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The Corporate Financing Effects of the Temporary Tax Deduction for Repatriated Dividends

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Summary

With the intent of stimulating domestic investment and employment, the American Jobs Creation Act of 2004 included a provision under section 965 that allowed for a one-time tax deduction on repatriated dividends. In accordance with the law, qualifying repatriated funds were to be allocated to specific types of investment-related expenditures. However, since money is fungible, there is a question as to whether the law increased domestic investment spending or simply freed up cash that was to be allocated to investment, allowing corporations to increase other types of expenditures instead which were unrelated to capital investment and labor demand.

Drawing from the 10-k filings of about 60 repatriating corporations, this paper analyzes the effect of the tax deduction on five types of corporate expenses, only three of which were permitted uses of qualifying funds. I find that the temporary tax deduction coincided with an increase in share repurchases and dividend payments to shareholders, both expressly unpermitted uses of qualifying repatriations. I find no evidence of a boost to the approved expenses of research and development, capital investment, or long term debt repayments. This suggests that the Act was ineffective at stimulating domestic investment, merely freeing up cash for other uses.

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Introduction

The United States government taxes the income of the corporations that operate within its borders. This extends to the income earned abroad by their controlled foreign corporations (CFCs), defined as foreign corporations owned 50% or more by U.S. individuals and firms who each own at least a 10% stake. Thus, in contrast with most countries which have adopted territorial systems of taxation, the United States has a worldwide tax system and the repatriation of foreign earnings into the United States is a taxable event. To reduce double taxation, the Internal Revenue Service (IRS) grants foreign tax credits for income taxes paid abroad by CFCs and generally defers taxes on foreign income until it is repatriated if the affiliates are separately incorporated in foreign countries (Foley et al, 2007).

Since these taxes can be deferred, corporations earn a present benefit by accumulating such income abroad. Dividend repatriations are highly responsive to tax rates (see Graham et al, 2010b) and the current U.S. corporate tax rate of 39% minus any applicable foreign tax credits result in considerable "lockout"—the withholding of cash abroad. Since a lower tax rate in a CFC's country increases the cost of repatriation, taxes on repatriations incentivize corporations to retain a greater share of their earnings in low tax territories and to shift income to jurisdictions where taxes are low through their decisions on production location and transfer pricing (Foley et al, 2007). Desai et al. (2001) present evidence that repatriation taxes reduce dividend payments, resulting in efficiency losses that would disappear if foreign income was exempt from taxation. In an empirical study of such taxes using data from the Annual Survey of U.S. Direct Investment Abroad from 1982 through 1997, they find that a 1% lower repatriation tax results in 1% higher dividend repatriations, noting that repatriation taxes result in deadweight loss by reducing the volume and efficiency of financial flows between parent corporations and their foreign subsidiaries as cash is accumulated. Due to "the large implicit burden from large growing accumulations," Grubert and Altshuler (2013) propose eliminating the burden of the dividend repatriation tax.

In the hope that reducing the disincentive to repatriate foreign earnings would stimulate domestic spending, in 2004 the 108th Congress passed Public Law 108-357, the American Jobs Creation Act, also referred to as the Jobs Act or AJCA, which was signed by President George W. Bush. In passing the AJCA, the stated goal of policymakers was to increase incentives for corporations to increase domestic investment and create jobs in the United States. Bill drafter Rep. Phil English stated that his bill would create 600,000 jobs in 2005, Rep. David Wu argued that AJCA would "help create jobs," and Rep. Jo Bonner stated that the bill would aid "economic growth and job creation" (Pinson, 2011). Toward that end, included in the law was a provision known as section 965, "Temporary Dividends Received Deduction" which allowed for a temporary tax deduction on dividends repatriated to U.S. corporations from CFCs. In offering corporations a one-time 85% tax deduction on repatriated dividends, the AJCA reduced the effective tax rate on repatriations from 35% to 5.25%.

Following passage of the law, total repatriations jumped from about $45 billion in 2002 and 2003 and $58 billion in 2004 to a massive $363 billion in 2005, before declining to $72 billion in 2006 according to IRS Statistics of Income, Table 20—Returns of Active Corporations. In all, of about 9,700 US corporations that held CFCs in 2004, 843 corporations took advantage of the temporary deduction, repatriating over $361 billion of the $804 billion that they held abroad at the time; $312 billion of that qualified for the deduction—an average qualifying dividend repatriation of $370 million per corporation (Redmiles, 2008). Qualifying funds were to be allocated per a domestic reinvestment plan to be filed with the IRS to ensure that funds were spent on approved investments. However, numerous studies ex post find that repatriations did not boost investment financing. Given that money is fungible, it may have been the case that corporations allocated qualifying repatriations to investments that were already planned, then spending newly freed-up cash on unapproved uses not related to investment.

This research project joins a growing body of literature in analyzing the effect that section 965 had on its stated goal of stimulating approved domestic investment expenditures. In this paper, I test the hypothesis that qualifying repatriations under the AJCA boosted only unapproved corporate purchases by gathering cash flow expenditures from the balance sheets of about 60 corporations that took advantage of the temporary tax deduction. Together, they likely account for well over half of all qualifying repatriated dividends. The data includes 2000-2009 spending on property, plant and equipment, research and development, debt repayments, share repurchases, and dividend payments to shareholders, only the first three of these constituting approved uses of qualifying repatriations under the law. Through graphical analysis, I find that the temporary deduction for repatriated dividends had no discernable effect on the approved investments, temporarily boosting only share repurchases and dividend payments to shareholders. This finding suggests that Section 965 as written was ineffective in stimulating domestic investment.

Literature Review

Following the 2004 passage of the AJCA, U.S. companies that repatriated earnings from CFCs qualified for a one-time tax deduction under section 965, reducing the effective tax rate on repatriations from 35% to 5.25% before tax credits. The law was passed with the expressed intent of attracting cash to the U.S. to be spent on corporate investments and job creation. To ensure that repatriated funds would be spent as intended while also mitigating the anticipated revenue loss to the Treasury, lawmakers imposed several conditions on qualifying funds. From the *IRC 965 Dividend Repatriation Audit Guidelines*, Section 965(b) imposed four principle limitations on the dividends received deduction: Section 965(b)(1) capped the amount of the eligible dividend at $500 million or “the amount shown on the applicable financial statements as permanently invested outside the U.S.” Section 965(b)(2) limits the Dividend Repatriation Deduction (DRD) to certain extraordinary cash dividends in excess of average dividends and other distributions received during a base period of the five previous years ending June, 2003; Section 965(b)(3) reduces the dividends otherwise eligible for the DRD by any increase in the indebtedness of the CFC to any related person; Section 965(b)(4) requires that the U.S. shareholder claiming the DRD invest the amount of the dividend in the U.S. pursuant to a written domestic reinvestment plan (DRIP) adopted prior to the payment of the dividend for the full pretax amount of the repatriated dividends.

The DRIP was to be written to ensure that funds were allocated to such approved uses, such as: the hiring and training of workers; investments in capital and infrastructure; research and development; financial stabilization including debt repayments and funding benefit plans; some business acquisitions; marketing; and acquisition of intellectual property. Expenditures which were not permitted under the domestic reinvestment plan include: executive compensation; intercompany transactions; dividends and shareholder distributions; stock repurchases; portfolio investments; debt instruments; and tax payments (Redmiles, 2008). However, one shortcoming of the DRIP is that since money is fungible, qualifying expenditures that would have taken place anyway could be included in the domestic reinvestment plan, freeing up cash that could then be allocated toward unpermitted expenditures. If this occurred, repatriation would result in little or no increase in investments, boosting instead such expenses as executive compensation.

At the time the law went into effect, Clausing (2005) predicted that it would not generate new investment, citing already low interest rates, lack of evidence "that the United States is experiencing a shortage of investment capital," and citing Shepherd (2003), argued that the corporations most likely to benefit already enjoyed plentiful credit access. If firms had sufficient credit access and were already optimizing their behavior, an inflow of cash would not affect their investment decisions; only credit-constrained firms' investments might benefit from such inflows, with the remainder only exploiting an opportunity to purchase items further down their list of priorities. Faulkender and Petersen (2012) find that most funds that were repatriated through the AJCA tax deduction by capital constrained firms were in fact spent on domestic investments approved by the law, although these firms constituted a minority of all firms that took advantage of the law. Among the unconstrained firms, the authors observe reductions in employment and no increase in investment; no change in leverage or cash holdings is observed among both constrained and unconstrained firms. Blouin and Krull (2009) find that the firms that repatriated under the AJCA had lower than average investment opportunities and larger cash flows. Instead of allocating repatriated funds to investments, they find that these firms increased their share repurchases relative to nonrepatriating firms, but do not observe a significant increase in their payments of dividends to shareholders. Dharmapala et al (2010) find that repatriations coincided with increased payouts to shareholders, estimating that between 60 to 92 cents of every dollar repatriated went to payouts in 2005.

Brennan (2014) argues that share repurchases and dividend payments only accounted for a portion of each dollar that was repatriated under the law, and that the law thus did succeed in increased approved investments such as research and development, debt repayments, and so on. He argues that the upper limit per repatriated dollar that was spent on things not allowed by the law is 55 cents, estimating that among the twenty firms with the largest repatriations, 72 cents per repatriated dollar was spent on permissible investments including cash acquisitions, debt reduction, research and development, and capital expenditures, with the remaining 28 cents spent on share repurchases and dividend payments. He also finds that among 341 firms not in the top twenty, which together account for 37% of repatriations, at least 59 cents per repatriated dollar is spent on approved investments, with less going to research and development and cash acquisitions relative to the top twenty firms, but more going to debt repurchases and capital expenditures. This may be surprising since the top twenty firms in particular were "well-governed and were not subject to financial constraints," with Brennan hypothesizing that perhaps firms spent repatriated funds on approved investments as part of a long-term game with the government, hoping to encourage future tax holidays and other favorable laws, which they balanced against their desire to increase share repurchases and shareholder payouts in the present.

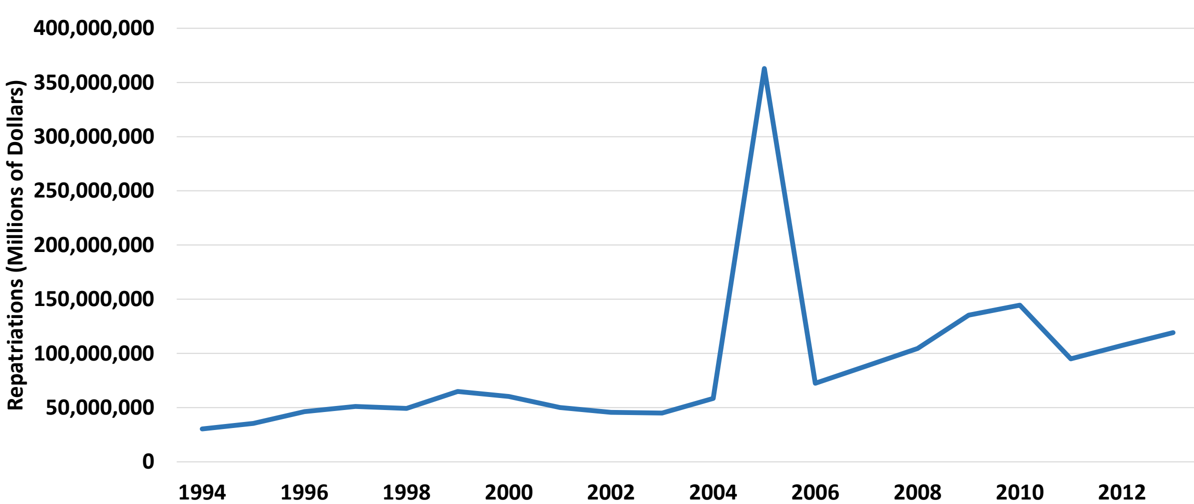
In a survey of tax executives, Graham et al. (2010a) find that the two most common uses of freed-up cash were debt repayments and share repurchases. They find that 75% of repatriated funds were drawn from holdings overseas, indicating a large lockout effect. Another 23% was from borrowed funds—some firms borrowed money to repatriate during the tax holiday. Clemons and Kinney (2008) find that only stock repurchases saw a significant increase in expenditures coinciding with the temporary tax deduction, with no statistically significant increase in capital purchases or research and development, suggesting that the law did not achieve its intended effect of increasing domestic investment. The authors note that this reveals both a lack of domestic investment opportunities and an ability for corporations to comply with the letter of the law while ignoring the spirit. According to a 2011 report by the Permanent Subcommittee on Investigations, companies that took advantage of the temporary deduction increased executive compensation and stock repurchases and cash holdings while downsizing workers and did not increase research and development spending; the top 15 corporations repatriated $150 billion but cut 20,931 jobs. Additionally, only 36% of respondents of a survey of CEOs acknowledged spending freed-up cash on additional capital investments (Graham et al, 2010a).

Looking forward, Pinson (2011) argues that a repeat of the temporary deduction "would further exacerbate the distortion in decision-making by creating an expectation among U.S. firms that those holidays would be a somewhat regular occurrence," resulting in moral hazard-driven cash hoarding as firms patiently waited for a repeat of the law which might have the effect of depressing domestic investment. He proposes instead "a separate, internationally competitive tax rate on foreign earnings." On the question of moral hazard, Brennan (2010) investigates whether firms increased the earnings permanently reinvested abroad after the law expired, presenting evidence that they have, more than offsetting the increase in repatriations stimulated by the temporary tax deduction. By this account, the AJCA was a short-term success in its ability to stimulate domestic investment in 2005 but might have been a long-term failure resulting in a net decrease in repatriations over a period of several years. However, Brennan notes that the increase seems to be driven in part by reclassification of foreign earnings as permanently reinvested income. He adds, "This reclassification may be an expedient way of relabeling funds so as to prepare to take advantage of a future repatriation tax holiday without needing to change behavior substantially." In fact, permanently reinvested earnings for the top 75 companies in the Fortune 500 have grown from $115 billion in 2000 to $250 billion in 2005 and $700 billion in 2010 (Kroh, 2012). Gauging the moral hazard question, Graham et al. (2010a) surveyed executives, finding that 29% estimate a 0 probability of a repeat of the law in the foreseeable future and 65% estimate that the probability is between 0 and .5, with only 5% of firms estimating better than even odds of a repeat. This suggests that moral hazard has not reduced domestic investment and that the only questions are whether the effect of AJCA on investment was positive or neutral and whether unapproved expenditures were also impacted. In the following section, I attempt to answer them.

Estimation of the Effects of Section 965

This paper seeks to determine whether the increased repatriations stimulated by section 965 of the AJCA were allocated to approved or unapproved uses of qualifying funds under IRS rules. According to data available in Returns of Active Corporations, Form 1120, Table 16 of the IRS, dividends received from foreign corporations for all industries jumped from $44.3 Billion and $55.8 Billion in 2003 and 2004, respectively, to an enormous $358.7 Billion in 2005.

Figure 1. Dividends Received from Foreign Corporations by Year
United States, 1994 – 2013



Source: IRS, Returns of Active Corporations, Form 1120, Table 16, for years 1994 through 2013

Total repatriations for the years 1994 – 2012 are shown in Figure 1 which clearly shows the 2005 spike in the context of typical annual repatriations. Since qualifying repatriations were to be allocated to investments, the spike may have contributed to a spike in investment spending. However, given the fungibility of money, this result is not assured. Corporations were free to spend repatriated dividends without proving that investment expenditures exceeded the amounts spent in previous years or that such expenditures were not already budgeted preceding the law's enactment (Pinson, 2011).

From Internal Revenue Bulletin 2005-6, expenditures considered investments under the AJCA include: funding of worker hiring, training, and other compensation; infrastructure and capital investments; research and development; financial stabilization of the corporation for the purposes of job retention or creation; acquisitions of interests in business entities; advertising and marketing expenditures; and intangible property. For the sake of clarity, IRS Notice 2005-10 specifies which expenditures are not permitted in the domestic reinvestment plans, including executive compensation, share repurchases, and dividend payments. Yet the permitted uses were sufficiently broad that corporations could meet the requirements of a domestic reinvestment plan without altering its planned expenditures (Pinson, 2011).

It seems reasonable to believe that corporations' income elasticities of demand for labor and capital are positive. Thus the impact of the law on investment financing is expected to be nonnegative and neutral at worst, even if some of the repatriated funds were allocated toward prohibited expenses such as executive compensation, dividend payments to shareholders, and share repurchases. Repatriated cash could either be spent or accumulated, so it is possible that repatriating firms did not see an increase in any expenditures, approved or disapproved.

Below, I estimate the capital financing effects of the AJCA based on the contemporaneous changes in several relevant expenditures: research and development, capital investment, share repurchases, dividend payments to shareholders, and debt repayments to determine whether Section 965 was positive, negative, or neutral in its effect on each. Data comes from corporations' 10-k filings, available at the U.S. Securities and Exchange Commission website. Corporate filings include Consolidated Statements of Cash Flows and list stock repurchases, debt repayments, dividend payments, research and development, and purchases of plants, property, and equipment (PPE) or capital expenditures more generally for 2000-2009. The list of repatriating companies for whom 10-k filings were obtained in the present analysis are drawn from the United States Senate Permanent Subcommittee on Investigations survey, "Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals" and from Brennan (2010). The firms that made the twenty largest repatriations accounted for 56% of total repatriated cash (Brennan, 2014), 15 of which are named by the Permanent Subcommittee on Investigations report, thus the present sample likely constitutes a majority of qualifying repatriations. The vast majority of corporations that participated repatriated their qualifying dividends in 2005.

Table 1: Determinations of Effects of Section 965

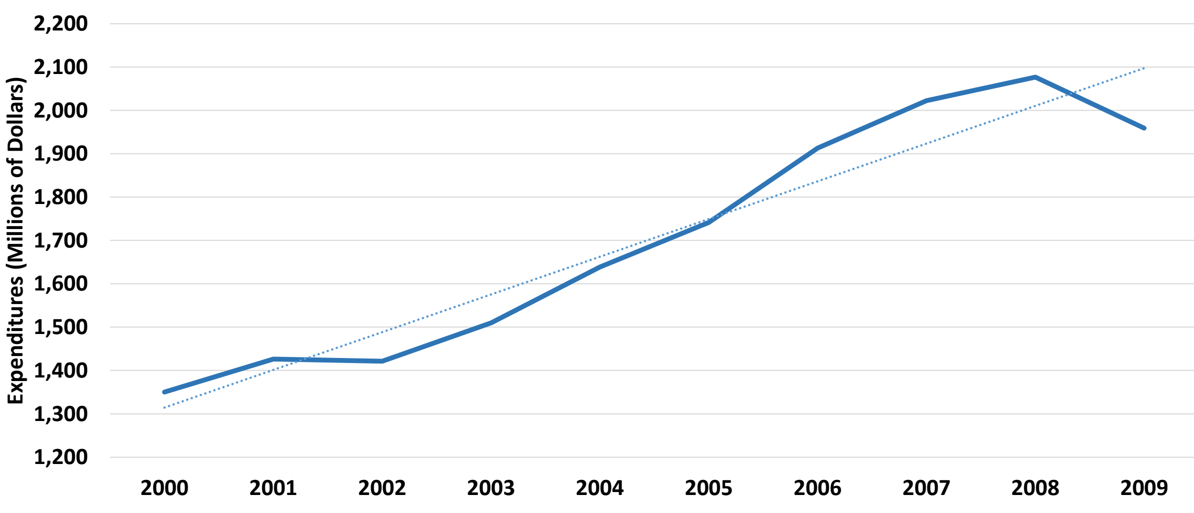
EXPENDITURE	APPROVED	EFFECT
Research and Development	Yes	Neutral
Property, Plant, Equipment	Yes	Neutral
Long-Term Debt Repayments	Yes	Neutral
Share Repurchases	No	Positive
Dividend Payments	No	Positive

With this data, I calculate the mean expenditures in each spending category by year for the decade. Graphical analysis is sufficient here to observe whether 2005 expenditures spike along with repatriations. Lines of best fit are included to assist in determining whether 2005 expenditures were impacted. A summary of this paper's conclusions is found in Table 1. In terms of investments approved by the IRS, this paper finds no evidence of stimulation of research and development, capital purchases, or debt repayments. Only the unapproved expenditures of share repurchases and dividend payments see an apparent boost following repatriation.

Research and Development

Repatriated dividends in themselves generate no growth effect. Their potential for growth lies only in the allocation of those repatriations to domestic investment activity. One of the IRS-approved expenditures for qualifying repatriations under section 965 was research and development (R&D) expenses. Such spending would generate growth by creating jobs and increasing productivity while producing new goods for consumers. To analyze the effect of the law on R&D, I gathered reported expenditures on R&D from 2000-2009, available in the 10-k filings and annual reports to shareholders of 53 corporations that participated in the one-time tax deduction. Note that not all companies in the sample listed R&D expenses in their annual reports. For example, McDonalds specifies that though they do conduct research, the expenses involved are not material. Banks also seemed to have no such expenses to speak of. Rather, manufacturing companies reported a large degree of R&D.

Figure 2. Mean Research and Development Expenditures by Year
United States, 2000 – 2009



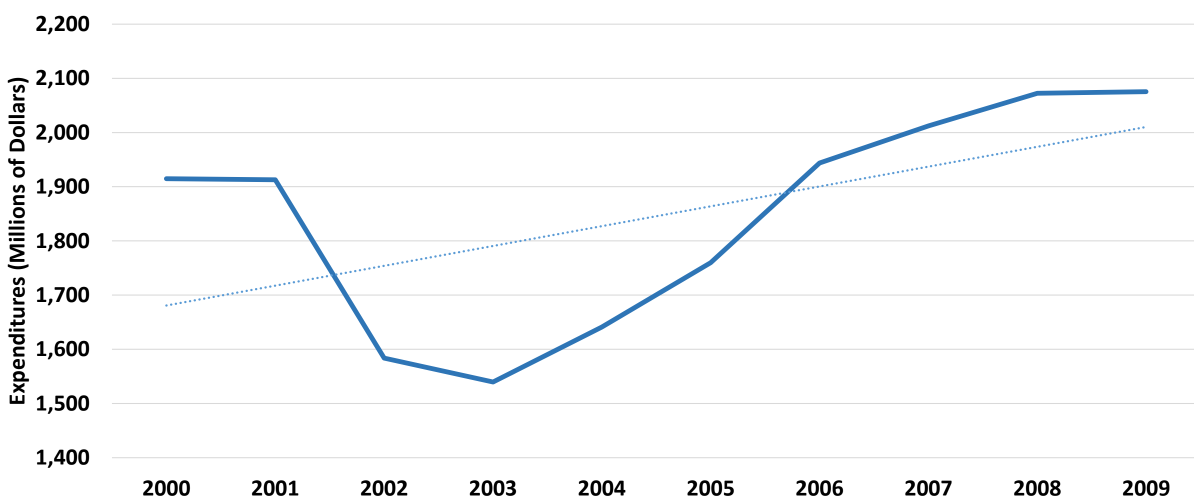
Source: Annual Statements of Corporations

Mean yearly R&D expenditures for the 53 companies that report such expenditures are reported in Figure 2. There does not seem to be a corresponding increase in R&D spending for 2005. Instead, R&D exhibits a slight S-curve pattern over the course of the decade with a noticeable dip following the economic crash of 2008. R&D expenses for 2005 are found precisely on the line of best fit for the decade. On this basis, the data reveals no evidence of a one-time increase in R&D expenditures in response to the law. The increase in repatriated dividends seems to have had no effect, neither positive nor negative. Although the lawmakers prefer a positive effect, the law seems to have also caused no harm with respect to R&D.

Capital Investment

Another approved allocation for qualifying repatriations was capital investment. Policymakers hoped that qualifying repatriations would be allocated to domestic spending projects, including property, plants, equipment, and other capital. However, there was also concern by some that there was no need to stimulate domestic capital purchases, that credit was plentiful, and that the lack of domestic investment represented not lack of access to liquidity but rather a lack of profitable investment opportunities.

Figure 3. Mean Property, Plant, and Equipment Expenditures by Year
United States, 2000 – 2009



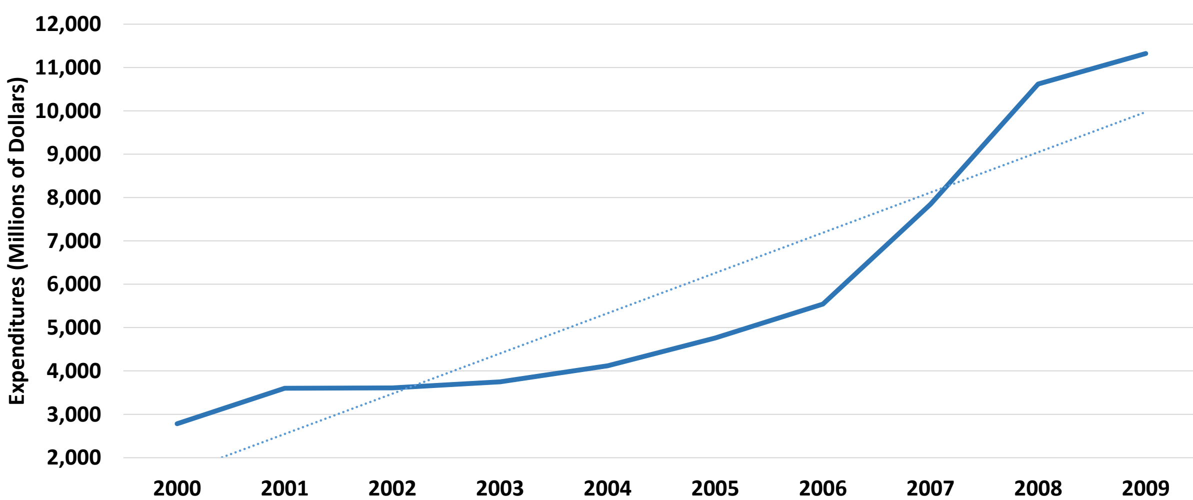
Source: Annual Statements of Corporations

To gauge the effect of the law on capital investment, I gathered reported expenditures on plant, property and equipment or on capital expenditures from 2000-2009, available in the 10-k filings and annual reports to shareholders of 62 corporations that participated in the one-time deduction. For each year, I calculated the mean capital expenditures. These are reported in Figure 3. As with R&D, there is no visual evidence of a spike in capital purchases in response to increase repatriations. Expenditures for 2005 seem to be exactly where expected as U.S. corporations rebounded from the economic slowdown early in the decade.

Debt Payments

Debt payments were an approved expenditure under section 965. To assess whether the AJCA had any effect on debt reduction, long term debt repayments were obtained from 10-k filings and annual reports to shareholders. I gathered reported expenditures on these payments from 2000-2009 for 59 corporations that participated in the one-time deduction. Mean long term debt repayments are graphed in Figure 4. These debt repayments seem to follow a smooth pattern throughout the decade. No impact of the law on these repayments is discernible. The slight uptick of 2005 continues the pattern of the previous two years and continues through 2006 and beyond even during the Great Recession.

Figure 4. Mean Debt Repayment Expenditures by Year
United States, 2000 – 2009



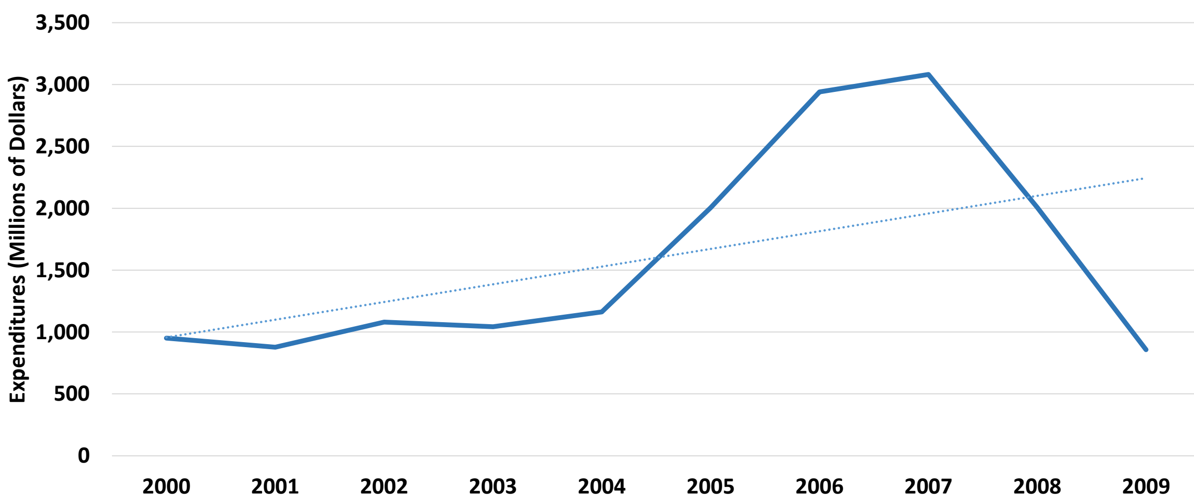
Source: Annual Statements of Corporations

Share Repurchases

Using qualifying repatriations to fund repurchases of stock shares was forbidden by the IRS. Yet since money is fungible, it is possible that repatriations were allocated to approved investment projects, freeing up cash that otherwise would have been spent on investment and reallocating it to disapproved purchases instead. Thus there is a theoretical basis for looking to see whether the law resulted in an increase in disapproved purchases such as stock repurchases.

Data for stock repurchases for treasury are drawn from about 60 repatriating corporations' annual 10-k filings available from the SEC. Listed in consolidated statements of cash flows, mean stock repurchases for treasury are graphed in Figure 5. It does indeed seem to indicate a large spike in repurchases occurring concurrently with the spike in repatriations of foreign earnings. On the one hand, the spike observed in 2005 continues in 2006 and 2007. However, this initial spike represented a tremendous deviation from the trend up to that point, where share repurchases trended up only slightly through 2004. After 2007, share repurchases collapse, falling to the lowest level of the decade in 2009 in the midst of the Great Recession. From this, it seems likely that repatriations partly funded share repurchases, spread over a three year period before the went back down to previous levels. This may be evidence that some repatriated funds were allocated to already-planned investment projects, freeing up cash for purchases that defied the spirit of the law.

Figure 5. Mean Share Repurchase Expenditures by Year
United States, 2000 – 2009



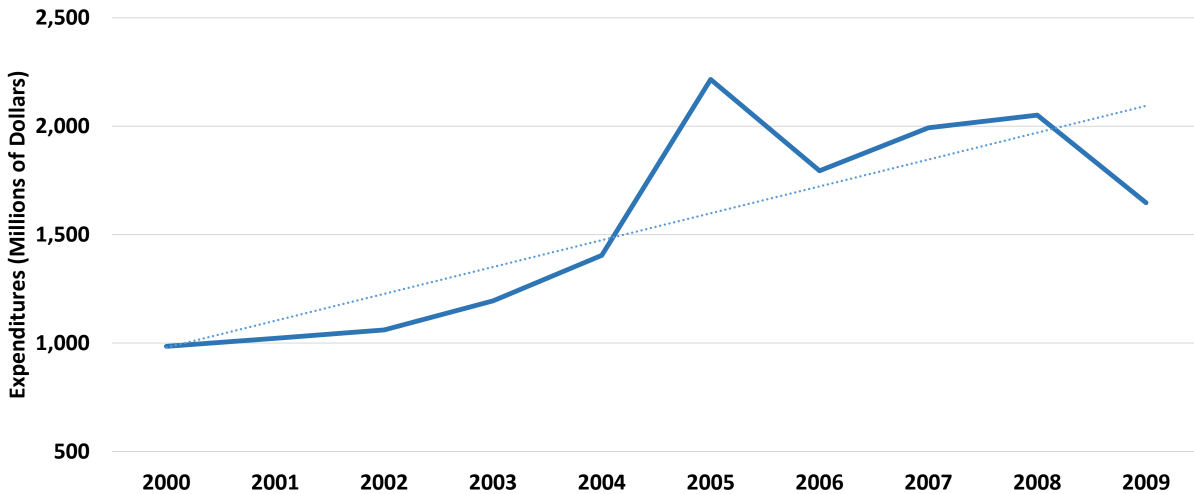
Source: Annual Statements of Corporations

Dividend Payments

Dividend payments to shareholders were not an approved expense under the law. However, like share repurchases, it is possible that companies used low-tax repatriations as an opportunity to make such purchases. Data on dividend payments to shareholders are drawn from 60 repatriating corporations' annual 10-k filings available from the SEC. Mean dividend payments for these corporations are graphed in Figure 6.

Here is the strongest graphical evidence so far that the law resulted in a spike in a specific category of expenses, revealing a sharp one-time increase in dividend payments coinciding with the increase in repatriations, which quickly returns to the decade's trend line the following year. It seems clear that the increase in repatriations stimulated by the law resulted in a large spike in dividend payments to shareholders in 2005. In one year, these payments increased by 50% before reverting back to the trend line, falling below it only in the aftermath of the 2008 economic crash.

Figure 6. Mean Dividend Payments to Shareholders Expenditures by Year
United States, 2000 – 2009

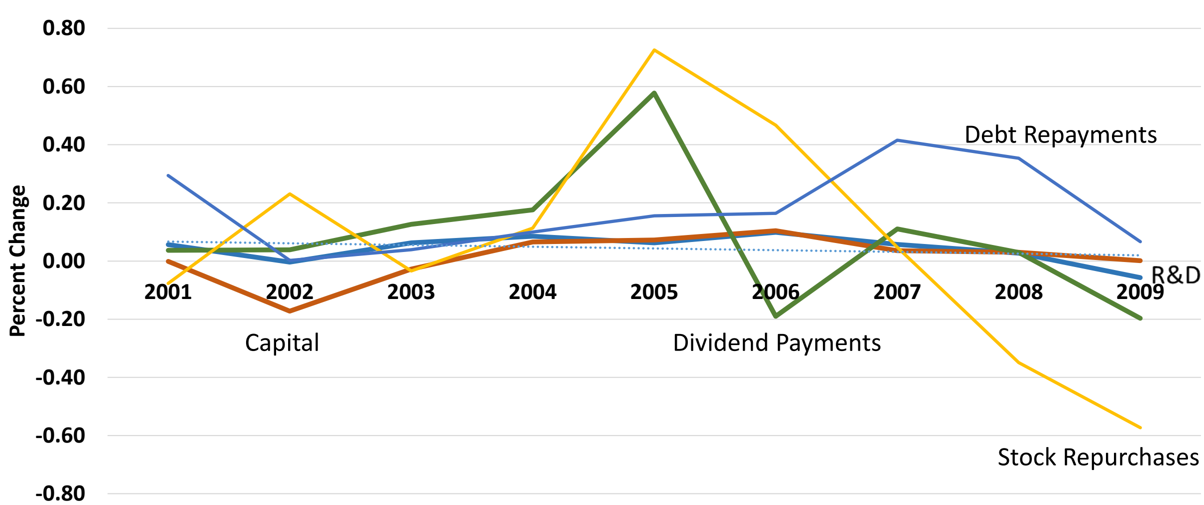


Source: Annual Statements of Corporations

All Expenditures

Figure 7 graphs the percent change in the above categories of expenditures for 2000 – 2009, revealing that the 2005 spike in repatriations only coincided with apparent spikes in stock repurchases and dividend payments to shareholders. No apparent change is seen in research and development, property, plant, and equipment, or debt repayments. On this basis, it would seem that the law had a minimal effect on capital investment.

Figure 7. Percent Change in Expenditures by Spending Category by Year
United States, 2001 – 2009



Source: Annual Statements of Corporations

Discussion

As part of the American Jobs Creation Act of 2004 (AJCA), Congress approved a one-time tax deduction of 85% on extraordinary dividends that U.S. corporations repatriated from controlled foreign corporations (CFCs). To qualify, corporations had to file a domestic reinvestment plan and the dividends could only be spent on certain investment expenditures. The law resulted in an explosion of repatriations from 2004-2006. In intention, these repatriations were to be allocated to job creation and capital investments. The present analysis suggests that it failed to stimulate the approved expenses of capital investment, research and development, or debt repayments, boosting only dividend payments to shareholders and share repurchases. These results are consistent with Blouin and Krull (2009), Graham et al (2010a), and Clemons and Kinney (2008) who find an increase in share repurchases, and with Dharmapala et al. (2010) who find an increase in payments to shareholders, but conflicts with several other studies finding an increase in investment activity. Based on the evidence presented above, a renewal of section 965 would likely have no effect on domestic labor demand or capital investment.

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About the Author

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