ECONOMIC ANALYSIS

# New Insight on Repatriation Holiday Not a Game Changer

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The most common use of the $312 billion of funds repatriated under the provisions of the American Jobs Creation Act of 2004 was for cash acquisitions and not, as widely believed, distributions to shareholders. That is the finding of a new study by professor Thomas J. Brennan of Northwestern University Law School (''Where the Money Really Went: A New Understanding of the AJCA Tax Holiday,'' Aug. 19, 2013.

The Jobs Act was signed into law by President George W. Bush on October 22, 2004. Among its many other provisions, the law added section 965, which provided a temporary 85 percent deduction for dividends received from foreign controlled corporations. Congress believed that a cut in the effective U.S. tax rate to 5.25 percent would ''stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings'' (Joint Committee on Taxation, JCS-5-05, 2005, p. 308). The U.S. tax that would otherwise be due on repatriation — that is, 35 percent less any foreign tax paid — discourages U.S. parent companies from tapping into their huge cache of foreign retained earnings. That phenomenon is called the lockout effect. Total unrepatriated foreign earnings were estimated to be $1.7 trillion in 2012. (See Emily Chasan, ''At Big U.S. Companies, 60% of Cash Sits Offshore: J.P. Morgan,'' *The Wall Street Journal*, CFO Report, May 17, 2012.)

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For years it has been the accepted wisdom that most of the funds unlocked by the provisions of the Jobs Act were used for share repurchases and dividends. That conclusion is largely based on the research of economists Dhammika Dharmapala, Fritz Foley, and Kristin Forbes (''Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act,'' *Journal of Finance*, 2011, p. 753). In their 2009 study, they estimated that between 60 and 92 percent of repatriated funds were used to make distributions to shareholders in 2005, mostly in the form of share repurchases. To arrive at this figure, they used statistical techniques to estimate how funds should have been used in the period after repatriation, subtracted these predicted values from actual values, and then ascribed the unpredicted use of funds to repatriations. The study found that the differences between actual and predicted values of distributions to shareholders in 2005 were very large.

The main reason why their findings are important is that in most economic models, distributions to shareholders have little of the job-creating macroeconomic stimulus. Therefore, the results strongly suggest that the repatriation holiday failed to achieve its objective. To convince most economists that the funds had a significant effect on employment, the repatriated cash would have had to have been spent on direct hiring, worker training, capital spending, or research and development.

## Fresh Perspective

In his study, the first thing Brennan does is prove that the estimated 60 to 92 percent range is too high. He simply adds up total actual share repurchases by repatriating firms, some of which may have had nothing to do with repatriation, and finds that total share repurchases and cash dividends were equal to 55 percent of total repatriations in 2005. So it is simply impossible that 60 percent or more of repatriated funds were used for shareholder distributions.

Next, Brennan develops his own method of estimating the use of repatriated funds. (In addition to a juris doctor, Brennan has a PhD in mathematics from Harvard.) His approach differs from that of Dharmapala, Foley, and Forbes in several ways. First, he constrains his estimates so that predicted values cannot exceed actual totals. Second, he bases each firm's predicted behavior on its own history and not the history of a group of firms. Third, his estimates do not give equal weight to all firms but weigh each firm's estimated value in proportion to its size. Finally, he allows for the possibility that firms may not use the funds for several years after they are repatriated.

Brennan estimates eight categories of uses of funds: cash acquisitions, share repurchases, dividends, research spending, capital expenditures, debt reduction, pension funding, and unexplained spending. (Brennan did not have data for spending on hiring or worker training.) As shown in Table 1, the leading use of repatriated funds was cash acquisitions (39 percent). Share repurchases were a distant second (27 percent). Research spending and capital spending account for only 4 percent and 3 percent, respectively. Brennan's estimated use of funds for the 20 firms with the largest amount of funds repatriated under the provisions of the Jobs Act is shown in Table 2.

| Table 1. Estimated Use of Funds Repatriated Under the Provisions of the AJCA | | |
|---|---|---|
| | Top 20 Firms | All Firms |
| Cash acquisitions | 54% | 39% |
| Share repurchases | 20% | 27% |
| Dividends | 2% | 3% |
| Research spending | 6% | 4% |
| Capital expenditures | 1% | 3% |
| Debt reduction | 16% | 21% |
| Pension funding | 1% | 1% |
| Unexplained spending | 1% | 3% |

*Source*: Thomas J. Brennan, ''Where the Money Really Went: A New Understanding of the AJCA Tax Holiday,'' Aug. 19, 2013.

Under the Jobs Act, share repurchases and dividends were not permitted uses of funds. Acquisitions of firms, as long as their assets were primarily in the United States, were. Brennan's research shows that repatriating companies behaved more in the spirit of the law than previously thought. That may provide consolation in some quarters.

## Job Creation

Let's be clear: The lockout effect is a needless hindrance on the free flow of capital. So in one very fundamental way, a repatriation holiday — although just a temporary Band-Aid — is a good thing. In particular, the law makes it cheaper for U.S. companies with most of their cash in a low-tax jurisdiction to acquire foreign rather than domestic firms. That is a bias we do not need. A top priority of any worthwhile international tax reform should be to eliminate the lockout effect. And we know the lockout effect drives acquisition-minded U.S. CEOs nuts.

Nevertheless, it is not easy for macroeconomists to make the case that eliminating lockout contributes significantly to job creation. If, as a result of increased repatriations, we observed firms hiring new employees, making capital expenditures, or doing more research, it would be another story. We know these uses of cash promote economic growth. But neither the Dharmapala nor the Brennan study indicates any significant increase in domestic capital spending or research. And that is not surprising given that we would expect to see this happen only if firms were cash- or credit-constrained. Most of the repatriated funds were brought home by large, financially secure U.S. firms that would have no trouble financing profitable domestic opportunities.

That isn't to say it is impossible for other uses of funds, like distributions or acquisitions, to promote economic growth. But if these channels of influence exist, they are not the types of effects economists typically incorporate into their macroeconomic models. Economists are generally wary of challenges to the Modigliani-Miller theorem that states that firm value is unaffected by dividend policy. Nor are they inclined to attribute much, if any, job creation to acquisitions like those by Hewlett-Packard of Electronic Data Systems in 2008 or by Pfizer of Wyeth in 2009.

One possible supply-side effect from increased dividends follows the school of thought associated with professor Michael C. Jensen of Harvard Business School. According to Jensen, distributions to shareholders are economically beneficial because they remove control of funds from CEOs who may be more interested in empire-building than maximizing shareholder return. (See Sullivan, ''The Economic Case for Unlocking Foreign Profits,'' *Tax Notes*, July 2, 2012, p. 7.) From this perspective, Brennan's results showing less distributions from repatriated funds means that the economic benefits of repatriations are less than previously believed.

In addition to potential effects on firms' uses of funds, when evaluating the pros and cons of tax relief for repatriations we must also keep in mind its effects on tax planning and profit shifting. Prior research by Brennan shows that after the 2005 tax holiday, the fraction of foreign earnings relative to domestic earnings increased substantially. Brennan suggests that the Jobs Act may have been the cause because firms came to expect that more holidays would follow the first (Brennan, ''What Happens After a Holiday? Long-Term Effects of the Repatriation Provision of the AJCA,'' *Northwestern Journal of Law and Social Policy*, Apr. 2010, p. 1). That is the same line of reasoning adopted by the JCT in its revenue estimates of proposed future tax holidays (Edward D. Kleinbard and Patrick Driessen, ''A Revenue Estimate Case Study: The Repatriation Holiday Revisited,'' *Tax Notes*, Sept. 22, 2008, p. 1191).

## Transition Rule

There is little chance that another repatriation holiday will be enacted in the foreseeable future. In 2011 legislation (H.R. 1834) for a second holiday was introduced by Rep. Kevin Brady, R-Texas, and by Sens. Kay R. Hagan, D-N.C., and John McCain, R-Ariz. (S. 1671). But these lawmakers have not bothered to reintroduce similar legislation in the 113th Congress. And the Win America Campaign — the most visible group lobbying for another holiday — has disbanded. (Prior coverage: *Tax Notes*, Mar. 18, 2013, p. 1321.) The main obstacle to reenactment is the official revenue cost. The JCT has estimated

**Table 2. Estimated Use of Funds Repatriated Under the Provisions of the AJCA for Top 20 Individual Companies**

| Company | Repatriated Funds (billions) | Estimated Leading Uses of Funds | |
|---|---|---|---|
| Pfizer Inc. | $35.5 | Acquisitions (100%) | |
| Merck & Co. | $15.9 | Acquisitions (81%) | Research (19%) |
| Hewlett-Packard Co. | $14.5 | Acquisitions (78%) | Share Repurchase (22%) |
| Johnson & Johnson | $10.7 | Acquisitions (100%) | |
| Int'l Business Machines Corp. | $9.5 | Acquisitions (11%) | Share Repurchase (89%) |
| Schering-Plough Corp. | $9.4 | Acquisitions (100%) | |
| Bristol-Myers Squibb Co. | $9.0 | Debt Reduction (72%) | Research (23%) |
| Eli Lilly & Co. | $8.0 | Acquisitions (50%) | Research (39%) |
| E. I. Du Pont De Nemours | $7.7 | Share Repurchase (55%) | Unexplained Spending (17%) |
| PepsiCo Inc. | $7.4 | Share Repurchase (57%) | Dividend (21%) |
| Intel Corp. | $6.2 | Share Repurchase (79%) | Dividend (20%) |
| Coca-Cola Co. | $6.1 | Debt Reduction (100%) | |
| Altria Group Inc. | $6.0 | Acquisitions (100%) | |
| Procter & Gamble Co. | $5.8 | Share Repurchase (100%) | |
| Abbott Laboratories | $4.3 | Debt Reduction (58%) | Research (27%) |
| Dell Inc. | $4.1 | Share Repurchase (53%) | Acquisitions (47%) |
| Morgan Stanley | $4.0 | Debt Reduction (100%) | |
| Citigroup Inc. | $3.2 | Debt Reduction (100%) | |
| Oracle Corp. | $3.1 | Debt Reduction (100%) | |
| McDonald's Corp. | $3.0 | Share Repurchase (68%) | Dividend (16%) |
| **Total** | **$173.3** | **Acquisitions (54%)** | **Share Repurchase (20%)** |

*Source*: Thomas J. Brennan, "Where the Money Really Went: A New Understanding of the AJCA Tax Holiday," Aug. 19, 2013.

that another holiday that would have begun in 2011 would have resulted in an estimated revenue loss of $78.7 billion over 10 years. Because the stock of unrepatriated foreign earnings is growing rapidly, an updated estimate with a 2014 effective date would be significantly higher.

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If there is going to be tax relief for repatriations of these earnings, it most likely will come as a transition rule in U.S. tax reform legislation involving a territorial system. In his October 26, 2011, international tax reform discussion draft, House Ways and Means Committee Chair Dave Camp, R-Mich., proposed that these earnings be subject to a 5.25 percent U.S. tax whether or not they are repatriated. The tax could be paid in installments over eight years, and a prorated portion of foreign tax credits could be used to reduce the tax.

We may soon have more insight into the fate of unrepatriated foreign profits. Both Camp and Senate Finance Committee Chair Max Baucus, D-Mont., said they will present tax reform legislation to their committees this fall. If those bills materialize, they almost certainly will include a territorial system and rules for making the transition to it. ■