IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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LET COMPANIES REPATRIATE THEIR FOREIGN INCOME

Current tax law impedes the repatriation of foreign earnings of U.S. multinational corporations. Firms are reluctant to bring home profits in excess of amounts protected by foreign tax credits. Those credits are getting scarcer, because, over time, foreign countries have reduced their corporate tax rates. The United States now has the second highest corporate tax rate in the 30 member Organization for Economic Cooperation and Development (OECD). The result is that repatriated profits face higher add-on U.S. taxes if the income is brought home. It is poor economic and tax policy to put up tax barriers to the free flow of capital and to discourage investment in the United States.

On October 1, the Senate Finance Committee reported out a bill (S. 1637) to repeal the Extraterritorial Income deduction (ETI) that was ruled illegal by the World Trade Organization (WTO). On October 29, the House Ways and Means Committee approved its own version (H.R. 2896). (ETI replaced the old Foreign Sales Corporation (FSC) export subsidy that also ran afoul of the WTO.) Both bills use the revenue from repealing the deduction to reduce business taxes. The Senate ETI bill includes a variant of the "Homeland Investment Act" which would temporarily allow U.S. multinational corporations to repatriate foreign profits at a reduced tax rate of 5.25% on dividends paid by a foreign subsidiary to its U.S. parent. The Ways and Means Committee considered a similar provision with a 7% tax rate, but dropped it to trim costs.

The Senate ETI bill ... would temporarily allow U.S. multinational corporations to repatriate foreign profits at a reduced tax rate of 5.25%... A study by JPMorgan Securities concludes that about $300 billion of "trapped" foreign source past profits might be repatriated ... increasing investment spending in the United States and raising GDP by half a percentage point.

These special tax rates may seem low compared to the U.S. corporate tax rate of 35%, but most foreign source corporate income is subject to foreign income taxes. The foreign tax credit reduces the residual U.S. tax to low single digits (about 3.7% in 1999 according to IRS data). Some companies, however, have exhausted their foreign tax credits, or cannot access them due to various restrictions on their use, and leave substantial earnings abroad to avoid the full U.S. tax. Luring that income home, even at a reduced tax rate, would raise revenue. A study by JPMorgan Securities concludes that about $300 billion of "trapped" foreign source past profits might be repatriated under the Homeland provision, increasing investment spending in the United States and raising GDP by half a percentage point. That is over $50 billion dollars a year in added U.S. output and income, on which the federal tax take would run about $10 to $12 billion a year. That tax feedback may seem like a small number, but it *annually* dwarfs the projected JCT ten year revenue loss. Alternatively, it is over 25% of the projected annual federal subsidy of the proposed prescription drug benefits under Medicare. These benefits are well worth going after.

Tax economists may dispute such investment gains, pointing out that "money is fungible" and there are already ways to tap unrepatriated profits without paying U.S. tax. For example, a firm could deposit the profits in a foreign branch of a multinational bank as proof of creditworthiness, and borrow a similar amount from the bank's U.S. branch. Alternatively, a firm with subsidiaries in both low tax and high tax foreign countries could repatriate all proceeds from the high tax country operation, and then replenish that subsidiary's working capital with a transfer of unrepatriated earnings from the low tax country subsidiary.

In the real world, however, such arrangements have costs. The offsetting bank deposits approach means that the firm would have to pay a loan origination fee and interest to borrow its own money back. Also, the foreign deposit could not be used as formal collateral, or it would be deemed a repatriated dividend subject to tax, so the bank would probably charge a higher interest rate for added risk. The high and low tax country gambit requires the company to maintain operations in a high tax jurisdiction that it might prefer to avoid.

If a FSC-ETI fix comes to a House-Senate conference, the repatriation provision should be part of the final bill.

With net-of-tax real returns to capital on the order of 3%, even a fraction of a percent of added cost can cut the value of a potential investment by enough to kill it. The Senate repatriation provision would lower the cost of obtaining funds to invest in the United States. Therefore, although the net increase in domestic investment might not match dollar for dollar the amounts projected in the JPMorgan study, the increase in investment would not be negligible.

The Joint Tax Committee scored the Homeland Investment Act (similar to the Senate provision) as costing about $4.4 billion over ten years, on a static basis. Initially, the bill is shown to raise revenue as the repatriated money is subject to tax. That effect — a modest revenue increase — is quite obvious and straightforward, and is probably the true "static" revenue result of the bill. However, the JCT goes on to assume that, in later years, the bill would cost more revenue than it first brought in, due entirely to the assumption that it would give firms hope for another amnesty in later years, causing them to delay future taxable repatriations. That assumption of future losses is pure speculation, and is highly suspect. Why? Significant future repatriations in excess of amounts protected by the foreign tax credit are highly unlikely to occur, especially if there is a residual U.S. tax, because investment opportunities are rising abroad.

China, with a fifth of the planet's population and heavily under-capitalized, is growing at about 7% a year. Russia, with a flat tax and huge natural resources, has just achieved "investment grade" according to Standard and Poors. India is liberalizing and is becoming a major high tech powerhouse. Much of the rest of Asia and Latin America is also moving toward free market economics, and will be growing apace. If this progress continues, these regions could profitably absorb all the future foreign profits of U.S. multinational companies for decades.

The repatriation proposal improves tax policy in that it moves, if only briefly, in the direction of a territorial tax. Under a territorial income tax, the United States would tax income earned here, and leave foreign source income to be taxed by the countries in which it is earned. That is the system generally used by other countries. It would be easier to enforce, requiring no tracking of foreign activity and no foreign tax credit. It would make American companies more competitive abroad, and would boost exports from U.S. suppliers to U.S. foreign subsidiaries. But that's for a future reform bill. Meanwhile, the repatriation proposal would probably raise U.S. tax revenue by shifting income to the U.S. and boosting domestic investment and GDP.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.