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A Repatriation Tax on Foreign Income of US-Based Multinational Corporations

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The 2017 tax reform debate has highlighted the question of how to tax the foreign income of US-based multinational corporations. One key question is how to treat the $2.6 trillion in such earnings that has so far gone untaxed by the United States.

Policymakers are considering two approaches to this issue. One strategy would create a "repatriation holiday" that would impose a temporary low-rate tax on profits from foreign affiliates that firms choose to repatriate in the form of dividends paid to the US parent corporation. An alternative would create a one-time low-rate tax on the accrued amount of those foreign profits whether they are distributed to the US parent company or not. In either model, the tax rate would be much lower than the current 35 percent federal corporate income tax rate.

This year, Congress will consider what may be the biggest tax bill in decades. This is one of a series of briefs the Tax Policy Center has prepared to help people follow the debate. Each focuses on a key tax policy issue that Congress and the Trump administration may address.

WHY DO FIRMS RETAIN PROFITS OVERSEAS?

A simple way to measure inequality is by looking at the The high US corporate tax rate encourages US companies to retain profits overseas. Currently, they owe income tax of up to 35 percent (with a credit for foreign income taxes paid) on profits they repatriate in the form of dividend payments from their foreign affiliates to the US parent company. Accounting rules that allow US companies to report such funds as permanently invested overseas also encourage firms to accumulate foreign assets. These rules allow companies to report net profits to their shareholders that ignore their deferred liability for taxes they would owe if they were to bring foreign profits back home.

US companies can use the dividends they receive from their foreign affiliates for domestic investments or to return cash to their shareholders in the form of dividends or stock repurchases. But repatriated dividends are not the only way firms can access foreign cash for such purposes. Some have used foreign assets as collateral for new loans to finance investments or payments to shareholders. Absent tax considerations, however, corporations would prefer to avoid carrying additional debt.

The repatriation tax generally encourages corporations to retain cash or assets overseas even if it could be used more effectively at home. Economists Harry Grubert and Rosanne Altshuler have estimated that this "lock-out" effect is equivalent to about a 7 percent tax on foreign profits. Although that is a much lower tax rate than companies would pay if they were to repatriate the profits, it nonetheless represents an efficiency cost. Unlike an explicit tax payment, it burdens companies but generates no government revenue.

As other countries have lowered their corporate tax rates, US-based multinationals have increased the amount of profits they retain overseas. US companies also have become more adept at shifting reported profits to tax havens, where the tax rate can be very low or zero. Growth in the share of profits attributable to intangible assets, such as patents and brand name reputation, has facilitated such profit shifting.

Consequently, foreign tax credits offset a much smaller share of the repatriation tax than they did previously, increasing the incentive for US firms to retain funds in their overseas affiliates.

HOW WELL HAVE REPATRIATION HOLIDAYS WORKED?

The US has some recent history with repatriation holidays. The American Jobs Creation Act of 2004 allowed US multinationals to pay a temporary 5.25 percent rate for one year (in place of the usual 35 percent rate) on dividends repatriated during tax years 2004 or 2005. The experience was not encouraging. The act did raise repatriations substantially: firms reported an estimated $300 billion of additional profits in 2005 because of the holiday. But even though the law required firms to use repatriated funds for domestic investments, researchers concluded that the holiday did not increase domestic investment. Firms used the repatriated dollars to finance investments that they would otherwise have funded from retained domestic profits or borrowing, thereby freeing up more cash for dividends and share buybacks. After the tax holiday expired, firms resumed their practice of accruing new profits overseas, possibly anticipating another temporary tax cut.

HOW WOULD FOREIGN ASSETS BE TAXED UNDER REFORM PROPOSALS?

Instead of a temporary repatriation holiday, some policymakers have proposed, as one component of a broader reform of international taxation, a one-time low-rate tax on accrued foreign income whether it is repatriated or not. Tax reforms proposed by former chair of the House Committee on Ways and Means Dave Camp, former president Obama, and Senators Rob Portman and Charles Schumer all included a one-time tax on foreign assets to be collected over several years. Such a tax is also included in "A Better Way," the 2016 House Republican Blueprint, and the tax reform outline announced by the Trump administration on April 26, 2017.

The proposed tax on foreign assets would accompany broader reforms that would impose a low-rate minimum tax on accrued foreign-source income of US multinationals and eliminate taxation of future repatriations. After firms pay the one-time tax, they could repatriate all overseas assets tax free.

The rationale for imposing the one-time tax as part of a transition to a new system is that firms would have paid tax on those profits when repatriated under the previous law. Therefore, the reforms should only fully exempt repatriations of future profits. Firms would pay a preferential rate, however, because current law allows them to defer tax until repatriation, making the effective rate on those profits much lower than the statutory rate imposed upon repatriation. Moreover, some legislators are interested in using the temporary revenue from the one-time tax to fund rate reduction or for specific purposes, such as investments in infrastructure.

Currently, policymakers seem to be leaning toward implementing a one-time transition tax on all accrued foreign profits as part of broader reforms rather than a temporary tax holiday on repatriated earnings. However, the structure of this transition tax, its rate, the period over which it would be collected, and the use of the revenue it raises will likely be the subject of intense debate in the coming months.