracle claims the acquisitions increased jobs at the firms it acquired. At the time of the purchases, the U.S. economy was growing, so one would expect employment growth at successful firms. If growth opportunities were extant, one would also expect that a foreign acquirer would have increased employment at the firms, as well. Would employment have stagnated or shrunk if the foreign suitors had acquired the firms acquired by Oracle? Possibly, but unlikely, and one will never know for certain. But it is far more likely that these foreign suitors saw the same potential for growth that led Oracle to make the winning bid.

It is, of course, impossible to prove whether the purchases by Oracle did or did not lead to more hiring than otherwise would have occurred. However, one ought not readily accept such claims unless the circumstances warrant. Again, the point hinges on the first dubious element that Oracle was capital-constrained and that, thus, the acquisitions were only possible using repatriated earnings.

A second example offered by WinAmerica is that Qualcomm, a California-based wireless technolo-

6. "Industrial Production and Capacity Utilization–G.17," Board of Governors of the Federal Reserve System, Table 7 ("Capacity Utilization"), September 15, 2011, at *http://www.federalreserve.gov/releases/g17/current/default.htm* (September 27, 2011), and press release, "The Employment Situation—August 2011," Bureau of Labor Statistics, September 2, 2011, at *http://www.bls.gov/news.release/pdf/empsit.pdf* (September 27, 2011).

7. For the list of examples of how American businesses used repatriated funds, see WinAmerica, "Resources: Myths vs. Facts," at *http://www.winamericacampaign.org/myth-vs-fact/* (June 15, 2011).

gies firm, repatriated $500 million, "which was used to assist in new acquisitions and the hiring of 8,200 workers." As with Oracle, the first question must be: If these acquisitions were worthwhile, was Qualcomm—a large, successful, profitable company—so short of internal domestic funds and so excluded from credit markets at the time that worthwhile investments, acquisitions, or hiring would not have occurred without the repatriation of foreign earnings? The answer is "almost certainly not," and thus the entire argument for repatriations again falls.

What Really Happens to Repatriated Earnings

Were Congress to enact another repatriation tax holiday, companies would almost certainly take advantage of the opportunity to slash their tax bills and strengthen their balance sheets by repatriating large sums. Businesses respond to shifts in tax policy—and a repatriation tax holiday is a large incentive to act.

Congress passed the first repatriation tax holiday in 2004, accompanied by similar arguments regarding the expected surge in domestic investment. As expected, the tax holiday resulted in a large number of companies repatriating their earnings. According to a study by the Internal Revenue Service, 842 of the 9,700 businesses with foreign subsidiaries transferred a total of $362 billion from their foreign subsidiaries to their U.S. parent companies.[8]

The evidence clearly shows that repatriated earnings in 2004 did not increase domestic investment, job creation, or research and development.

The evidence clearly shows that these repatriated earnings did *not* increase domestic investment, job creation, or research and development (R&D).[9] As the authors of the leading paper on the subject concluded in 2010, "repatriations did not lead to an increase in domestic investment, domestic employment, or R&D."[10] The authors continued:

> Instead, estimates indicate that a $1 increase in repatriations was associated with a $0.60–$0.92 increase in payouts to shareholders—despite regulations stating that such expenditures were not a permitted use of repatriations qualifying for the tax holiday. The results indicate the U.S. multinationals were not financially constrained and were reasonably well-governed. The fungibility of money appears to have undermined the effectiveness of the regulations.

If companies that repatriate earnings do not invest those earnings in additional productive capacity or additional R&D in the United States, what happens to the money? There are many possibilities, and each company has its own story. In some cases, companies "round-trip" the money: Able to finance their capital needs adequately at home, they repatriate the funds to the United States, thereby reducing the deferred tax liability on the parent company balance sheet (the tax windfall), and then ship the cash overseas again to wherever it is needed.

Some repatriating companies may use the cash to declare a special dividend, paying out cash to shareholders. Others may buy back shares, which is effectively the same thing. The Dharmapala study noted above found that more than half the repatriated earnings were paid out to shareholders. Another study found that a firm was *more* likely to repatriate earnings if it had more free cash flow relative to its investment opportunities—it was more likely to repatriate if it was less likely to be capital-con-

8. Melissa Redmiles, "The One-Time Received Dividend Deduction," Internal Revenue Service *Statistics of Income Bulletin*, Spring 2008, at *http://www.irs.gov/pub/irs-soi/08codivdeductbul.pdf* (September 27, 2011).

9. Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, "Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act," National Bureau of Economic Research *Working Paper* No. 15023, June 2009, at *http://www.nber.org/papers/w15023* (September 27, 2011), and Michael Faulkender and Mitchell Petersen, "Investment and Capital Constraints: Repatriations Under the American Jobs Creation Act," National Bureau of Economic Research *Working Paper* No. 15248, August 2009, at *http://www.nber.org/papers/w15248.pdf* (September 27, 2011).

10. Dharmapala, Foley, and Forbes, "Watch What I Do, Not What I Say."

strained. This study further found that such companies were more likely to repurchase shares as a way of distributing its repatriated earnings than invest it in the U.S.[11]

Of course, paying shareholders more dividends is generally a good thing, and there is nothing wrong with buying back shares. Neither course of action will harm domestic investment or the economy. But all that has happened in the end is that the company's asset base has declined slightly along with its deferred tax liability, and the shareholders have a bit more cash and lower share prices in the event of a dividend, or slightly higher share prices under a share buyback program. In short, the companies received an unexpected tax break and the shareholders saw a shift in their portfolios. But these events did not create jobs.

Another possibility is that the companies could use the extra cash from repatriating foreign earnings to buy other companies, as Oracle claims. Again, there is nothing wrong with corporate mergers. On the contrary, the buying and selling of companies in this way is an important source of flexibility and competitiveness as U.S. firms apply resources to greatest advantage. However, unless the company was capital-constrained and needed the repatriated earnings to finance the purchase, the repatriation was not necessary to allow the purchase to go forward. The options available to repatriating companies are many, but the one option few, if any, pursued last time, or would pursue today, is to increase domestic investment in new production facilities or R&D.

A Better Alternative

One goal of tax holiday proponents is to take a step away from worldwide taxation toward territoriality. They are right to want to fix this misguided, protectionist policy hampering the competitiveness of U.S. businesses and driving them to make decisions based on Washington's curious behavioral preferences, rather than sound investment strategies. So, rather than a temporary tax holiday, a better approach would be to consider a step toward permanent, forward-looking territoriality. In practice, territoriality may be achieved simply by allowing companies an explicit exemption for some or all of their repatriated earnings.[12] Thus, in lieu of a tax holiday, policymakers might consider allowing some percentage, perhaps 10 percent or more, of future foreign earnings to be permanently exempt from U.S. tax as a starting point.

A permanent, partial exemption would be an important step toward full territoriality. In contrast to a one-time repatriation tax holiday, a permanent partial exemption would prospectively alter the incentives for U.S. companies to engage in international commerce. These companies would be more competitive in global markets, enhancing their incentives to invest more at home and abroad.

Focus on Real Reforms

The repatriation tax holiday proposal is built on three arguments, only two of which are explicit. The first argument is that many U.S. companies generate large amounts of foreign earnings through their foreign subsidiaries, on which heavy U.S. tax would be due if the funds were brought home. Of this, there is no doubt.

The second argument is that these companies would substantially increase their domestic investment if they could repatriate some of their already accumulated foreign earnings. This is unlikely, especially in light of the 2004 experience and the weakness of the nation's economy today.

In between these two explicit arguments lies the third, implicit, argument that the companies in

11. Jennifer L. Blouin and Linda K. Krull, "Bringing it Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004," Social Science Research Network, July 21, 2008, at *http://ssrn.com/abstract=925348* (September 27, 2011).

12. The justification for a partial exemption is that companies typically incur some domestic expenses in the production of foreign income. An obvious example is the expenses associated with domestic corporate headquarters. Rather than fall back on cumbersome sourcing rules, it is generally simpler to apply a modest "haircut" to the exemption amount, allowing an exemption of 90 percent or 95 percent of foreign income rather than the full 100 percent.

question have inadequate access to capital and that it is this lack alone that prevents companies from undertaking the full amount of investment they would prefer. There is no evidence that U.S. multinational corporations are capital-constrained today, just as there was none in 2004. Thus, since there is no domestic need for additional capital resources, the repatriation tax holiday would not produce a surge in domestic investment. Instead, it would likely have the same effects it did in 2004—backward-looking tax relief for international companies and their shareholders, but little in the way of new investment, economic growth, or job creation.

In his March 23, 2011, blog post on the subject, Assistant Treasury Secretary for Tax Policy Michael Mundaca correctly observed that "Comprehensive [tax] reform can be done. We should not allow ourselves to be distracted from that goal."[13] Policymakers should focus on fundamental reforms, like lowering the corporate tax rate and permanently moving toward territoriality for future earnings. Job growth will be sure to follow.

*—**J. D. Foster, Ph.D.**, is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies, and **Curtis S. Dubay** is a Senior Analyst in Tax Policy in the Roe Institute, at The Heritage Foundation.*

13. Michael Mundaca, "Just the Facts: The Costs of a Repatriation Tax Holiday," Treasury Notes, March 23, 2011, at *http://www.treasury.gov/connect/blog/Pages/Just-the-Facts-The-Costs-of-a-Repatriation-Tax-Holiday.aspx* (September 27, 2011).