Congress of the United States

JOINT COMMITTEE ON TAXATION
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JUN 06 2014

Honorable Orrin Hatch
United States Senate
SH-104
Washington, DC 20515

Dear Senator Hatch:

This letter is a partial response to your request of June 4, 2014, for a revenue estimate of a proposal to re-enact section 965 for 2014, and for additional background information.

Section 965 provided an elective, temporary, 85-percent dividends-received deduction ("DRD") for certain dividends received by a domestic corporation from controlled foreign corporations, subject to a number of conditions and limitations. Included in these limitations were requirements that eligible dividends be: (1) in excess of a specified level of historical average repatriation; (2) no more than the greater of $500 million or the amount of overseas earnings identified for financial accounting purposes as permanently reinvested earnings ("PRE") which is discussed in detail below; and (3) reinvested in the United States pursuant to a dividend reinvestment plan approved by the management and board of directors of the electing corporation and meeting certain other criteria. An election under section 965 was available only for either the taxpayer's (i) last taxable year beginning before the date of enactment of section 965 (which was October 22, 2004) or (ii) first taxable year beginning during the one-year period beginning on such date of enactment.

It is assumed that your proposal would permit an election under section 965 for the taxpayer's first taxable year beginning after December 31, 2013, with appropriate changes to other dates and provisions necessary to adhere to the intent of section 965.

Assuming that your proposal would be enacted July 1, 2014, we estimate that your proposal would change Federal fiscal year budget receipts in the following manner:

Fiscal Years
[Billions of Dollars]

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
6.5	13.1	-10.0	-16.9	-16.0	-13.4	-12.3	-12.0	-11.6	-11.6	-11.7	-36.7	-95.8

NOTE: Details do not add to totals due to rounding.

Our revenue estimate draws from the evidence on the usage of section 965 in the 2004-2006 period, as well as evidence from other temporary reductions or holidays in areas such as sales taxation and the taxation of capital gain income. For example, the Internal Revenue Service has produced a descriptive analysis of the tax holiday and found that corporations repatriated $362 billion under the holiday, which resulted in a total deduction of $265 billion.[1] In addition, there has been extensive research regarding the effects of the section 965 tax holiday on repatriation behavior and the location of income, economic activity and investment, and firm governance.

Our estimate includes the following major components. The first is the loss in revenue associated with the reduced tax liability afforded under section 965 for certain dividends that taxpayers are predicted to repatriate even in the absence of enactment of the proposal. Although there are tax costs associated with repatriating dividends, recent research using experience from the repatriation holiday has shown that there is also an implicit (and potentially high) cost with deferring repatriations, with the cost rising as the amount of permanently reinvested earnings grows.[2] This suggests that, under present law, repatriations are likely to increase in the future as corporations expand their economic activity overseas.

The second major component of our estimate captures the U.S. tax effects associated with taxpayers changing their dividend repatriation amounts and/or timing in response to the proposal. These tax effects will increase or decrease revenue collected in the budget period depending on the source of those dividend repatriations that are accelerated into 2014 as a result of the proposal. Dividend repatriations accelerated from within the budget period, say from 2016, into 2014 will reduce federal receipts. Dividend repatriations may also be accelerated from outside the budget period into 2014, and these repatriations will increase federal receipts.

The third major component of the estimates reflects the moral hazard problem that the proposal creates. By encouraging taxpayers to increase total dividend repatriations with a special deduction, the proposal may also discourage taxpayers from repatriating certain dividends within the budget window if they anticipate that similar legislation may be enacted in the future that will

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[1] Vanessa Redmiles, "The One-Time Received Dividend Deduction," *SOI Bulletin*, vol. 27, no. 4, Spring 2008, pp. 102-114. The paper also analyzedthe distribution of qualifying dividends, finding that they were highly concentrated in a few industries and source countries.

[2] Rosanne Altshuler and Harry Grubert, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," April 1, 2013, available at ftp://snde.rutgers.edu/Rutgers/wp/2013-05.pdf.

enable them to repatriate dividends at a lower tax cost. This will have a direct effect on revenue collections as multinational corporations may delay dividend repatriations that would have occurred in the window absent the proposal, but do so without substantially altering where they plan to locate investment and income. However, tax revenue may also fall indirectly under the proposal as multinational corporations may also locate more income and investment overseas, or locate more overseas income and investment in lower-tax jurisdictions. This could be a profitable strategy if they expect that future dividends can be repatriated with little U.S. residual taxation, and research has found evidence that corporations increased overseas investment and reported greater amounts of permanently reinvested earnings as a result of the section 965 tax holiday.[3] A second repatriation holiday may be interpreted by firms as a signal that such holidays will become a regular part of the tax system, thereby increasing the incentives to retain earnings overseas rather than repatriating those earnings and to locate more income and investment overseas.

The final major component is the predicted distribution of the repatriated funds to shareholders in the form of dividends or share repurchases, and the subsequent changes in individual income tax liability, mainly from increases in dividend tax payments or capital gains recognized. Academic research on how companies deployed dividends repatriated under the section 965 tax holiday is mixed but generally suggests that most of the funds were used to increase dividend payments and share repurchases even though there were restrictions placed on the use of repatriated dividends for these purposes.[4] However, some research has found that there was little change in firm payouts as a result of the holiday.[5]

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[3] Thomas Brennan, "What Happens After a Holiday: Long-Term Effects of the Repatriation Provision of AJCA," *Northwestern Journal of Law and Social Policy*, vol. 5, Spring 2010, pp. 1-18.

[4] See, for example Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, "Watch What I Do, Not What I Say: The Unintended Consequences of the of the Homeland Investment Act, *Journal of Finance*, vol. 66, no. 3, June 2011, pp. 753-787, and Jennifer Blouin and Linda Krull, "Bringing It Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004," *Journal of Accounting Research*, vol. 47, no. 4, September 2009, pp. 1027-1059. These papers found that the holiday had no effect on investment.

[5] Michael Faulkender and Mitchell Petersen, "Investment and Capital Constraints: Repatriations Under the American Jobs Creation Act," *The Review of Financial Studies*, vol. 25, no. 11, November 2012, pp. 3351-3388. This paper found that investment increased among the subset of firms facing capital constraints.

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I hope that this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

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cc: Chris Campbell