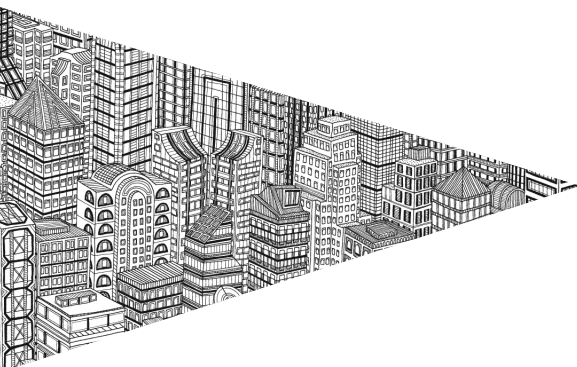


# International Tax Alert



## Senate's Permanent Subcommittee on Investigations issues report on effects of 2004 tax repatriation provision in Section 965

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### Executive summary

On 11 October 2011, the Permanent Subcommittee on Investigations (PSI), part of the Committee on Homeland Security and Governmental Affairs (the PSI), chaired by Senator Carl Levin (D-MI), issued a majority staff report, *Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals*, on the effects of the Dividends Received Deduction of Section 965 (referred to as the 2004 repatriation provision) enacted by the *2004 American Jobs Creation Act* (AJCA).

The report explains the findings of research conducted by the PSI involving 20 US based multinational corporations that used the 2004 repatriation provision, including the 15 corporations that reported the highest amounts of repatriation. The top 15 corporations together brought back a total of \$150 billion in offshore earnings, representing close to half of the \$312 billion total funds repatriated as qualifying dividends. The study focused on how the repatriated funds had been used by the corporations in four key areas: job creation, R&D, executive compensation, and stock repurchases.

The report includes findings that there were no job increases or acceleration of R&D spending as result of the repatriation and that there was an increase in stock repurchases and executive pay. The report also states that, the repatriation benefitted a narrow portion of the US economy, primarily pharmaceutical and technology corporations, and that funds were repatriated primarily from low tax or tax haven jurisdictions. Additionally, the report states that since the repatriation companies have accumulated funds at a greater rate than before 2004.

The report concludes that the 2004 repatriation cost Treasury an estimated net revenue of \$3.3 billion over ten years, produced no appreciable increase in US jobs or research investments, and led to US corporations directing more funds offshore. On this basis, the report recommends against enactment of any similar repatriation initiative.

## Detailed discussion

### Temporary dividends received deduction

The temporary dividends received deduction enacted by the AJCA in Section 965, generally provided US corporate shareholders of controlled foreign corporations (CFCs) an election to claim for one year a deduction equal to 85% of cash dividends received in that election year from CFCs (CFC cash dividends) in excess of a base-period amount of CFC dividends that reflects the CFCs' dividend-paying history. The 85%

deduction was available, however, only if the amount of the cash dividends generating the deduction was invested in the United States pursuant to a properly approved domestic reinvestment plan.

Further, the cash dividend amount eligible for the 85% deduction was limited to the greater of: (A) \$500 million, (B) the amount shown on the applicable financial statement of the corporate US shareholder as earnings permanently reinvested outside the United States, or (C) if a specific amount of permanently reinvested earnings was not shown, but a specific amount of tax liability attributable to such earnings was shown, then the amount equal to such liability divided by 0.35. All US shareholders that were members of an affiliated group of corporations filing a US consolidated tax return were treated as a single corporate US shareholder for purposes of Section 965.

The election was available for either the US corporate shareholder's last taxable year that began before 22 October 2004, or the first taxable year that began during the one-year period beginning on 22 October 2004.

Notice 2005-10,<sup>1</sup> issued on 13 January 2005 provided guidance on how to satisfy the domestic reinvestment requirement, as well as more general definitional and compliance issues. Such Notice provided that the permitted investments specifically included:

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1 2005-1 C.B. 474.

(1) expenditures for the funding of worker hiring and training only to the extent attributable to services performed by the workers in the United States; and, (2) R&D expenditures described in Treas. Reg. Section 1.174-2, but also only to the extent that the R&D activities are performed in the United States.

In addition, the Notice described prohibited investments: (1) executive compensation; (2) intercompany transactions between members of the same consolidated group described in Treas. Reg. Section 1.1502-12; (3) acquisition of debt; (4) distributions with respect to stock and stock redemptions and repurchase agreements; (5) certain portfolio investments in business entities; and, (6) tax payments.

### PSI majority staff report

The PSI's review of the consequences of the 2004 repatriation provision started in 2009. As part of this review, PSI staff sent a questionnaire to 20 US multinational corporations, including the 15 companies that had repatriated the highest amounts of funds back to the US. The PSI staff also gathered information from SEC filings, IRS published data, interviews, and other research.

The report describes data and findings in nine areas, which lead the PSI to recommend against enacting a second corporate repatriation provision:

#### 1. US jobs

The report states that the primary purpose of the 2004 repatriation provision was to stimulate job

growth. Accordingly, the report looks at the level of repatriation of the companies surveyed and the changes in the size of their US workforce. For the top 15 repatriating corporations, the survey data showed an overall reduction in US jobs from 2004 to 2007.

### ***2. R&D expenditures***

The report indicates that the survey data showed that the top 15 repatriating corporations increased R&D expenditures from 2004 to 2007. However, the report notes that the growth is slightly slower than the growth occurring before repatriation. The report states that the fact that the 2004 repatriation did not require corporations to document their use of the repatriated funds, and the fungibility of the dollar, it is impossible to determine a correlation between the repatriation and this slight increase in R&D expenditures, and notes that there are studies that show no difference in R&D expenditures between repatriating and non-repatriating corporations. Accordingly, the report concludes that the repatriation provision did not result in an increase in R&D expenditures.

### ***3. Stock repurchases***

The report states that stock repurchases and shareholder dividends were explicitly prohibited as a use of the repatriated funds. However, the report indicates that research demonstrates a parallel between an increase in repatriated funds and an increase in share buybacks at repatriating corporations. Based on the data

collected by the PSI, The rate of stock repurchase and buyback transactions accelerated after the repatriation compared to the years before repatriation, with the steepest increase between 2005 and 2006. The report finds that in the years following the repatriation, the 20 surveyed corporations more than doubled the amount of their average stock repurchases from \$2.2 billion in 2004 to \$5.3 billion in 2007.

### ***4. Executive compensation***

The report indicates that similar to stock repurchases, despite a specific prohibition of use of repatriated funds for executive compensation, the data shows that such payments increased by 27% from 2004 to 2005 and by 30% from 2005 to 2006. The report further notes, that 18 of the surveyed companies increased restricted stock awards to their senior executives in the two years (2005 and 2006) following the repatriation.

### ***5. Industry sectors benefiting from repatriation***

Based on the data analyzed, the report states that the 2004 repatriation provision benefited only a narrow sector of US multinational companies. Namely, the benefited industry sectors were larger multinationals, mainly in the pharmaceutical and technology industries. According to the report, the repatriation provision thus unfairly benefited large US corporations, and undermined US competitiveness by shifting the tax burden to medium and small domestic businesses.

### ***6. Source of repatriated funds***

Another finding noted in the report was that the survey data showed that a significant amount of the repatriated amounts flowed from low tax jurisdictions, including Bahamas, Bermuda, BVI, Cayman Islands, Costa Rica, Hong Kong, Ireland, Luxembourg, the Netherlands Antilles, Panama, Singapore, and Switzerland.

### ***7. Corporate funds held offshore post-repatriation***

The report also states that there is evidence of an increased buildup of offshore funds since the 2004 repatriation provision. The report notes that the data collected demonstrates that nine of the top ten companies repatriating the most cash under the 2004 repatriation provision have increased their offshore funds every year since their use of such provision.

### ***8. Current domestic cash assets***

The report states that US corporations collectively hold more domestic cash assets in 2011 than in 2004, so that lack of cash would not be a constraint to hiring and making domestic investments and such goals should not be viewed as a rationale to justify a second repatriation initiative.

### ***9. 2004 repatriation did not achieve intended stimulus effect***

The report states that supporters of the 2004 AJCA repatriation tax break contend that the repatriated funds had a stimulus effect on the US economy, resulting in more jobs and domestic investment, but that

such supporters are unable to cite persuasive research to support those claims. The report states that not only did the 2004 repatriation not achieve the job creation and R&D goals intended, but it has increased the shifting of corporate dollars and investments offshore, as US corporations are hoping for a second repatriation provision as advantageous as the 2004 one.

### **Implications**

Senator Carl Levin has been investigating offshore activities of US individuals and US corporations for several years and has introduced legislation aimed at stopping what

he considers abusive practices that avoid US taxes by increasing foreign activities. He has been a vocal critic of repatriation proposals in the past. It is not surprising that this report has been released while there are multiple bills that have been introduced in the House and in the Senate that include some sort of repatriation "holiday". The findings of the PSI may make it more difficult for the advocates of another repatriation provision to gain support given the current economic and financial environment and the focus on job creation and US growth stimulation. The current proposals do attempt to more closely

tie repatriation to job creation. For example, the provision proposed by Sens. Kay R. Hagan, D-NC and John McCain, R-AZ, would provide for an additional benefit beyond the 75 percent dividends received deduction with respect to repatriated earnings if the taxpayer expands its "qualified payroll" in the US by 10% during 2012. Moreover the proposal would impose a penalty on companies that reduce their payroll at a rate of \$75,000 per full-time employee that is eliminated. However, it remains to be seen whether discussion of a new repatriation holiday will gain traction in the current environment.

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