Tax Holidays (and Other Escapes) in the American Jobs Creation Act

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Kimberly A. Clausing
Dept. of Economics
Reed College
3203 SE Woodstock Blvd.
Portland OR 97202-8199
email: clausing@reed.edu

Abstract: This paper considers the international tax incentives created by the American Jobs Creation Act of 2004. The temporary dividend repatriation tax break is evaluated in the context of previous theoretical and empirical work. While this tax break is likely to lead to a surge in temporary repatriations, it is unlikely to encourage new investment in the United States. Instead, the tax break sends a confused message about the intent of the U.S. tax system and, together with the other international tax provisions in the legislation, is likely to encourage foreign investment in low-tax countries.
I. An Introduction to the American Jobs Creation Act

The American Jobs Creation Act (AJCA) was signed into law on October 22\textsuperscript{nd}, 2004. The heart of the bill is a repeal of an illegal trade subsidy—the Extraterritorial Income (ETI) exclusion—plus a number of new tax breaks for business interests, including a deduction for U.S. “production” income. There were also important changes in U.S. international tax provisions.

The root motive for the legislation was a worthy one: to remove an export tax incentive that the World Trade Organization has repeated ruled illegal. In response to previous reluctance to remedy the problem, the European Union levied retaliatory tariffs on over 1,600 U.S. products beginning in March 2004. Tariffs began at 5 percent, and rose by 1 percentage point per month thereafter; they stood at 12 percent when the American Jobs Creation Act (AJCA) was passed.\textsuperscript{1}

The repeal of the export tax incentive in the American Jobs Creation Act is both good tax policy and good trade policy. There is no reason for the tax system to favor export income.\textsuperscript{2} Further, the U.S. current account deficit is an outcome of the U.S. economy’s savings/investment imbalance, not trade measures or tax policy. Thus, even if exports were considered \textit{a priori} desirable, it is quite unlikely that the export tax incentive would be an effective way to improve the trade balance.\textsuperscript{3} Finally, resolving the ETI issue is important for assuring future multilateral trade liberalization and for resolving a longstanding trading dispute between the United States and the European Union.

\textsuperscript{1} See European Council regulation no. 2193, 8 December 2003.
\textsuperscript{2} Export income is not especially likely to stimulate the economy or generate other special benefits. But even if export industries were more likely to generate benefits such as research and development expenditures, there are still far more direct ways to encourage these beneficial effects.
\textsuperscript{3} See Clausing (2004) for a detailed discussion of this fact.
Despite the existence of many attractive uses for the revenue resulting from the ETI repeal, the American Jobs Creation Act instead took many steps to lighten the tax load for U.S. firms. Still, in most cases tax breaks were not effectively targeted at those firms unfavorably affected by the ETI repeal. The popular press often focused on a large number of provisions in the bill that were directed at special interests. However, the general provisions of the legislation warrant more examination. For example, the legislation provides an income tax deduction for domestic production activities that is equivalent to a 3-percentage point rate cut. There is little economic justification for giving tax preferences to narrow definitions of activity, as there is no reason to suspect that these activities would be more beneficial to the economy than the excluded activities. Further, this provision will create compliance and enforcement difficulties as firms will have incentives to characterize as much income as possible as production income.

The net effect of all provisions was legislation that purports to be revenue-neutral over ten years. However, the legislation follows recent practice of using artificial sunset provisions and phase-ins to obfuscate the true cost. Many of the new tax breaks are ostensibly temporary, but it is hard to imagine that the political pressures that produced those provisions will evaporate over the next few years. If the provisions are extended, Friedman (2004) suggests that the bill could add over $80 billion to the U.S. budget deficit over the next ten years.

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4 The Economist magazine’s headline was “Lobbyists’ Delight”, and for good reason, as myriad special interest provisions for groups including tobacco quota holders, foreign gamblers, whalers, bow manufacturers, and the makers of sonar fish-finding devices, were included in the bill.

5 For instance, firms would have an incentive to have the divisions of the firm that are subject to favorable tax treatment be more profitable than those divisions that do not receive such favorable treatment. By shifting paper profits among divisions, firms can reduce their overall tax liability. Such efforts will lead to unnecessary accounting and compliance costs for firms and unnecessary enforcement costs for the Internal Revenue Service.
The following analysis will focus on the international tax provisions of the AJCA, which represent a somewhat subtle shift toward a territorial system of taxing international income in the United States. Although many of these changes are quite complex, the overall effect of the legislation clearly lessens the overall burden of the U.S. tax system on the foreign income of multinational firms. Section II of the paper will consider the effects of the dividend repatriation tax holiday. Section III will consider other international tax incentives provided by the AJCA. Section IV will conclude by offering some reflections on the overall impact of the international tax measures in light of the objectives of the U.S. tax system.

II. The Dividend Repatriation Tax Holiday

The AJCA contains a provision to allow a temporary tax holiday for dividend repatriations of 5.25 percent. U.S. firms may elect a one-year window during which they may deduct 85% of extraordinary cash dividends received from controlled foreign corporations. (This effectively taxes those dividends at 5.25%, or 35% of 15%.) As discussed below, under U.S. law, when a corporation repatriates income from a low-tax country, it must pay the difference between the U.S. tax rate (35 percent) and the foreign tax rate, although in many cases it can use excess foreign tax credits from affiliates based in high-tax countries to offset taxes due. This temporary provision of the new law would provide a substantial tax advantage to repatriate funds from low-tax countries in the year of the tax break. The following section will explore the incentives created by this provision in greater detail.

*The U.S. International Tax System*
The United States government taxes U.S. multinational firms on a residence basis. Thus, U.S. multinational firms incur taxation on income earned abroad as well as income earned in the United States. However, U.S. firms receive a tax credit for taxes paid to foreign governments. This tax credit is limited to the U.S. tax liability although firms may (in some cases) use excess credits from income earned in high tax countries to offset U.S. tax due on income earned in low-tax countries. Taxation only occurs when income is repatriated; thus, there is an incentive to incur income in low-tax countries as income can grow tax-free prior to repatriation. There is also typically an incentive to avoid incurring income in high-tax countries as the tax credit received by the U.S. firm is limited to the U.S. tax liability.

As an example, consider a U.S. based multinational firm that operates a subsidiary in Ireland. Assume that the U.S. corporate income tax rate is 35% while the Irish corporate income tax rate is 12.5%. The Irish subsidiary earns €800 and decides to repatriate half of the profits to the United States. (Assume, for ease of computation only, a 1:1 exchange rate.) First, the Irish affiliate pays €100 to the Irish government on profits of €800. It then repatriates $350 to the United States, using the remaining profit (€350) to reinvest in its Irish operations. The firm will pay U.S. tax on the repatriated funds, but it is eligible for a tax credit of $100 (taxes paid) times 350/700 (the ratio of dividends to after-tax profits), or $50. If the U.S. multinational firm has excess foreign tax credits from its operations in high tax countries, it can use these credits to offset taxes due on the repatriated Irish profits.

The remaining profits (€350) can grow abroad tax-free prior to repatriation; this process is referred to as deferral. However, U.S. tax law does contain some provisions
aimed at discouraging firms from taking full advantage of deferral. Under the subpart F provisions of U.S. tax law, certain foreign income of controlled foreign corporations is subject to immediate taxation. Most importantly, this includes both income from passive investments and foreign base company income.

Some countries (such as the U.K and Japan) use a tax credit system similar to that used by the United States. Still, others (such as France and the Netherlands) exempt foreign income from taxation; this is referred to as a territorial system of international taxation. In addition, several countries have hybrid systems that lie in between these two systems; for instance, foreign income may be exempt from taxation in the home country provided that the foreign country’s tax system is sufficiently “similar” to that in the home country.

**How Does the U.S. Tax System Affect Repatriation Decisions?**

Prior to Hartman (1985), it was assumed that the residual U.S. taxation of income earned in low-tax countries discouraged repatriation, as there was a tax price associated with repatriating profits. By keeping profits abroad instead, firms avoid incurring this tax price, and income grows free of U.S. tax. As a result, some worried about a “lock-out” effect that could discourage productive reinvestment of funds in the United States. Note that any lock-out effect results from the deferral of U.S. taxation on foreign income; absent deferral, there would be no incentive to postpone repatriation as foreign income would be taxed currently in the United States as earned.

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6 Controlled foreign corporations are foreign corporations with over 50% American ownership, where each owner (an individual or corporation) owns at least a 10% stake.
7 Foreign base company income is derived from sales of goods between related parties where the goods are both manufactured outside the base country and sold for use outside the base country.
Still, while the lock out effect appears plausible, Hartman (1985) demonstrated that, if the ultimate U.S. taxation of income earned in low-tax countries is inevitable, then repatriation taxes do not affect the decisions of mature firms regarding whether to reinvest funds abroad or repatriate them home. A dollar in repatriated foreign profits generates

\[
\frac{1-t}{1-t^*}
\]

in cash flow for the parent firm, where \(t\) is the home tax rate, assumed to be larger than the foreign tax rate, \(t^*\). For example, in the case of the $350 repatriated from Ireland above, the firm would have $350*(.65/.875), or $260, in cash after U.S. taxation.

If the firm is trying to decide between reinvesting the funds abroad and repatriating the funds to the United States, it will compare the after-tax return associated with each option. In the case of reinvestment for \(n\) years, the firm will eventually earn:

\[
[1 + r^*(1 - t^*)]^n \left[ \frac{1 - t}{1 - t^*} \right]
\]

where \(r^*\) is the return in the foreign country, which is taxed by the foreign government in each period. Eventually, the funds are repatriated to the United States and incur an associated one time reduction in value.

If the funds are repatriated immediately instead, after \(n\) years, the firm will earn:

\[
[1 + r]^n \left[ \frac{1 - t}{1 - t^*} \right]
\]

where \(r\) is the net return at home. Comparing equations (2) and (3), one ascertains that the level of the home-country taxation of foreign profits does not affect the decision
between reinvestment and repatriation. The cost of repatriating funds shown in equation (1) is incurred irrespective of whether one reinvests the funds or repatriates them.\(^8\)

This result implies that a *permanent* reduction in the tax price of repatriation would provide a windfall gain to investors, but it would not change the time path of repatriation flows from abroad, assuming of course that the economic actors in question view the change as completely permanent.

The Hartman result does not imply, however, that repatriation taxes have no effect for immature firms. In the case of immature firms, the home country tax of foreign profits is a deterrent to investment in low-tax countries, in comparison to a system that exempted foreign income from taxation. Sinn (1993) and Hines (1994) have demonstrated that firms will have an incentive to under-invest in low-tax countries in order to take full advantage of deferral. If firms can reinvest earnings in passive investments that earn competitive returns, however, they will have no incentive to under-invest, as demonstrated by Weichenrieder (1996). Further, there may be plentiful alternative investment opportunities in other active investments as well.

Further, the Hartman result certainly does not imply that temporary changes in the tax price of repatriation will not affect repatriation decisions. Consider the temporary dividend holiday in the AJCA in this light. By allowing a one-year window in which to repatriate funds at a low 5.25% rate, the AJCA removes Hartman’s assumption that the tax price of dividend repatriation does not change over time. The repatriation tax price

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\(^8\) Of course, tax differences among host countries continue to have large influences on the magnitudes of investments across countries. In fact, investors in the United States (and elsewhere) appear to be increasingly responsive to tax differences among countries. These sensitivities indicate that any home country taxation of profits originating in low-tax countries does not offset the tax advantages of investing in such locations. See de Mooij and Ederveen (2003) for a comprehensive meta-analysis of 25 studies on this question.
terms would no longer drop out in a comparison of equations (2) and (3) above. As the
holiday tax price is lower than the permanent tax price, this would lead to an incentive,
relative to the status quo, to repatriate while the holiday is in effect. This assumes, of
course, that the holiday is attractive relative to the other strategies firms may have
developed in order to effectively repatriate earnings without incurring U.S. taxation. 9

If the dividend tax break is unexpected, it will not affect decisions before
enactment. Once it is in place, some firms will have incentives to repatriate more funds
during the holiday year. Such excess repatriations will presumably be offset by reduced
repatriations in future years for two reasons. First, there will be a lesser stock of offshore
profits available for repatriation. Second, to the extent that firms come to anticipate
future holidays, they will no longer view the regular tax rate as the permanent one, and
firms may thus defer future repatriations in the hope of similar holidays down the road. 10

Interestingly, if the holiday provided by the AJCA was anticipated, as some have
argued, this would have generated a reduced incentive to repatriate profits from abroad in
prior years as well. 11 This again results from firms viewing the repatriation tax not as an
unavoidable eventuality (ala Hartman), but as something that can be avoided through
careful tax planning or simply patience.

 Evidence on Dividend Repatriations

There have been several previous studies that have examined how the tax price of
dividend repatriations affects repatriations, including Hines and Hubbard (1990),

9 These strategies are discussed further below.
10 Some have suggested that the holiday in fact represents an initial step toward the exemption of foreign
income. If firms anticipate such a transition, they may be particularly reluctant to incur the normal tax
price of repatriation.
11 See Simpson and Wells (2003) and Sullivan (2004) for arguments that firms may have anticipated this
tax break.
Altshuler and Newlon (1993), Altshuler, Newlon, and Randolph (1995), Desai, Foley, and Hines (2001), and Altshuler and Grubert (2001). All of these studies find that dividend repatriations are highly sensitive to their tax price. For example, Altshuler and Newlon (1993) use 1986 tax return data to show that a 1% higher tax price is associated with a 1.5% reduction in dividend repatriations. Desai, Foley, and Hines (2001) use affiliate level Bureau of Economic Analysis data from 1982 to 1997 to relate the tax cost of dividend repatriations to dividend repatriations, examining both affiliates, who face this tax cost, and branches, who do not. They find that when affiliates face a 1% higher tax cost, this is associated with 1% lower dividend repatriations, while branches do not exhibit this pattern.

This sensitivity, however, need not be inconsistent with the theoretical result of Hartman. U.S. multinational firms are adept as using careful tax planning to avoid unnecessary repatriation taxes, including the use of cross-crediting so that repatriations from low-tax countries are done only when there are offsetting excess tax credits due to operations in high-tax countries. Such tax planning in order to exploit temporary changes in the tax price of dividend repatriation can help reconcile the theoretical result of Hartman with studies such as Desai, Foley, and Hines (2001) that indicate a high responsiveness of dividend repatriation to its tax price.

Altshuler, Newlon, and Randolph (1995) use a panel of tax return data over 4 years to separate permanent tax prices from temporary tax prices. Tax prices vary over time due to differences in tax bases across countries as well as the movement of firms into and out of excess-credit status. Their results indicate that firms are responsive to
transitory (but not permanent) changes in the tax price of repatriation. As the authors state on p. 270:

The tax price effects on dividend repatriations found in previous studies … apparently measure largely the effect of the timing of dividend repatriations undertaken to take advantage of intertemporal variation in tax prices. These timing opportunities may arise either endogenously, though tax planning that affects both tax prices and dividend payments, or through exogenously caused variations in tax prices. Therefore, although repatriation taxes seem to affect dividend repatriation behavior, this is apparently only because tax prices vary over time. This result is consistent with the prediction of Hartman’s model.

Such results have important implications for interpreting the tax responsiveness of dividends. For instance, Desai, Foley, and Hines conclude that repatriation taxes reduce dividends repatriations by 12.8%, creating efficiency losses in the process. They note that “these effects would disappear if the United States were to exempt foreign income from taxation.” However, if these tax elasticities are a result of temporary variations in tax prices, a permanent change (such as that envisioned by a move toward an exemption system) need not generate the same boost in repatriations.

Further, as Fleming and Peroni (2004) point out, these sorts of estimates do not account for the fact that U.S. parent companies have been able to utilize alternative strategies to effectively repatriate earnings from low-tax countries without incurring U.S. taxation. For example, by retaining profits in low-tax countries abroad, U.S. parents benefit from enhanced financial statements that likely allow borrowing from unrelated third parties. Firms are also increasingly using hybrid entities to achieve what Sheppard (2004) refers to as “do-it-yourself” repatriation. If this is the case, then a move toward an exemption system is unlikely to result in a correspondingly large increase in cash
available to parent firms but may instead manifest itself as a conversion of indirect repatriations into dividends.

The available evidence shows that very little U.S. tax is collected on the foreign income of U.S. multinational firms, indicating that these firms are adept at using cross-crediting and other strategies to avoid paying such taxes. For example, Grubert and Mutti (1995) undertake a series of calculations that indicates that the effective U.S. tax rate on active foreign income in 1990 is quite low, approximately 2.7%, or less under some assumptions. Grubert (2001) and Altshuler and Grubert (2001) support similar conclusions using 1996 data. Thus, one could argue that excess foreign tax credits and deferral already obscure the distinction between the U.S. tax system and one that exempts foreign income.

What are the implications of this work for the likely response of repatriations to the provision in the AJCA? As argued above, the temporary nature of this provision is likely to heighten the responsiveness of dividend repatriations. In fact, one of the great lessons of tax responsiveness learned from the 1986 Tax Reform is that tax-related timing responsiveness is quite large and exceeds financial responsiveness, which in turn exceeds real behavioral responsiveness. See Auerbach and Slemrod (1997) for thorough documentation of this finding.

Even so, two considerations are likely to moderate the response of dividend repatriations to the AJCA provision. First, to the extent that firms have already achieved low-tax-cost means of effectively repatriating income from low-tax countries, this

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12 For example, lower tax rates result if one accounts for unrepatriated foreign income in the denominator of the tax payments/ income fraction. Other adjustments allow royalty and sales source income to be domestically sourced income rather than foreign source income, adjust for artificial income allocation rules, and allow for worldwide fungibility.
holiday may be less of an escape than one might imagine. Second, Kaufman (2005) notes that the recent dollar depreciation may complicate firms’ decisions regarding taking advantage of this provision, as it is more advantageous to repatriate (the taxable portions) of dividends at times when the dollar is stronger vis a vis a subsidiary’s functional currency. Further, while some have argued that the repatriations spurred by this provision may strengthen the dollar, the magnitude of foreign exchange market transactions relative to the likely size of repatriations make this outcome unlikely.\textsuperscript{13}

Brumbaugh (2003) attempts a rough estimate of the likely pool of funds that would benefit from these provisions, suggesting that just under $500 billion of earnings have been retained abroad that would likely be subject to U.S. tax if repatriated. However, it is important to remember that (a) not all firms will find repatriation advantageous and (b) not all of these dividends will necessarily qualify for favorable treatment. The amount of eligible dividends is limited to $500 million unless a greater amount is shown as “permanently reinvested” on a firm’s financial statements. Also, dividends must be “extraordinary”, exceeding a base period amount which is calculated as the average of the previous five years of dividends, excluding the lowest and highest years.

Further, the temporarily high dividend repatriations in the year of the holiday will likely be offset by lower dividends in subsequent years. The Joint Committee on Taxation (2004) scores this provision as resulting in a net revenue gain of $2.8 billion in 2005, with revenue losses over the following nine years, resulting in a ten-year revenue loss of $3.2 billion.

\textsuperscript{13} Daily turnover in foreign exchange markets averages $1.9 trillion in the cash market and an additional $1.2 trillion in the over-the-counter foreign exchange and interest rate derivatives market. See http://www.newyorkfed.org/fxc/about.html.
Effects on U.S. Investment

If one believes the title of the legislation, “The American Jobs Creation Act”, or the title of the provision, “Incentives to Reinvest Foreign Earnings in the United States”, then the presumed goal of the repatriation tax holiday is to increase U.S. investment. Still, there are numerous reasons to doubt that the provision will be effective in its stated aim.

Foremost, the dividend repatriation holiday does not alter the underlying attractiveness of investing funds in the United States vis a vis other locations. In a world of free capital markets, arguably an accurate description of reality, overall investment in the United States will be determined by (a) investment opportunities in the United States, which determines an investment demand schedule, and (b) the opportunity cost of funds, given by the world interest rate. Since the tax holiday does not alter either of these considerations, it should not alter the aggregate level of investment in the United States. More likely, it will simply lead to financial reshuffling.

Perhaps in response to such concerns, the AJCA requires firms to generate a domestic reinvestment plan, or a “drip”, to demonstrate that they intend to invest the repatriated earnings in the United States. Such a plan needs to be approved by the company’s president or CEO. In January 2005, the IRS issued guidance regarding this provision, and this guidance indicated a very flexible approach to the uses of repatriated funds. Funds may be used for funding of worker hiring or compensation, infrastructure and capital investments, R&D, financial stabilization, debt repayment, and marketing, among other things. As funds are fungible among alternative uses, firms should have
ample flexibility to satisfy the legislation’s requirements without changing their underlying investment decisions.

Thus, in light of the sophistication of the accountants and lawyers who watch over the finances of multinational firms, it is unlikely that the repatriation provision will generate new investment in the United States that would not have occurred otherwise. This likelihood is buttressed by several considerations. First, there is no evidence that the United States is experiencing a shortage of investment capital. Second, interest rates continue to be at historically low levels. Third, as Sheppard (2003) argues, the firms that are most likely to benefit from this provision already have “stellar” credit ratings and thus are unlikely to find borrowing constraints eased by any resulting debt repayment. Fourth, as mentioned previously, any increase in repatriations is likely to be offset by reductions in repatriations in subsequent years.

Finally, it is important to recognize that, despite the titles, the provision’s overall effect is to make investments in low-tax countries more attractive relative to the status quo, as there is now the promise of simple methods for repatriating profits from low-tax countries without incurring large tax costs. Further, if such holidays are anticipated for the future, there is also a reduced incentive to undercapitalize initial investments in low-tax countries in order to take full advantage of deferral.

Other Effects of the Dividend Holiday

Thus far, it appears that the dividend repatriation holiday of the AJCA may spur large temporary increases in dividend repatriations but it is unlikely to generate corresponding increases in U.S. investment relative to the prior status quo. However, the dividend holiday does have two other important consequences. First, it provides a
windfall gain to multinational firms that have accrued substantial unrepatriated earnings in low-tax countries. These firms are disproportionately the largest and wealthiest corporations, as Fleming and Peroni (2004) point out. Further, Simpson and Wells (2003) note that a dozen of the companies that lobbied Congress for this tax break (as part of the Homeland Investment Coalition) have been cited by the IRS for improperly sheltering funds overseas. This dividend holiday is effectively a tax break that rewards the past behavior of a group of firms that have been particularly adept at taking advantage of the deferral privilege and have therefore accumulated large quantities of unrepatriated profits in low-tax countries.¹⁴

Second, the one time repatriation holiday damages the integrity of the U.S. international tax system. The U.S. tax system has the stated intention of taxing the foreign income earned by U.S. multinational firms upon repatriation. By granting a temporary tax break for firms with large accumulations of untaxed profits in low-tax countries, this provision sends the signal that the U.S. government may grant such holidays in the future, or perhaps even move toward exempting foreign dividends from taxation. Indeed, this provision shares many of the characteristics of a tax amnesty, which can be expected to reduce future compliance absent increased enforcement efforts; see, e.g., Alm, McKee, and Beck (1990). Thus, firms will have an incentive to repatriate profits during the holiday but will likely face a reduced incentive to repatriate in subsequent years, as the prospects have improved for a future “one-time” holiday, an extension, or even a permanent change.

¹⁴ Further, the firms who will most benefit from this provision do not have a sufficient quantity of profits (and thus excess tax credits) from operations in high tax countries.
While there is language in the legislation that refers to this holiday as a temporary stimulus measure, it should nonetheless lead to permanent changes in expectations regarding the U.S. tax system. For example, there will presumably be other needs for stimulus in the future, and the dividend repatriation tax break has now joined the arsenal of potential responses. Also, the tax writers admit that they view the bill as taking “baby steps to a territorial system”.\textsuperscript{15} Thus, it is quite possible that this tax break will gain a constituency that will continue to seek extensions or permanence, and in the meantime, firms will be reluctant to repatriate funds without favorable tax treatment. An additional danger of the “baby steps” approach is that it can lead to a de facto adoption of a territorial system of taxation without the close policy analysis and debate that should accompany such a major change in the intent of the U.S. tax system.

III. International Tax Changes in the AJCA

In addition to the dividend repatriation holiday, there were a number of other changes to the U.S. international tax system. These changes have the net effect of further lightening the U.S. tax burden on foreign income earned by U.S. multinational firms. As discussed above, the overall U.S. tax burden on foreign income is already quite low prior to these changes. On net, the international tax provisions of the legislation are estimated by the Joint Committee on Taxation to lose over $40 billion in tax revenue over 10 years.

1. Reduction in the Number of Foreign Tax Credit Baskets

Under prior law, taxpayers determined their foreign tax credit limit separately for nine “baskets” of income; these categories of foreign income limited the ability of

\textsuperscript{15} See quote in Glenn (2004).
multinational firms to use taxes paid in high tax jurisdictions to offset income earned from activities in low-tax countries. Under the AJCA, beginning in 2007, the number of baskets is reduced from nine to two; the only separation is between passive and general income. 16 This change will allow greater flexibility of firms in shielding income earned in low-tax countries from taxation upon repatriation.

As discussed above, U.S. multinational firms are adept at using such cross-crediting strategies to diminish U.S. tax due on income earned in low-tax countries. The reduction in the number of foreign tax credit baskets makes this process more simple, facilitating a more efficient use of cross-crediting strategies. As a result, the JCT scores this provision as providing a revenue loss of $7.8 billion between 2007 and 2014.

While the intended purpose of the foreign tax credit is to avoid double taxation, the use of cross-crediting implies that foreign tax credits have other consequences. For example, earning income in high tax countries is less burdensome than it would be otherwise as such earnings generate valuable foreign tax credits that can shield income earned in low-tax countries from taxation upon repatriation. Excess tax credits can also be used to offset interest and royalty income earned from abroad.

Further, cross-crediting increases the incentive to earn profits in low-tax countries as it allows for such profits to be repatriated without triggering U.S. taxation. This brings

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16 While this provision would allow for some simplification, Fleming and Peroni (2004, p.1396) argue that the simplification gains are likely overstated. “U.S. taxpayers would still have to apply the sourcing rules to all items of income and the allocation and apportionment rules to all deduction items to determine whether those income and deduction items have a domestic or foreign source. Moreover, U.S. taxpayers would still have to sort through all foreign-source income items, foreign-source deduction items, and creditable foreign taxes to determine which of the two baskets those items and taxes fall within. This would continue to be a particularly challenging task for a corporation with extensive domestic and foreign operations…A decrease in the number of basket limitations would, of course, mean reduced computational complexity because of a smaller number of limitation fractions. However, given the availability of computer resources, a reduction in computational complexity seems unlikely to significantly reduce taxpayer compliance costs.”
the U.S. tax system closer to a de facto territorial system with respect to low-tax
countries, as income earned in low-tax countries can often be repatriated without
incurring U.S. taxation. As already discussed, the dividend repatriation holiday in the
AJCA works to similar effect.

2. Changes in the Carry Forward Provisions

Companies can now carry foreign tax credits forward for 10 years instead of 5
years previously. The carry back period has been reduced, however, from two years to
one year. While ceteris paribus firms have an incentive to use foreign tax credits as soon
as possible (as the associated benefits are not deferred), this provision should reduce the
probability of foreign tax credits expiring unused. It thus enables a greater degree of
cross-crediting than would otherwise occur. This provision has a 10-year revenue loss of
$6.9 billion, according to the JCT.

3. Provisions Weakening Subpart F

As noted above, subpart F limits the advantages of deferred taxation on income
earned in low-tax countries, as certain foreign income of controlled foreign corporations
is subject to immediate taxation. This legislation makes several changes that would have
the net effect of reducing the number of activities that generate subpart F income,
resulting in revenue losses. Such provisions increase the tax benefits of operating in low-
tax countries, as deferral of U.S. taxation on foreign income earned in such locations is
more likely.


17 Cross-crediting works in the opposite direction with respect to high-tax countries, as investments in high-
tax countries are more attractive than they would be in the absence of cross-crediting.
Numerous other provisions generally reduce the taxation of international income. Most importantly, these include changes in interest expense allocation rules, beginning in 2009. These changes allow corporations to elect to allocate interest expense on a worldwide basis, accounting for the global fungibility of finance. Consequently, firms will be able to reduce the amount of interest that is allocated to foreign-source income, effectively reducing tax payments for firms in excess credit position. This is the largest revenue loser of the international provisions, with a loss of over $14 billion in revenue over the period it is in effect, 2009-2014.

There are also international tax provisions that raise a small amount of revenue. Most noteworthy among these are provisions aimed at discouraging corporate inversions. In particular, some types of inverted corporations which under U.S. law would normally be considered foreign for tax purposes are instead considered domestic for tax purposes.

**IV. The Impact of the AJCA on the U.S. International Tax System**

This paper has focused solely on the international tax measures in the AJCA. This section will evaluate these measures in the context of the overall U.S. tax system. Judging the legislation by its title is perhaps unfair, as job creation is usually considered by economists to be outside the scope of most tax legislation. Instead, this section will judge these provisions by the standard metrics that economists use to evaluate tax systems: efficiency, equity (both horizontal and vertical), and simplicity (related to compliance costs, administrative burdens, and enforceability).

*Efficiency*
Prior to the AJCA, the U.S. tax system already favored income earned in low-tax countries relative to income earned in the United States. U.S. taxation on profits earned in low-tax countries is deferred until repatriation, allowing a substantial tax savings relative to a system that taxed profits currently. This leads to a tax incentive favoring operations in low-tax countries as well as financial maneuvers designed to shift worldwide profits toward low-tax locations. There is substantial evidence that U.S. multinational firms are responsive to these incentives.

Such tax preferences are inconsistent with efficient worldwide capital allocation, as they lead to artificially high levels of economic activity and profits in low-tax countries relative to high-tax countries. The AJCA strengthens these tax incentives in many ways, taking the U.S. tax system further from the ideals of tax neutrality and efficient worldwide capital allocation. Although in a second-best world it is not possible to make unambiguous statements regarding movements away from efficiency, it remains difficult to view the AJCA in a sympathetic light.

As discussed in Section II, the dividend repatriation holiday is likely to lead to a one-time surge in dividend repatriation, providing a windfall tax gain to multinational firms with a large quantity of unrepatriated earnings in low-tax countries. However, repatriations are likely to fall in subsequent years, and it is unlikely that this surge will have a substantial effect on real U.S. investment decisions. Further, this tax holiday makes future investments in low-tax countries more attractive, as the prospect of tax holidays that allow the easy repatriation of funds from low-tax destinations lessens the expected U.S. tax burden on income earned in low-tax countries. In addition, the other international tax provisions in this legislation also unambiguously lighten the U.S.
taxation of foreign income. For instance, the provisions weakening subpart F allow more
income earned in low-tax countries to qualify for deferral. Also, steps that enable greater
cross-crediting for multinational firms further the tax preference associated with
operating in low-tax countries.\textsuperscript{18}

From an efficiency perspective, one would want the tax treatment of U.S. and
foreign income to be similar. Yet, with respect to low-tax countries, similar tax treatment
is also a desirable objective in terms of encouraging economic activity in the United
States, the purported intention of the American Jobs Creation Act. While this legislation
may encourage job creation in the accounting sector, any stimulus to job creation in the
United States as a whole is dubious at best.

\textit{Equity}

The tax burden on capital income has fallen dramatically in recent years, with
dramatic cuts in the tax rate on capital gains and dividend income. These tax cuts have
often been based on a desire to avoid “double taxation” of corporate income. Yet
corporate tax receipts are at historically low levels relative to GDP, as shown in Figure 1.
Further, the General Accounting Office (2004) reports that 61\% of U.S. controlled
corporations report no U.S. tax liability at all over the period 1996-2000, and an
astonishing 94\% of U.S. controlled corporations report tax liabilities that are less than 5\%
of total income over the same period.\textsuperscript{19}

The incidence of the corporate income tax is a complex matter, although
economists generally agree that it is more likely to fall on the owners of capital than on

\begin{footnotesize}
\textsuperscript{18} As noted above, provisions enabling more efficient cross-crediting simultaneously reduce the tax penalty
associated with operating in high-tax countries, assuming the firm is also operating in low-tax countries (or
otherwise has use for foreign tax credits).

\textsuperscript{19} They utilize data from the IRS Statistics on Income files on corporate tax returns.
\end{footnotesize}
While this legislation has a claim of revenue neutrality, this claim is suspect due to the use of phase-ins and sunsets. The legislation will likely result in net tax break on corporate income, reducing the tax burden on capital owners, and lessening the progressivity of the tax system.

Even if revenue neutrality holds up, the AJCA creates some interesting horizontal inequities. For example, the dividend tax break provides a windfall tax gain to firms that have taken advantage of deferral and accumulated large stocks of unrepatriated profits in low-tax countries. As noted above, the major beneficiaries from this provision are also some of the larger, wealthier American corporations. Further, many other provisions of the legislation that are not addressed in this paper (such as the production income deduction and the sundry special interest provisions) are clearly at odds with the goal of horizontal equity.

**Simplicity**

A major rationale for the international tax provisions discussed in Section III was simplification of the U.S. international tax system. Indeed, this is a noble goal. Observers of the U.S. international tax system appear to share the opinion that it is excessively complex; few even claim to understand it. This complexity undoubtedly increases compliance costs, raises administrative burdens, and reduces enforceability. While there are some aspects of the AJCA that simplify the international tax system, most practitioners argue that the AJCA made insufficient progress. As Taylor (2005, p.22) notes, simplification was “more than offset by the complexity of other newly-enacted rules…[The legislation] did not even begin the process of addressing broad..."
simplification or the development of coherent rules.” PricewaterhouseCoopers (2004, p.711) concluded that the AJCA will “generate a number of challenges that may make it difficult for companies to comply with and benefit from the opportunities available to them. The challenges PwC sees include a number of complexities within the act, particularly in the international provisions…”

**Other Concerns**

If these international tax changes do not encourage efficiency, equity, or simplicity, then what are their possible merits? As argued above, these changes are unlikely to encourage U.S. job creation and they are likely to lose revenue. Advocates for these provisions often maintain that such changes will help the competitiveness of U.S. firms. These statements deserve close scrutiny. Presumably, if the government values the competitiveness of U.S. based multinational firms, it is because beneficial external effects are expected from their operations. Indeed, it is quite possible that U.S. multinational firms engage in a disproportionate amount of research and development, pay higher wages, and undertake valuable headquarters activities that may have beneficial spillover effects for the U.S. economy.

If this is the rationale for giving these firms special tax preferences, then several questions should be addressed. First, how confident are we that these beneficial external effects exist and are sizable in magnitude? Second, how does the size of these beneficial effects compare with those associated with other activities that the government could favor, such as education, basic science research, and infrastructure investments? Third, if these effects are large and compare favorably with those effects generated by other activities, what is the most efficient way for the government to encourage such activities?
The dividend repatriation tax holiday and the other international tax provisions in the AJCA are unlikely to be sensible responses.

**An Overall Assessment**

This paper has focused on the international tax provisions of the AJCA. The U.S. international tax system taxes the foreign income of U.S. resident firms, providing a tax credit for tax paid to foreign governments. However, income from low-tax countries is not taxed until repatriation, providing firms with an incentive to locate operations in low-tax countries and to shift profits to such destinations. The AJCA allows a temporary dividend repatriation tax holiday aimed at encouraging the repatriation of funds from low-tax countries. Since the provision is temporary, it is likely to spur sizable repatriations, as some firms will have an incentive to take advantage of a temporarily low tax price associated with repatriation. Still, the responsiveness of firms to this temporary measure may be dampened by the fact that not all firms will find repatriation advantageous. Further, due to the fungibility of funds across uses, it is unlikely that the earmarking required by the AJCA will lead to new investments in the United States relative to what would have otherwise occurred.

The net effect of this holiday, as well as the other international tax measures in the AJCA, is to make investments in low-tax countries more attractive. The dividend repatriation tax break benefits firms who have large accumulations of unrepatriated profits in low-tax countries. With the implementation of this tax break, the U.S. government has also raised the probability of similar tax breaks in the future. This change in expectations will likely increase the incentive for multinational firms to invest in low-tax countries and to shift profits to such destinations. Further, other international
tax provisions lessen the impact of subpart F and facilitate the use of cross-crediting, further easing the possible tax burden associated with foreign income. Overall, the international tax provisions of the AJCA send a confused message about the intention of the U.S. tax system and provide an unjustified tax gain to firms with profits in low-tax countries.
References


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Figure 1: U.S. Federal Corporate Income Tax Revenues/GDP, 1954-2004

Note: Data are from the Economic Report of the President 2005.