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Student Handout #6: **Congressional Research Service, “Tax Exemption for Repatriated Foreign Earnings: Proposals and Analysis”**

**Summary**

An important feature of several broad business and international tax bills in the 108<sup>th</sup> Congress has been their different proposals to reduce the tax U.S. firms pay on dividends they receive from their overseas subsidiaries. Most prominent were S.1637 as passed by the Senate, the House-passed version of H.R. 4520, and the broad business tax bill that was approved in October, 2004 — the American Jobs Creation Act (P.L. 108-357). The proposals fit into the U.S. tax structure as follows: while the United States taxes corporations that are chartered in the United States on their worldwide income, it does not tax foreign-chartered corporations on their foreign source income. Thus, with some exceptions, if a U.S. firm conducts its foreign business through a foreign-chartered subsidiary corporation, its overseas earnings are not subject to U.S. tax as long as the income remains in the hands of the foreign subsidiary and is reinvested abroad. The income is subject to U.S. tax only when it is ultimately repatriated to the U.S. parent corporation as dividends or other intrafirm payments. At that point, U.S. taxes ordinarily apply, although credits may be claimed for foreign taxes paid. It is these U.S. taxes due upon “repatriation” that would be reduced under the proposals.

The feature of the U.S. tax code that allows U.S. firms to postpone taxes on their overseas earnings is known as “deferral.” Although the tax code in some cases denies deferral to passive investment income, the benefit is generally available for active business income earned through foreign subsidiaries. In general, deferral poses a tax incentive for U.S. firms to invest in foreign countries with low tax rates. This is because a postponed tax matters less to a firm than a tax that is paid currently; as long as payment is postponed, a firm can invest and earn a return on what would otherwise be spent on taxes. Supporters of a tax cut for repatriated dividends argue that the tax that applies to repatriated dividends is a part of deferral’s tax incentive to employ capital abroad. They argue that the tax on repatriations discourages U.S. firms from repatriating their foreign earnings. In some cases, they point out, U.S. firms confront the choice of reinvesting a given amount of foreign profits in a lowtax foreign country without immediately paying U.S. tax, or of triggering U.S. tax by paying dividends to the U.S. parent. The U.S. tax, it is argued, discourages repatriation, and has induced some U.S. firms to accumulate large stocks of reinvested earnings abroad. Reducing the tax, it is argued, will stimulate a flow of earnings back to the United States and will increase investment in the United States.

According to economic theory, a temporary tax cut for repatriations may induce a near-term increase in dividend remittances to U.S. parent firms. A permanent rather than temporary tax cut, however, may have no impact on repatriations, while at the same time inducing firms to increase new capital outflows from the United States to locations abroad. If repatriations occur, it is not clear whether U.S. firms would use the repatriated funds to finance investment or put them to other uses — for example, the payment of dividends to stockholders. In the area of economic stimulus, some or all of the stimulative impact of repatriations may be offset by exchange rate adjustments that would reduce net exports. This report will not be updated.