Proposed Tax Law Change: Many Other Factors Will Influence Repatriation of Foreign Earnings

Recently much interest has been expressed in enacting a temporary change to tax laws that arguably have encouraged non-repatriation of earnings by foreign subsidiaries of US corporations. The goal would be to spur repatriation and thus, arguably, additional investments in the US, boosting domestic employment and the overall economy. The most commonly voiced idea is to replicate the 2004 American Jobs Creation Act (a tax law) provision that granted a temporary 85% dividends-received deduction which effectively lowered the U.S. tax rate on foreign earnings to about 5.25% from 35%, and which, it is variously asserted, resulted in the repatriation of as much as $360 billion of the $1 trillion of earnings held abroad at that time. Currently, some $1.5 trillion may be held by foreign subsidiaries, suggesting that as much as $500 billion of fresh capital inflows could be stimulated.

It should be noted both that the actual historical record regarding previous repatriations is not unambiguous, *and* that many other factors conceivably also affect repatriation behaviors.

Regarding the former, as explained more fully in my recent article, *The Differential Influence of U.S. GAAP and IFRS on Corporations' Decisions to Repatriate Earnings of Foreign Subsidiaries*[1], it is the availability of profitable investment opportunities, in the U.S. or elsewhere, that most obviously affects decisions to keep profits invested abroad or to bring them back to America. The fact that much of the repatriated earnings seemingly was used to fund stock buy-backs or dividends, as documented in several academic studies (cited in the above-referenced article), also suggests that even if it does inspire earnings repatriation, the funds may well be used in ways that do not directly affect employment or capital formation.

Regarding the latter, one need only look at today's headlines to be reminded that many exogenous factors can and do influence capital flows, which in turn affect many other key economic determinants. In the news today is the fact that Japanese yen hit its highest exchange rate with dollar in many decades. This makes yens worth more dollars (now around 79 per dollar; it had been in range of 130 within the last decade), causing Japanese exports to become more costly, hurting its exports, and encouraging imports (good news for US exporters, accordingly).

More interesting is the fact that the yen has gone from about 82 to the current 79 in the last four days (hitting under 78 at one point), ostensibly partly in reaction to the recent earthquake/tsunami/nuclear plant tragedies. It has specifically been observed by analysts that the strengthening of the yen has been a result of the repatriation of assets and foreign currency by Japanese insurance firms, anticipating the need for large quantities of yen to fund the huge rebuilding effort that will be needed in tsunami-impacted areas ($300 billion has mentioned as the expected cost). As holders of foreign currency-denominated assets rush to buy yen, the price of yen goes up, and price of selling currency goes down, under the elementary principle of supply and demand.

This experience, if borne out in fact, indicates that there could be a wide range of exogenous factors that impact exchange rates, with potentially major (if unforeseen or undesired) consequences. One such factor is the unanticipated demand for yen caused by damages from the tsunami. Another could be the repatriations that would be spurred on by changes in tax law.

The estimated $300 billion rebuilding cost in Japan almost equals the widely-cited amount of earnings repatriations under 2004 AJCA tax act, and a repeat phenomenon today could trigger $500 billion. If the Japanese experience is what it has been speculated to be, it is possible that large repatriations of earnings from overseas could similarly contribute to a strengthening of the dollar.

The desirability of repatriation will be impacted by many factors, as it was in 2004, and even if legislated, it may or may not have the salutary effects that have been touted, but which academic research following the 2004 AJCA suggests might not have happened. Whether or not corporations will take the bait, if it is offered, also now will be influenced by a new element not foreseen in 2004: the (proposed) ability to choose to report under two different financial reporting regimes (GAAP or IFRS), which offer different financial reporting incentives for keeping foreign earnings out of the U.S. This is fully addressed in the above-referenced article.

[1]"The Differential Influence of U.S. GAAP and IFRS on Corporations' Decisions to Repatriate Earnings of Foreign Subsidiaries," by Barry Jay Epstein and Lawrence G. Macy, *International Tax Journal*, a bimonthly journal published by CCH, a Wolters Kluwer business, March-April 2011, pp. 29-40.

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