

Section 965
A Traditional Corporate Tax Policy Evaluation

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Introduction

The American Jobs Creation Act of 2004¹ dramatically reduced the tax on foreign subsidiary dividend payments to their United States parent companies. The Act created §965², a one-year deduction for repatriated earnings, effectively rewarding multinational corporations for having kept their assets overseas. The influx of earnings the provision's drafters expected to flow back to the U.S. as a result of the tax incentive justified the corporate tax break.³ By many accounts, §965 introduces perverse incentives into the tax code. Critics of §965 argue that the possibility of a future repatriation holiday encourages multinationals to hoard even greater profits abroad and lobby for their tax-free return.⁴ In the long run, §965 may exacerbate rather than mitigate the deferral of foreign source income taxation. So tax revenues will fall over time, because deferrals will increase.⁵ Worse than falling tax revenues is the possibility that foreign earnings retention will also undue any economic stimulus created by the tax holiday.

Now that §965 is set to expire and the repatriation taxes it triggered have been collected, its full impact is beginning to come clear. As part of the American Jobs Creation Act, §965 proposed to stimulate the economy, ideally to create jobs. The provision's critics have focused on its success in accomplishing those stated goals. This Article accepts those criticisms and instead looks to see if §965 can be defended with respect to other policy goals. Traditionally, corporate taxation had been justified as a limit on corporate management and opacity and as a revenue raiser. This Article argues that §965 may be defended as a revenue raiser, but further

¹ H.R. 4520, 108th Cong. (2004).

² Internal Revenue Code, 26 U.S.C. §965 [hereinafter I.R.C.].

³ See H.R. Rep. No. 108-548, pt.1 (2004).

⁴ See e.g., See Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 GEO. MASON. L. REV. __ (2007), on SSRN; Martin Sullivan

⁵ See Martin Sullivan, *Economic Analysis: U.S. Drug Firms Bring Home \$98 Billion*, 42 TAX NOTES INT'L 321 (Apr.24, 2006).

criticized as a means of regulating managerial power and increasing corporate transparency. Part I of this Article provides a basic overview of foreign profits tax deferral. Part II explains how §965 proposed to encourage repatriation and analyzes current data on its success. Part III presents the spectrum of criticisms of §965, paying special attention to the lessons learned by analogy to tax amnesties. Part IV explores the extent to which §965 implicates corporate tax policy makers' historical concerns, concluding that §965 provides some limited benefits in terms of short term revenue and transparency, but not enough to justify its long term costs.

PART I: Repatriation Before §965

A. Taxation of Foreign Source Income

Generally, the U.S. operates on a worldwide international tax system. In its most basic conception, the tax system attempts to tax all individuals and corporations in the U.S. on all their income, no matter where they earn it. This applies to a U.S. corporation's subsidiaries, or controlled foreign corporations (CFCs), as well. To prevent double taxation, the U.S. grants a non-refundable foreign tax credit for the amount of tax already paid to other countries. These basic principles were built into the tax code in the 1920's, when multinational corporate structures were still the exception not the norm. Today, corporations participate in global economies, and the old rules of international taxation have had to adjust accordingly. In the last ten years, annual CFCs' retained earnings have more than tripled.⁶ Subpart F, or Internal Revenue Code §§951-965⁷, determine the tax treatment of CFC income. Generally, Subpart F allows U.S. corporations to defer U.S. taxation of CFC profits as long as they remain overseas.

⁶ See Timothy Aepfel, *Break of Foreign Profits is Temporary, but will U.S. Companies Expect an Encore?*, WALL ST. J., Dec. 19, 2005, at A2.

⁷ I.R.C., 26 U.S.C. §§951-965.

In the meantime that income is still subject to the foreign jurisdiction's taxation. When those profits are distributed as dividends back to the U.S. corporation, they are subject to U.S. tax. The distribution of CFC income back to the parent corporation is called repatriation. Delaying taxation until repatriation is called a deferral. Under Subpart F, the repatriation deferral is subject to a few important exceptions.

First, the U.S. denies deferral for profits routed abroad, via related party transactions, simply to exploit tax benefits. So for instance, a U.S. company might try to route its distribution of a product through a low tax country like Bermuda for no business purpose but to avoid taxation. If the U.S. corporation were allowed to locate profits in Bermuda instead of the U.S., they could avoid paying income tax on those profits so long as the money stayed in Bermuda. Subpart F's foreign base company sales rules treat such a scheme as abusive and do not allow deferral.⁸ So related party transactions like transfer pricing and cost splitting, discussed in more detail below, are prohibited.

Second, the deferral is only available for active income. On the margins, the distinctions between passive and active income can become difficult to define. Generally, income from portfolio-type investments, not related to the controlled foreign corporation's primary business, are considered passive and ineligible for deferral.

Finally, insurance, financial services, and oil companies' CFC incomes are each taxed according to individualized rules, which allow limited deferral opportunities. These industries are treated differently for historic as well as regulatory purposes.⁹ For instance, financial services make a business out of transactions that would normally be characterized as passive investment. Any other company, participating in the same transaction, would be prohibited from deferring

⁸ I.R.C. §954.

⁹ I.R.C. §953.

taxation. Even if the tax code did allow a financial service company to defer taxation on some portion of its foreign investment profits, because money is fungible, such a transaction would be untraceable. Insurance companies present a similar problem, since they too are making a business out of liquid asset management. Moreover, because financial services, insurers, and oil companies are providing a public commodity, they have been subject to greater government scrutiny and regulation throughout the modern era, their tax treatment being yet another example. Despite these limitations on the opportunity to defer foreign income taxation, U.S. multinationals have devised a series of transactions to maximize their deferrals.

B. Maximizing Deferral: Profit Sharing and Tax Avoidance

The methods, by which U.S. corporations maximize repatriation deferral all aim at minimizing the impact of the exceptions to deferral, outline above. The transactions involved in skirting the limitations, which Subpart F places on U.S. multinationals, are extremely complex. There are, however, a few common techniques, which can be categorized as either profit shifting or tax avoidance.

The opportunity for deferral flows from the ability of a U.S. corporation to split its profit pie amongst its foreign subsidiaries. Subpart F can be characterized as a set of rules determining how those slices are allocated amongst foreign subsidiaries. Allocating a greater piece of the profit pie abroad is called profit shifting. One profit shifting mechanism is cost sharing. Cost sharing occurs when a U.S. corporation transfers the intellectual property rights, and therefore the profits, of a patent to a low tax jurisdiction subsidiary.¹⁰ The technique is a tax saver if the

¹⁰ For a more in-depth analysis of cost sharing see Martin A. Sullivan, *Cost-Sharing Regs.: Half the Profits for None of the Work*, 108 TAX NOTES 1243 (Sept. 12, 2005); Keith

U.S. company can transfer the patent before it becomes profitable. The U.S. company sells the patent to a Bermuda subsidiary for a low price (based on its current irrelevance). Then, when the market for the patent grows, the U.S. corporation claims that the Bermuda company made the new application of the patent possible. By claiming that the profit was the result of work in Bermuda and not the U.S., the CFC keeps a greater share of the patent's profits and avoids U.S. taxation.¹¹

Another profit shifting structure is transfer pricing.¹² The basic structure of a transfer-pricing scheme exploits the difficulty of assessing the size and location of profits generated from patents, trademarks and other intellectual property. The classic example involves a U.S. firm with high research and development costs and an affiliated manufacturing subsidiary in Ireland. The product is sold to customers in the U.S. for \$100, but only costs the Irish subsidiary \$20 to manufacture. In the absence of tax considerations the Irish subsidiary might charge the U.S. corporation a 50% profit, or \$30. The Irish subsidiary's \$10 profit would be subject to Ireland's low tax rate and the U.S. corporation's \$70 dollar profit would be subject to a relatively higher tax burden. Instead, arguing that the Irish manufacturer contributed valuable product improvements and that the U.S. patents and trade name are not significant factors in the product's price, the Irish subsidiary charges the U.S. parent company a much higher price, say \$50 instead of \$30. Now roughly 30% more of the product's profits are located in low-tax Ireland instead of the higher tax U.S. Obviously companies whose profits are more attributable

Reams et al., *Proposed Cost-Sharing Regulations: Are They a Realistic Alternative?*, 109 TAX NOTES 239 (Oct. 10, 2005).

¹¹ Profits attributable to the U.S. corporation's brand name can not be allocated to the Bermuda subsidiary, but the U.S. corporation will argue as they did in the transfer pricing hypothetical, that their brand name is of minimal value.

¹² For a more in depth discussion of transfer pricing schemes, see Stanley I. Langbein, *Transfer Pricing and the Outsourcing Problem, Special Report*, 106 TAX NOTES 1299 (Mar. 14, 2005).

to intellectual property, like high-tech and pharmaceutical firms, have greater opportunities to exploit transfer-pricing regimes. As the U.S. moves from an industrial to an information economy transfer pricing becomes an increasingly significant area of concern for U.S. corporate tax collection.

A third and final profit shifting device is for a low tax jurisdiction subsidiary to make a loan to a high tax jurisdiction parent corporation such that the interest payments effectively transfer the parent's profits to the subsidiary. The interest payments are tax deductible to the U.S. parent company. This transaction is simple enough that Congress has been able to regulate this version of deferral. However, more complex transactions involving non-corporate entities and discrepancies between the U.S. and foreign tax laws are harder to detect. Such instruments continue to proliferate and avoid detection or enforcement.¹³ Now that Congress has identified low-tax affiliate loans as an abusive deferral mechanism, the continued use of the techniques falls into the second category of deferral maximization: tax avoidance.

The tax law has adapted to the rise of transfer pricing arrangements. When a corporation enters into a transaction with no economic substance with a related party, the Subpart F base company sale rules capture and immediately tax those profits. In response, corporations and their tax advisors have re-characterized related party sales as related party contracts. So now, in the same Irish example from the transfer pricing discussion above, the Irish manufacturing subsidiary never takes ownership of the product. Instead of selling a making the product and selling it to the U.S. parent at an inflated price, the Irish subsidiary manufactures the product for the U.S. parent under a service contract. The parent company buys the raw materials and delivers them to the Irish manufacturer. The Irish manufacturer charges the U.S. parent

¹³ For examples of such instruments see Martin Sullivan, *Economic Analysis—International Tax Planning: A Guide for Journalists*, 36 TAX NOTES INT'L 117, 119, 120 (2004).

company the same inflated price of \$50 per product for its manufacture. So the same amount of profit is transferred to the low tax jurisdiction, but without implicating transfer-pricing rules, because it is accomplished through service contracting instead of a sale of goods.

The result of the availability of these deferral-maximizing vehicles is effective exemption of CFC profits from U.S. corporate income.¹⁴ By moving profits abroad, U.S. multinationals avoid U.S. corporate taxation altogether. The only cost to such tax avoiders is transactional. U.S. multinationals pay tax-planning professionals to design these deferral maximization transactions. A tax planner's work does not end there, because once the earnings are abroad they must design mechanisms allowing parent companies to utilize foreign earnings without triggering tax recognition. The only hard and fast limit on domestic use of foreign funds is that they may not be distributed to stockholders as cash dividends. U.S. multinationals can leverage against their foreign earnings for almost any other purpose, not to mention report them in their financial disclosures as profits of the parent corporation. This reality, that U.S. corporations are able to make use of foreign source profits without ever paying tax on them, was a key justification for the adoption of §965's temporary repatriation tax deduction.

PART II: The Impact of §965

Section 965 came into law as part of the American Jobs Creation Act of 2004.¹⁵ Section 965 was not part of the bill originally proposed by President Bush¹⁶, but appeared by way of a

¹⁴ See Charles I. Kingson, *The Great American Jobs Caper*, 58 TAX L. REV. 327, 329 (2005).

¹⁵ H.R. 4520, 108th Cong. (2004).

¹⁶ Actually, President Bush proposed exactly the opposite approach, recommending Congress adopt a permanent deduction. That proposal acknowledged the reality that U.S. multinationals were enjoying effective exemption. Unlike §965, it openly encouraged the practice. See Press Release, White House, President Bush Taking Action to Strengthen America's Economy (January 7, 2003) available at <http://www.whitehouse.gov/news/releases/2003/01/2030107.html>.

Senate Amendment.¹⁷ As one would expect, the provision attracted the backing of multinational corporations.¹⁸ In its committee report, the Senate Ways and Means Committee argued that the current tax on repatriated earnings discouraged repatriation.¹⁹ Section 965, the Committee reasoned, would prompt “the repatriation of foreign earnings that otherwise would have remained abroad.”²⁰ Lawmakers limited the availability of §965 in time and scope to maximize its revenue return. In conference, legislators put special emphasis on the uniqueness of the reduced-tax repatriation opportunity: “this is a temporary economic stimulus measure, and ... there is no intent to make this measure permanent, or to ‘extend’ or enact it again in the future.”²¹ At the same time, lawmakers limited the uses to which repatriated funds could be put once they were brought home. Recognizing that repatriation didn’t automatically translate into economic stimulus, Congress limited deductibility to funds used for job creation, capital investment, and other growth-producing expenditures.

A. Operation

The impetus for the American Jobs Creation Act came from European complaints about lack of U.S. foreign tax credit sanctions. There is an irony in that the answer to these complaints was a bill that legitimized abusive international tax practices and rewarded corporate America with provisions like §965 among many others. See Kingston, *supra* note 14 at 330.

¹⁷ See The Jobs and Growth Tax Act of 2003, H.R. 2, 108th Cong. §201 (2003).

¹⁸ See Glen R. Simpson & Gregory Zuckerman, *Tax Windfall May Not Boost Hiring Despite Claims; Some Companies Plan to Use New Break on Foreign Profits for Debt and Other Needs*, WALL ST. J., Oct. 13, 2004, at A12.

¹⁹ While this premise seems logical on its face, there is research demonstrating that the repatriation tax does not effect corporate profit shifting. See David L. Brumbaugh, Congressional Research Service Report for Congress, *Tax Exemption for Repatriated Foreign Earnings: Proposals and Analysis*, at 8 (2006) *reprinted in CRS Analyzes Exemption for Repatriated Foreign Earnings*, Tax Notes Today, (May 10, 2006), LEXIS 2006 TNT 90-44; *cf.* C. Fritz Foley, et al., “Why Do Firms Hold So Much Cash? A Tax-Based Explanation” (October 2006). AFA 2006 Boston Meetings Paper Available at SSRN: <http://ssrn.com/abstract=654881>.

²⁰ H.R. Rep. No. 108-548, pt.1 (2004). The Committee’s argument is intuitive, but not necessarily correct. See *e.g.*, Brumbaugh, *supra* note 19.

²¹ See H.R. CONF. REP. NO. 108-755 at 256 (2004).

Section 965 reduced the tax on repatriated dividends by providing an 85% deduction on their taxation.²² So if a corporation is paying tax at the 35% marginal rate, an 85% deduction reduces their tax to an effective rate of 5.25%. A U.S. corporation would normally pay \$70 in taxes on \$200 in cash dividends from one of its CFCs; under §965 the tax would be reduced 85% to just \$10.50.

Section 965's deduction was subject to several limitations. Most importantly, the measure was a temporary one. U.S. shareholders could only claim the deduction during one taxable year.²³ They could choose from the point of enactment in October 2004 to deduct repatriated earnings from the previous fiscal year or the following year, but only one or the other. So the deduction was available for any twelve months between November 2003 and September 2006. As noted above, the legislative history put special emphasis on the intent of the enacting congress that §965 be a one-time only opportunity to repatriate at reduced tax rates.²⁴

Section 965 deductions were also limited in dollar amounts. A U.S. parent company could deduct the greater of \$500 million or the foreign earnings reported in the U.S. shareholder's applicable financial statements as permanently reinvested abroad.²⁵ In the case of publicly traded corporations, which constituted the vast majority of §965 repatriation participants, the applicable financial statements were Securities and Exchange Commission (SEC) financial filings.²⁶ For participating multinational corporations, reported foreign

²² I.R.C. §965(a)(1).

²³ I.R.C. §965(f).

²⁴ As discussed in Part III, *infra*, such a professed intent is unlikely to sway future congresses.

²⁵ I.R.C. §965(b)(1).

²⁶ I.R.C. §965(c)(1)(A).

investments generally exceeded \$500 million.²⁷ Therefore, the \$500 million limit was inapplicable to most of §965 deductors.

The availability of the §965 deduction was also limited to “extraordinary” dividends.²⁸ This meant only permanently retained earnings, as opposed to current profits, were eligible for repatriation deductions. Permanent retained earnings were defined as those repatriated funds that exceeded the average annual repatriation amounts across the three-year period beginning five taxable years before 2003.²⁹ The intent of this limitation was to ensure that the measure in fact encouraged repatriation beyond what a corporation would normally choose to make and reached funds normally inaccessible to the Internal Revenue Service (IRS).

A final, significant limitation to the temporary dividends reduction was the domestic reinvestment requirement.³⁰ In order to qualify for the deduction, repatriated funds had to be reinvested in U.S. business operations according to a pre-approved domestic reinvestment plan.³¹ The IRS enumerated a non-exhaustive list of permitted investments. These included employee (but not executive) compensation, capital investments, intangible investments, and research and development expenditures.³² Other investments, like stock dividends and redemptions, passive investment, debt financing, tax payments, and inter-company distributions, were expressly prohibited.³³ These transactions were disallowed, because they failed to provide the type of economic stimulus §965 was designed to produce. However, as discussed in Part III, because repatriated funds are fungible, it was difficult to enforce these guidelines. Repatriation occurred

²⁷ See Sullivan, *supra* note 5; Martin Sullivan, *Economic Analysis: U.S. High-Tech Firms Bring Home \$58 Billion*, 43 TAX NOTES INT’L 616 (Aug. 21, 2006).

²⁸ I.R.C. §965(b)(2).

²⁹ I.R.C. §965(c)(2).

³⁰ I.R.C. §965 (b)(4).

³¹ *Id.*

³² I.R.S. Notice 2005-10, 2005-1 C.B. 474.

³³ *Id.*

in the form of cash dividend payments to the parent company. Once the parent company deposited that cash in their U.S. accounts with their other earnings, the IRS could not confirm that that cash was reinvested as promised, or whether it went to some other expense, while normal earnings paid for the stated reinvestment. The only real way to see how repatriated earnings were spent was to track what new activity a corporation engaged in, and attribute at least some of that to the repatriation. However, the legislation did not require that employee compensation or capital investments be new ones. So while a corporation could have reported that they were using repatriated funds to pay employee salaries, the truth could have been that those wages would have been paid from earnings with or without the addition of repatriated funds. Meanwhile, instead of using the excess cash to create new jobs, the corporation might spend it on nominally prohibited expenses, like debt financing or stock repurchasing.³⁴

In addition to specifying acceptable forms of reinvestment, the IRS issued limiting guidelines concerning related-party debt. Multinationals keeping hundreds of millions of dollars in retained earnings abroad were unlikely to leave the funds in cash, so repatriating the funds presented a liquidity problem. CFCs needed to be allowed to borrow cash to pay repatriation dividends. So the IRS advised CFCs that borrowing to pay dividends was acceptable, so long as they did not borrow from their parent corporations. Accordingly, §965 specified that eligible funds would be reduced by any increase in related party debt.³⁵ Despite this clear limiting language, the IRS, pursuant to the decision in *Plantation Patterns v. Commissioner*,³⁶ issued

³⁴ In fact it appears that many, if not most, firms that took advantage of §965, and used their repatriated funds to pay down debt. See Lee Sheppard, *News Analysis: The Repatriation Endgame*, 40 TAX NOTES INT'L 789 (2005) (citing James Tobin of Ernst & Young as reporting that while firms allege repatriating to fund wages, in act they plan to retire debt with the funds).

³⁵ I.R.C. §965(b)(3).

³⁶ 462 F.2d 712(5th Cir. 1972).

regulations allowing CFC borrowing on parent company credit.³⁷ So a CFC could borrow at its parent company's interest rate. The limitation on financing repatriation through related party lending was even more significantly undermined by the expiration of all limitations on lending with the expiration of §965 itself. At the end of the §965 election year the parent company can refinance the loan its subsidiary took out to pay for repatriation. The interest on such a loan would also be tax deductible.³⁸ So the language prohibiting parent company financing of repatriation funds is rendered meaningless within a year.³⁹ By allowing tax-deductible borrowing to finance repatriation, §965 not only decreases the tax on repatriation, it subsidizes it.

B. Actual Outcomes

Before the provisions of §965 had taken full effect, economists Susan Albring, Ann Dzurainin, and Lillian Mills estimated that there was at least \$318 billion permanently reinvested abroad that would be eligible for repatriation deductions.⁴⁰ If it were all repatriated, §965 would generate \$7 billion in tax revenues, and save U.S. multinationals \$39 billion in avoided income tax.⁴¹ Albring et al., predicted that large firms, especially those in high-tech and pharmaceutical industries would benefit the most from the deduction. So far those forecasts have been accurate.

³⁷ Notice 5005-38, 2005-22 IRB 1100.

³⁸ See Sheppard, *supra* note 34 at 790.

³⁹ Sheppard reports that the majority of practitioners' requests for information from the IRS regarding §965 have pertained to these issues of related-party debt financing. The IRS has not only assisted U.S. multinationals in financing their own tax reduced repatriation, but they've given bankers, accountants and tax lawyers a boost as well, impliedly recommending opinion letters accompany these debt instruments. *See id.*

⁴⁰ Susan Albring et al., *Tax Savings on Repatriations of Foreign Earnings Under the American Jobs Creation Act of 2004*, 108 Tax Notes 655, 657 (2005).

⁴¹ *Id.*

Martin Sullivan reported pharmaceutical firms repatriated more than \$98 billion during the deduction period.⁴² High-tech companies brought back over \$58 billion.⁴³ A few of the world's largest multinationals account for the lion's share of the repatriated funds: Pfizer (\$37 billion), Merck (\$15.9 billion), Hewlett Packard (\$14.5 billion), IBM (\$9.5 billion). The financial institution J.P. Morgan estimated that §965 would be responsible for roughly \$300 billion of repatriated funds in 2005, 50% of that coming from large pharmaceutical firms.⁴⁴

Section 965 and subsequent regulations specified that repatriated funds be used for active U.S. business purposes, like new hiring, training and capital asset acquisition. Nevertheless, multiple reports indicate that most firms are using the funds for other purposes. James Tobin of Ernst & Young reported that most U.S. corporate shareholders used repatriated funds to pay down debt, despite claiming the funds were going to job creation.⁴⁵ Even when corporations were using the repatriated funds for allowable investments, Tobin found they were still mischaracterizing those investments. This is the path of least resistance. Spending on employee wages is easy to document and clearly allowable under the statute. Money is fungible, so there is little risk that mischaracterizing the intended use of the funds will be identified by the IRS.

There is also evidence suggesting that firms are using their repatriated earnings to repurchase their own corporate stock, a practice clearly prohibited by the statute.⁴⁶ So, for instance, in the first half of 2005 Hewlett-Packard reported repatriating \$14.5 billion while

⁴² See Sullivan, *supra* note 5.

⁴³ See Sullivan, *supra* note 27.

⁴⁴ See *Homecoming Victory*, WALL ST. J., Oct. 17, 2005, at A18. At the time of reporting \$225 billion had already been repatriated and J.P. Morgan estimated another \$75 billion would follow before the end of the year, more than doubling the Joint Tax Committee's estimate. See *id.*

⁴⁵ See Sheppard, *supra* note 34.

⁴⁶ See Jennifer Blouin & Linda Krull, *Bringing it Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings under the American Jobs Creation Act of 2004*, (August 2006) on SSRN; Aepfel, *supra* note 6.

laying off 14,500 employees and buying back \$4 billion in stock.⁴⁷ Hewlett-Packard's tax savings more than made up for the cost of its layoffs.⁴⁸ The stock repurchase was three times larger than its repurchase the previous year. In a study of 246 firms electing to deduct repatriated funds under §965, Jennifer Blouin and Linda Krull found stock repurchases increased by \$28.95 billion dollars in the year in which the firms repatriated under the act.⁴⁹

Now that the monetary effects of §965 are recorded, it is appropriate to evaluate them against the early criticisms of the deduction. The predictions that §965 would not fulfill its stated purpose, appear to have come to fruition. Warnings that it would create incentives to harbor even greater amounts of retained earnings abroad also seem likely to come true.

PART III: Criticisms of §965

A. Criticism by Comparison: Tax Amnesties

Recently, Craig Boise analyzed the merits of §965 by comparing it to a traditional tax amnesty.⁵⁰ Like §965, tax amnesties occur infrequently. Also like §965, tax amnesties lower the tax burden on a specific group of taxpayers who are currently escaping taxation, in an effort to reintroduce them to revenue collection. Amnesties are generally enacted to increase revenue, encourage compliance, and signal increased compliance enforcement in the future.⁵¹ Boise bases his analysis on the assumption that an optimal tax amnesty increases compliance over time. Of course deferral is not non-compliance, so rather than §965 encouraging compliance, the analogy

⁴⁷ *Postcards from a Tax Holiday*, N.Y. TIMES, Nov. 12, 2005, at A12.

⁴⁸ See Editorial, *Bringing It All Back Home*, N.Y. TIMES, Aug. 26, 2005, at A18.

⁴⁹ See Blouin, *supra* n. 46 at 3.

⁵⁰ See Boise, *supra* n. 4.

⁵¹ See generally, James Alm, *Tax Policy Analysis: The Introduction of a Russian Tax Amnesty*, 3 (Ga. St. Univ. Int'l Studies Prog., Working Paper No. 98-6, 1998); Gary P. Freeman, *Can Liberal States Control Unwanted Migration?*, 534 ANNALS OF THE AM. ACAD. POL. & SOC. SCI. 17 (1994).

would be to §965 encouraging repatriation. The analogy works, because the justification for §965 was that a decreased tax burden would encourage repatriation, and that an increased flow of earnings back to the U.S. would stimulate the economy. Just as an optimal tax amnesty encourages increased compliance in both the short and long term, an optimal economic stimulus should increase domestic reinvestment in both the short term and the long term.⁵²

Boise explains that there are also costs associated with amnesties.⁵³ First, they tend to injure public perception of the system. Tax amnesties seem unfair, because they benefit those in violation of the law. Similarly, the repatriation deduction conveys the greatest benefit to those multinationals that have been hoarding the most profits abroad. Second, amnesties can undermine how seriously the public perceives tax evasion, again because it effectively rewards violators. On the one hand, because deferral is in compliance with corporate tax law, this cost might not apply to §965. On the other hand, on reason some corporations have so much money reinvested abroad is because they have designed questionable methods for transferring profits there. From this perspective, repatriation can be characterized as compliance, and §965 can be seen as a move by the government to welcome back CFC income at a low tax rate rather than truly enforce Subpart F. Third, amnesties create the expectation of repetition, which compounds the perception of an unfair system not worth obeying. History has shown that these expectations are realistic. Most jurisdictions that have enacted “one-time” amnesties have been unable to resist reenactment.⁵⁴ Boise explains that repeated amnesties not only dilute their own effectiveness as revenue collectors, but also discourage future compliance. The analogous problem in the case of repatriation taxation has been the focus of most of the scholarly criticism

⁵² See Boise, *supra* n. 4 at 33.

⁵³ *Id.*

⁵⁴ See *id.* at 34.

of §965. In the wake of the American Jobs Creation Act, U.S. multinationals are encouraged to retain more earnings overseas while they lobby congress for another deduction.

Boise explains that an optimal tax amnesty must minimize these costs by including new tougher enforcement mechanisms or risk causing more harm to the system than good.⁵⁵ According to Boise, an optimal amnesty is unique, fair, and revenue indifferent. Unfortunately, §965 was none of these things. The American Jobs Creation Act of 2004 did not include any transition to a more limited deferral treatment. If anything, the President's initial proposal to make the current deferral an exemption, would signal the opposite: a commitment to allowing deferral. Though the legislative history of §965 does emphasize the uniqueness of the provision, it is a promise easily broken.⁵⁶ Section 965 also was not particularly fair: it rewarded U.S. companies in proportion to the amount of revenue they had retained overseas rather than reinvesting in the U.S. For instance, it might have been fairer if the deduction had been extended to domestic CFCs as well, though even that would still have only benefited the very rich.⁵⁷ Finally, §965 was not revenue indifferent. Though raising revenue was not §965's stated objective, it was at least a consideration in the provision's enactment.⁵⁸ There were congressional findings estimating expected returns from the provision.⁵⁹ More problematic, some critics are allegations that the stated goals of 965, to stimulate the economy, were really just a pretext for raising revenue in a year with many other tax cuts.

⁵⁵ See *id.* at 36.

⁵⁶ See, e.g., Sullivan, *supra* note 27 (“[T]here is no reason-except shame- to keep Congress from breaking that promise. So don’t be surprised if lobbyists soon start making a case for a repeat of the allegedly unrepeatable Jobs Act.”).

⁵⁷ A former Bush Administration official was quoted as saying about §965 that “you might as well have taken a helicopter over 90210 and pushed the money out the door.” Allen Sloan, *Ford Takes a Tax Holiday For Jobs Creation*, WASH. POST, Jan. 25, 2006, at D2.

⁵⁸ 150 Cong. Rec. S3527-03 (daily ed. Apr. 1, 2004)(statement of Sen. Smith).

⁵⁹ See *id.*

B. Pretext for Raising Revenue

Section 965 triggered such massive repatriation, that even the 5.35% tax produced significant revenues, roughly \$20 billion all told.⁶⁰ Critics have called §965 a calculated mitigation for the country's mounting budget deficits, specifically for shortfalls in 2004, 2005 and 2006 caused by other tax breaks.⁶¹ The revenue produced by the repatriation provided a stopgap in a year when other revenues were expected to fall.⁶² There are two lines of criticism inherent in these arguments. First, there is the more cynical perspective that the provision was never what it set out to be. The argument criticizes lawmakers for enacting the American Jobs Creation Act, which reduced corporate international tax burdens, in response to pleas from European lawmakers to shore up leaky international taxation rules.⁶³ The provisions of the act were really only designed to create the appearance of rising revenues under the guise of economic stimulus, when in fact revenues were falling.

Second, there is the more academic critique that regardless of political pretext, this is a bad way to raise revenue, if that was the true purpose. As demonstrated through the analogy to tax amnesties, temporary holidays of this kind tend to be revenue losers over time. Like a tax amnesty, the repatriation deduction gained access to a pool of money that would not otherwise have been collectable.⁶⁴ Tax amnesties provide governments with information about how taxpayers are avoiding taxation. The repatriation deduction, on the other hand, creates a new

⁶⁰ See *Homecoming Victory*, *supra* n. 38.

⁶¹ See Jackie Calmes, *Tax Revenue Trims '05 Deficit But Gains May Be Short-Lived*, WALL ST. J., Jul. 14, 2005, at A2; Kingson, *supra* note 14.

⁶² See Calmes, *supra* note 61; but note that despite short-term gains, amnesties tend to produce less revenue over the long term, see William M. Parle & Mike W. Hirlinger, *Evaluating the Use of Tax Amnesty by State Governments*, 46-3 PUBLIC ADMINISTRATION REVIEW, 247 (1986).

⁶³ See e.g., *Bringing It All Back Home*, *supra* note 48; Sullivan, *supra* note 5.

⁶⁴ *Id.* at 28.

revenue source, because of the porous character of current deferral rules. Tax amnesties can be effective revenue raising propositions over time, because they give the taxing jurisdiction information about taxable sources that they might not otherwise have had. But unlike tax amnesties, §965 does nothing to provide the government with more information about how U.S. shareholders are investing retained earnings abroad, because in order to qualify for the deduction repatriation amounts must have already been reported in applicable financial statements.⁶⁵ So even though there may be more than \$20 billion in new tax revenue this year, there is no potential for enhanced collection after the expiration of §965 in the way there might be with an effective amnesty. So even if raising revenue in a year of budget shortfalls had been the stated goal, this would have been an inappropriate means of accomplishing it. This conclusion is compounded by §965's introduction of perverse incentives into future tax planning.

C. Perverse Incentives

The fear among many scholars and critics of §965, is that it will encourage firms to hold out for future re-enactments.⁶⁶ The concern is that having enjoyed the benefits of a §965 deduction once, U.S. multinationals will continue to defer taxation on increasingly large sums of CFC income in anticipation of another tax reduction. Firms' expectation of a future holiday would be self-fulfilling, because as U.S. multinationals retain more earnings overseas in the hopes of another §965, they have more incentive to lobby Congress to enact one. As more revenue is hoarded offshore, Congress has an increasing incentive to bring it home. Not only will they be subject to greater lobbying pressure, but the problems repatriation causes to the health of the U.S. economy will become more acute as well. Sullivan observed U.S.

⁶⁵ See I.R.C. §965(b)(2).

⁶⁶ See Sullivan, *supra* note 27.

multinationals retaining more earnings overseas in anticipation of §965.⁶⁷ Though it is still too early to tell, one would expect that post-repatriation, these firms are behaving similarly.⁶⁸

PART IV: Fidelity to Traditional Corporate Tax Policy

In 1909, when Congress taxed corporations as separate entities from their shareholders for the first time, the corporate tax had the primary goal of regulating corporate power.⁶⁹ First, by requiring disclosure of assets and earnings, corporate tax publicized corporate behavior to both its shareholders and its government regulators.⁷⁰ Second, by reducing the corporation's assets the government limited corporate managerial power and indirectly taxed shareholders.⁷¹ Over time, the corporate tax also became an important source of tax revenue. Reliance on this revenue stream has given rise to the “cynical” rule of taxation, which holds that a publicly accepted tax that produces significant revenue, like the corporate tax, will be maintained regardless of more legitimate policy considerations.⁷² Section 965 and its effects implicate each of these three concerns.

A. Corporate Transparency

⁶⁷ See Sullivan, *supra* note 27.

⁶⁸ And indeed, as Boise writes, this is what happens with badly designed tax amnesties. See Boise, *supra* note 4 at 35.

⁶⁹ See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 66 (1990); REUVEN S. AVI-YONAH, “The Story of the Separate Corporate Income Tax: A Vehicle for Regulating Corporate Managers,” BUSINESS TAX STORIES, 17 (2005).

⁷⁰ See *id.* at 19; 44 Cong. Rec. 3937 (1909) (one of the original corporate tax's proponents, Senator Flint, said argued that the new tax, “would give a certain amount of control of corporations by the National Government, publicity as to the condition of the affairs of corporations, and supervision to a certain extent over those corporations”).

⁷¹ See Avi-Yonah, *supra* note 69 at 20.

⁷² See RICHARD GOODE, THE CORPORATE INCOME TAX 26 (1951).

On the one hand §965 generated little new information about corporate expenditures or assets. Repatriations were limited by reporting requirements. CFC earnings not already reported to the SEC were ineligible for deduction.⁷³ So it could be argued that §965 failed to increase the transparency of corporate affairs to either stockholders or regulators.

On the other hand, although SEC filings disclosed the total sums reinvested abroad, before §965 there was only speculative data on the portion of foreign earnings retention attributable only to tax avoidance as opposed to some legitimate business purpose.⁷⁴ The actual outcomes of §965 have clearly demonstrated which industries and which industry giants are exploiting deferral. High-tech and pharmaceutical companies brought home more than half of all earnings repatriated under §965. A few companies within these industries, like Pfizer and Hewlett-Packard, represented the majority of those repatriations. Meanwhile, many large U.S. manufacturing multinationals declined to participate in the deduction altogether. Section 965 revealed in quantitative terms that certain industries, and a few of those industries' giants in particular, were the beneficiaries not just of §965, but also of CFC earning deferrals in general. While it was always a logical conclusion to assume that information-rich industries were maximizing deferrals to a greater extent than traditional manufacturing firms, §965 provided new data on the magnitude of that dichotomy. Because repatriations under §965 generated significant media attention, this new data was widely disseminated to the public as well as to regulators.

Nevertheless, given evidence that corporations mischaracterized their use of repatriated funds in their domestic reinvestment plans, it can still be argued that §965 actually contributed to corporate opacity.⁷⁵ Moreover, because so much of the repatriated funds were used to

⁷³ I.R.C. §965(c)(1)(A).

⁷⁴ *U.S. Multinationals Reap Overseas Bounty*, WALL ST. J., April 4, 2005, A2.

⁷⁵ See Sheppard, *supra* note 34.

repurchase base company stock §965 has contributed to opacity, because they can be done without formal announcement to stockholders.⁷⁶ So on balance, §965 seems to have hurt corporate publicity more than it helped it. To the extent that it did generate new information about corporate activity, it served only to quantify existing notions, rather than reveal formerly unrecognized behaviors.

B. Limiting Managerial Power:

If §965 successfully encouraged corporate managers to bring more revenues back to the U.S., or at least to allocate their earnings according to business purposes as opposed to tax avoidance, then it may be said to have positively influenced managerial control of excess profits. This argument is premised on the assumption that repatriation tax distorts reinvestment decisions. Significant economic research on this question has produced mixed answers.⁷⁷ Assuming that corporate tax does distort reinvestment decisions, repatriation taxation only limits managerial control at home, not abroad where managers are free to stock pile funds. If the corporate tax is justified as a check on corporate stock piling, then the Subpart F rules that encourage managers to keep CFC earnings overseas were bad policy to begin with, and temporarily alleviated their perverse incentives. Prior to §965, because of the effective exemption deferral rules provide, managers could keep vast sums of profits abroad tax free and practically indefinitely. The corporate tax failed to check that corporate power. Section 965, with its 5.25% tax, at least touched that power, even if only for one year and at significantly reduced rates.

⁷⁶ See Blouin, *supra* note 40 at 2.

⁷⁷ See Brumbaugh and Foley, *supra* note 19.

The problem with this argument is that all analyses show that in the long term §965 will encourage greater offshore cash reserves.⁷⁸ Correcting the distortion caused by repatriation cannot justify §965, because in the long term it magnifies that distortion. Section 965 encourages managers to hoard earnings abroad in the long term, and then it will have failed to promote managerial restraint. Instead, §965 creates a new agency cost for corporate shareholders, who rely on managers to make prudent business decisions and distribute profits when they cannot be put to a better business purpose. As managers increase their overseas holdings and lobby for a §965 re-enactment, domestic cash flow for distributions will be constrained.

C. Raising Revenue

To the extent that corporate taxation is justified by its own reliability as source of revenue, §965 could be lauded as a means of accessing revenue streams normally unavailable to the IRS. With deferral rules translating to effective exemption for many U.S. multinationals, the repatriation taxes collected during §965 would probably never have been raised but for §965. The roughly \$20 billion collected is a significant amount, especially if it is viewed as formerly uncollectible. However, as discussed above, the long-term incentives will decrease revenue in the long term. So the \$20 billion collected during the lifetime of §965 must be offset against falling revenue in future years as multinationals repatriate even less than in pre-§965 years in expectation of a re-enactment.

CONCLUSION

⁷⁸ See Boise, *supra* note 4; Sullivan, *supra* note 5.

Past criticism and commentary has successfully undermined §965's credibility as an economic stimulus. Now it is also clear, §965 cannot be justified on traditional corporate tax policy rationales. Section 965 contributed to greater corporate secrecy by encouraging U.S. firms to repatriate under false pretenses. Section 965 failed to limit managerial power by encouraging corporate executives to hoard more not less cash overseas in the long term. Section 965 also failed to maintain a reliable source of revenue by encouraging U.S. firms to retain increasing CFC profits in anticipation of a future holiday. Traditional tax policy analysis leaves little argument left in support of §965. The only thing worse than §965, would be its future reincarnation, which would only compound the original's costs.