International Association for Official Statistics
Ottawa, September 6-8, 2006

U.S. Multinational Companies, Dividends, and Taxes

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Companies have many incentives for investing abroad—proximity to markets or suppliers, lower cost labor, or favorable tax and legal environment. Tax consequences have always been considerations in investment decisions made by U.S. multinational companies (MNCs), but these considerations seem to be playing an increasingly important role, as businesses are expanding their investments and levels of transactions internationally. In particular, MNCs strive to minimize their tax burden while also achieving their other investment objectives, and they are quick to alter their existing practices or to employ new techniques to take advantage of tax laws when opportunities arise.

For example, U.S. MNCs have increasingly established holding companies in countries with favorable tax rules to oversee the operations of their foreign units and to reduce their overall tax obligations.[1] The establishment of holding companies in low tax foreign countries can reduce the U.S. tax consequences when internal funds must be redeployed internationally. For example, if a subsidiary in a foreign country pays a dividend to its U.S. owner, the dividend will be subject to U.S. taxes even if the U.S. owner immediately invests those funds in another foreign subsidiary. However, if the dividend is instead paid to a foreign holding company affiliate that invests those funds in another foreign subsidiary, there typically are no U.S. tax consequences. Investment in holding companies accounted for 35 percent of the value of the U.S. direct investment position abroad in 2004, compared to just 9 percent in 1982.[2]

In addition, MNCs have structured or restructured certain assets and activities across their various organizational units, and have located some profitable activities in foreign countries with favorable tax or regulatory environments. For example, U.S. companies have shifted the ownership of some income-generating assets, including intangibles such as patents, to their foreign affiliates. MNCs also have used transfer pricing to their advantage to shift profits to lower tax countries. Although the relative importance of tax considerations versus other

[1] A holding company is a company whose primary activity is holding the securities or financial assets of other companies.
[2] Estimates for 2005 will be released in the September 2006 issue of the *Survey of Current Business,* which will be available in the middle of September.

considerations in individual trade and investment decisions often is unclear, it is clear that MNCs carefully consider tax consequences in their decisions.

Governments also have a stake in MNC investment decisions, and there are some obvious reasons why governments may want to attract and control or influence certain types of MNC activities. The establishment of MNCs in an economy can lead to transfers of advanced technology and improvements in productivity, higher tax receipts, and increases in host economy employment and wages. Capital inflows can provide funds for increased domestic investment, workforce training, and R&D spending. Governments have various means for attracting or promoting MNC trade and investment. For example, in addition to offering low corporate tax rates, they can provide tax holidays, import duty exceptions, investment allowances, or favorable depreciation rates (Morisset, 2003).

The home countries of MNCs (i.e., the countries where the parent companies are located) also are concerned about how their economies are affected by these companies' activities. As the world's largest source of outward direct investment, U.S. policy makers recognize that the activities of U.S. MNCs may have a major impact on the U.S. economy. In an effort to give the U.S. economy a boost, the U.S. Congress enacted the American Jobs Creation Act of 2004 (AJCA).

The AJCA allowed U.S. parent companies that received dividends from their foreign affiliates during a specified period, and who used those dividends for particular purposes (described later), to be effectively taxed at substantially reduced rates. This tax relief led to a surge in dividends by MNCs in 2005.

This paper will review the provisions of the AJCA that relate to dividends; identify data that the U.S. Bureau of Economic Analysis (BEA) produces that are relevant to an analysis of the effects of the AJCA; describe how dividends, reinvested earnings, and earnings are treated under international standards; follow the dividends through the accounts using charts and graphs to illustrate the effects; and provide a profile of companies that took advantage of the tax incentives provided by the AJCA.

The American Jobs Creation Act

The AJCA provided U.S. MNCs with a tax incentive to boost dividends from their foreign subsidiaries and to use those funds for certain domestic activities. The AJCA, which was signed into law on October 22, 2004, allows U.S. companies that received dividends from foreign subsidiaries during a specified period (calendar year 2004 or calendar year 2005, at taxpayer option, for calendar year taxpayers) to exclude a large portion of the dividends from U.S. taxable income. Companies that take advantage of this incentive are required to develop a domestic reinvestment plan for the dividends.

The tax relief is in the form of a deduction for 85 percent of extraordinary dividends. Extraordinary dividends are dividends in excess of the average level of dividends over the past five years, excluding the highest and lowest years. (This results in an effective tax rate on the extraordinary dividends of 5.25 percent if the company is subject to the highest corporate tax rate (35 percent) on the 15 percent of the dividends that are still subject to U.S. tax.) The tax relief is for one year only—the first tax year beginning on or after the October 22, 2004 enactment date (calendar year 2005 for calendar-year taxpayers), or the preceding taxable year (calendar year 2004 for calendar-year taxpayers). The amount of income eligible for tax relief is reduced by any increase in the foreign subsidiary's indebtedness to related parties, effectively meaning the funds must actually be distributed by the foreign subsidiary and not returned to it in the form of a loan.

The domestic reinvestment provisions of the act allow a number of different uses for the dividends, including as a source of funds for worker hiring and training, infrastructure or capital investment, research and development expenditures, "or the financial stabilization of the corporation for the purposes of job retention or creation." This last category may include a number of different uses, such as satisfaction of tort liabilities where a connection can be made between extinguishing the liabilities, financial stabilization, and job retention and creation. Companies may not use the funds for executive compensation or to pay dividends to their shareholders. Companies are not required to show that they have created new jobs. The plan must be approved by a company's CEO (or similar official) before payment of the dividend, and then subsequently approved by its board of directors (or similar body).

Bureau of Economic Analysis Data

BEA is responsible for compiling the U.S. balance of payments and international investment position accounts, as well as data on the operations of U.S. parent companies, their foreign affiliates, and U.S. companies that are foreign owned. To meet these responsibilities, BEA designs and conducts a number of different surveys. BEA's direct investment balance of payments surveys cover cross-border transactions between affiliated companies, including items relevant to the analysis of the impact of AJCA such as dividends, reinvested earnings, and intercompany debt positions and transactions.[3] Data from the balance of payments surveys provide information on the U.S. parent companies' shares in the earnings of their foreign affiliates and on the affiliates' payments of dividends to their U.S. parents; data through the 1st quarter of 2006 are available now and are used in this paper to gauge the responses of U.S. MNCs to the AJCA.

How Dividends, Reinvested Earnings, and Earnings are Treated under International Standards

In compiling its data on balance of payments transactions, BEA adheres to the standards recommended by the International Monetary Fund in the *Balance of Payments Manual* and by the Organisation for Economic Co-operation and Development in the *Benchmark Definition of Foreign Direct Investment*.

Under these standards, direct investment exists when an investor directly or indirectly owns 10 percent or more of the voting securities of a foreign business enterprise. At this ownership level, direct investors are usually able to exert significant influence over the companies in which they invest, including influence over the timing and amount of dividends. Indeed, in the U.S. direct investment data set, a substantial majority of foreign affiliates are majority owned by U.S. parent

[3] BEA also conducts surveys of the activities of MNCs that cover relevant items, including taxes paid, capital expenditures, R&D spending, and employment of U.S. parent companies and their foreign affiliates. However, BEA's data on the activities of MNCs in 2005 are not included in this paper because they first become available in summer 2007.

companies, and there is little question about the ability of these U.S. parent companies to influence the timing and size of foreign affiliates' dividends. Direct investment earnings (a component of direct investment income in the current account of the balance of payments) include the direct investor's share in the total (distributed plus reinvested) earnings of its foreign affiliate.

The above may be contrasted with portfolio investment. Portfolio investors own less than 10 percent of the voting securities of the foreign business enterprise. They do not exercise significant control over the companies in which they invest, and so they generally cannot substantially influence the timing or amount of dividends. In the balance of payments accounts, income on holdings of portfolio equity consists only of dividends; reinvested earnings are excluded.

Following the Dividends through the International Accounts

Impact on the Current Account:

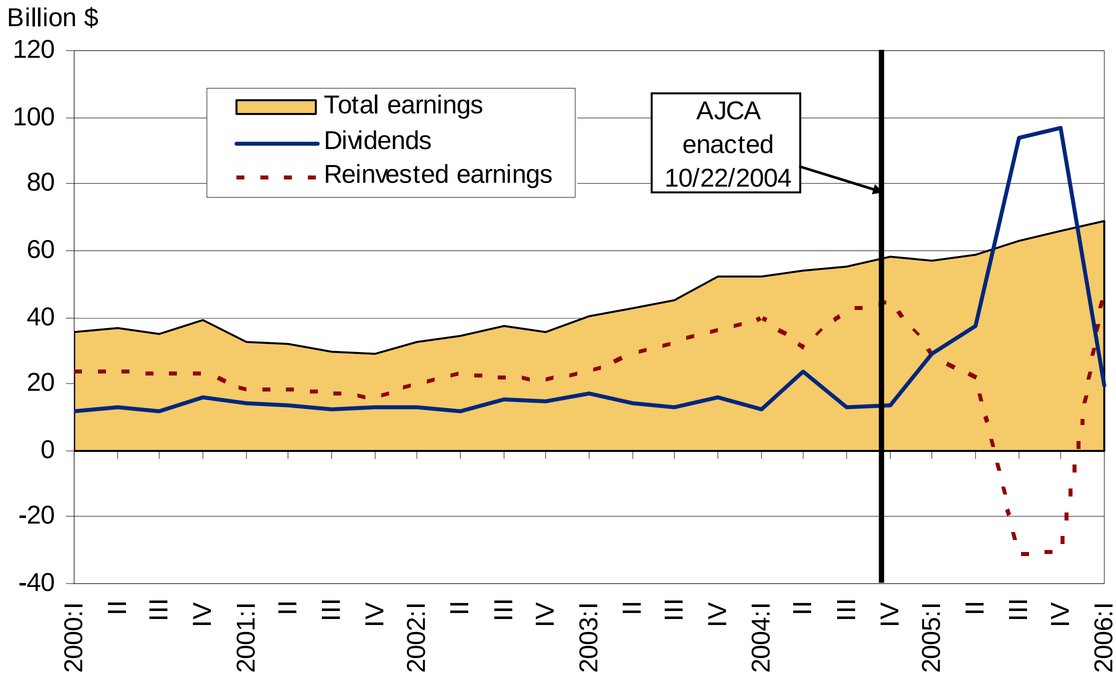
The AJCA created an incentive for U.S. parent companies to receive dividends from their foreign operations. As explained above, total direct investment earnings (not just dividends) are included in the current account in the balance of payments.[4] An increase in direct investment dividends resulting from the incentives offered by the AJCA is exactly offset by a decrease in direct investment reinvested earnings, resulting in no net change in direct investment earnings in the current account. The only impact on the current account from the increased distributions is a small increase in U.S. payments of foreign taxes, resulting in a small increase in the U.S. current account deficit (explained later).

Chart 1 below shows earnings, dividends, and reinvested earnings on U.S. direct investment abroad for 1st quarter 2000 to 1st quarter 2006:[5]

[4] The current account of the balance of payments includes imports and exports of goods and services, income, and current transfers such as gifts and grants. Direct investment earnings are included in income in the current account.

[5] For convenience, the term "dividends" is used throughout this paper to refer to the BEA data that are shown, but BEA data for "distributed earnings" are actually shown. Distributed earnings consist of dividends paid by foreign corporations plus distributions by unincorporated foreign affiliates. (In some cases, distributions by unincorporated affiliates are not identifiable, in which case the direct investor's entire share in the earnings of the affiliate is recorded as having been distributed.) Separate estimates of distributed earnings for incorporated and unincorporated

Chart 1: U.S. Direct investment Abroad: Earnings, Dividends, and Reinvested Earnings



In Chart 1, quarterly earnings on U.S. direct investment abroad are shown by the shaded area, dividends are shown by the solid line, and reinvested earnings are shown by the dotted line. After enactment of the AJCA, direct investment dividends moved sharply higher in the 1st quarter of 2005, they continued higher in the 2nd quarter, they surged in the 3rd quarter, and rose still higher in the 4th quarter. Dividends exceeded earnings in the third and fourth quarters, causing reinvested earnings to be negative for the full year 2005. Negative reinvested earnings, while not uncommon for an individual company for a single quarter, are unprecedented at the global level for a full year since at least 1950. Dividends were $256.3 billion in 2005, compared to $62.5 billion in 2004; reinvested earnings were -$11.2 billion in 2005, compared to $157.3 billion in 2004. In the 1st quarter of 2006, dividends and reinvested earnings returned to more typical levels, reflecting the end of the tax relief on dividends available under the AJCA for most companies.

foreign affiliates for 2005 were not available at the time of the writing of this article. However, unincorporated affiliates have accounted for only a small share (often about 10 percent) of total distributed earnings in most years.

As noted earlier, the increase in dividends led to a small increase in U.S. payments of foreign taxes. When dividends are paid by foreign affiliates to their U.S. parent companies, foreign countries sometimes impose a tax on the dividends that must be withheld by the foreign affiliates. Not every foreign country imposes such taxes, and the amount of the withholding taxes assessed by countries that do assess them is usually not large—often around 5 percent of gross dividends. Although a foreign affiliate that is paying a dividend withholds a portion of the dividend to satisfy the tax obligation, the tax is regarded as falling on the entity that is receiving the dividend (not the payor), and thus the gross dividend is reflected in the accounts as a distribution of earnings, and the tax is reflected in the balance of payments accounts as having been paid by the recipient of the dividend. Pursuant to international standards, cross-border payments of taxes are included in “private remittances and other transfers” in the balance of payments current account. The increase in taxes paid to foreign governments associated with the dividends paid pursuant to AJCA is not large relative to other components of the “private remittances and other transfers” account. (In 2005, this category of the current account was dominated by the effects of insurance claims and donations as a result of Hurricane Katrina.)

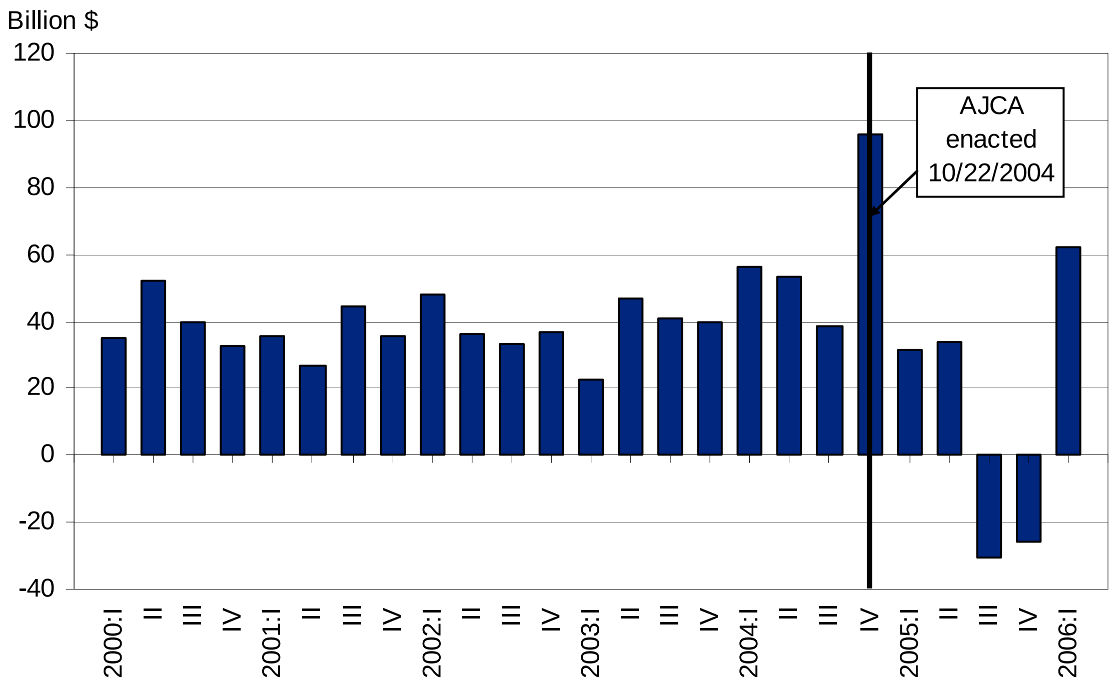
Impact on the Financial Account:

Several components of the financial account in the balance of payments were affected by the AJCA, but the act had a small net impact on the financial account balance. As the accounts are constructed, the net impact on the financial account balance is equal to (but has the opposite sign of) the act’s impact on the current account balance; as noted earlier, the latter is equal to the small increase in U.S. payments of foreign taxes.

Direct investment financial account transactions include reinvested earnings on U.S. direct investment abroad, intercompany debt transactions, and equity capital transactions. (Financial account outflows increase the value of the U.S. direct investment position abroad, and financial account inflows decrease the value of the U.S. direct investment position abroad.) The shift in direct investment reinvested earnings from positive to negative (discussed above) and a shift in intercompany debt transactions (from outflows to inflows, discussed later) resulted in smaller direct investment financial account outflows. For the year, direct investment financial account outflows fell from $244 billion in 2004 to $9 billion in 2005. Chart 2 shows direct investment financial account outflows for the 1st quarter of 2000 to the 1st quarter of 2006:

Chart 2: U.S. Direct Investment Abroad: Financial Account Outflows

(+ increase in direct investment abroad)

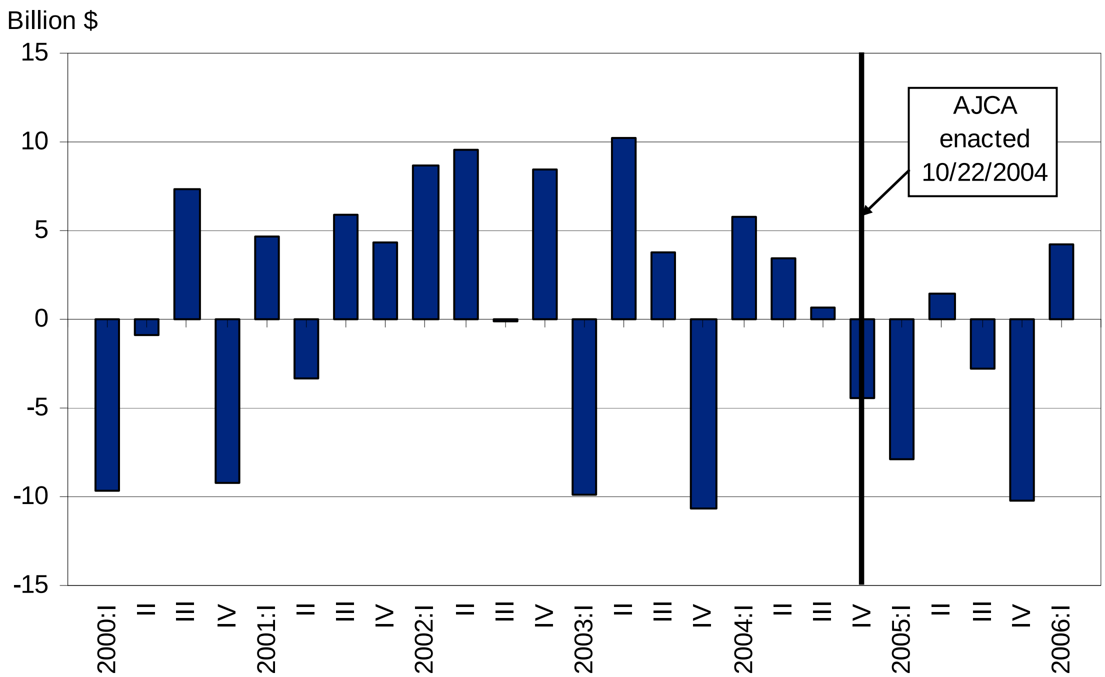


Depending on the means of settlement, the decrease in direct investment financial account outflows stemming from the increase in direct investment dividends was balanced by changes in one or more other financial account components, such as U.S. claims reported by U.S. banks, U.S. liabilities reported by U.S. banks, or direct investment intercompany debt. The changes in these components reflect the transmission of funds through the international banking system or – in cases where the dividends were declared payable but were not actually distributed – the increase in intercompany debt owed by foreign affiliates to their U.S. parents.

The AJCA indicated that increases in U.S. parent debt claims on their foreign affiliates would reduce the tax benefits available under the act, resulting in a disincentive for U.S. parent companies to increase their intercompany receivables on their foreign affiliates. Indeed, as shown in Chart 3 below, U.S. net debt receivables, included in U.S. direct investment abroad, declined by $19.4 billion in 2005, compared to an increase of $5.4 billion in 2004. A detailed examination of data for the specific affiliates accounting for large dividends in 2005 showed that no U.S. parent company substantially increased its net debt receivables on any affiliate that paid a large dividend in 2005.

Chart 3: U.S. Direct Investment Abroad: Intercompany Debt Transactions

(+ net increase in parent debt claims on affiliates; - net decrease in parent debt claims on affiliates)

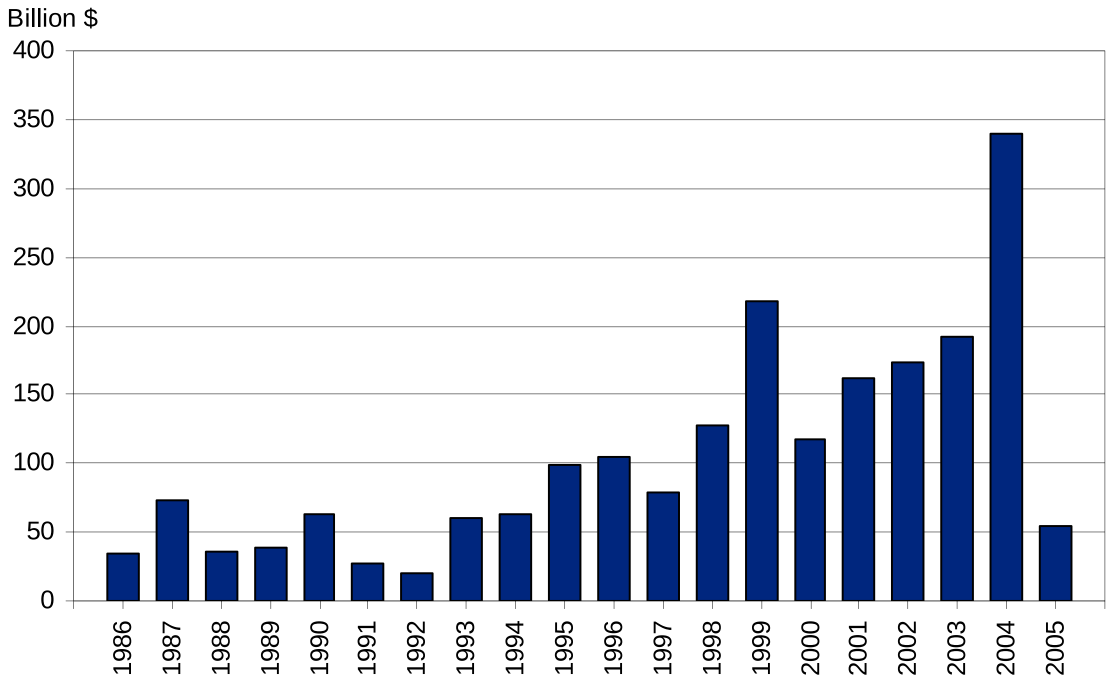


The transmission of funds through the international banking system from the payment of the dividends resulted in increases in assets or decreases in liabilities reported by U.S. banks included the financial account of the balance of payments. U.S. bank transactions tend to be relatively large and they frequently change direction from quarter to quarter, and the increase in dividends did not result in extraordinary or particularly irregular movements in U.S. bank financial account transactions.

Impact on the U.S. International Investment Position:

The AJCA led to a smaller increase in the U.S. direct investment abroad position than would have occurred with the continuation of historical trends in reinvested earnings and financial account transactions. As noted earlier, both reinvested earnings and net intercompany debt transactions, by themselves, caused the U.S. direct investment position abroad to move lower in 2005, whereas valuation adjustments (from exchange-rate changes, price changes, and other changes) and equity capital transactions more than offset the impact from these factors. Chart 4 below shows the annual change in the U.S. direct investment position abroad at current cost (that is, with tangible assets valued at replacement cost).

Chart 4: Change in U.S. Direct Investment Position Abroad at Current Cost



Annual increases in the direct investment position were gradually trending higher since the early- to mid-1990s, but the increase in the position in 2005 was the lowest in more than a decade. With direct investment at current cost, the position increased $55 billion in 2005, compared to an increase of $340 billion in 2004 and an average annual increase of $161 billion over the 10 years ending in 2004.

Profile of Companies That Took Advantage of AJCA

A few very large foreign affiliates accounted for a substantial majority of the increase in direct investment dividends in 2005. At least five affiliates paid dividends exceeding $5 billion and over two dozen paid dividends exceeding $1 billion. Some of these companies paid dividends that were several times larger than current year earnings.[6]

The foreign affiliates that accounted for most of the dividends (and negative reinvested earnings) were holding companies. (Reinvested earnings in holding companies were -$98.8 billion in 2005, compared to $65.8 billion in all other industries.) Holding companies' dividends were nearly 2½ times their earnings for the year. The U.S. parents of the holding companies that accounted for the large dividends are in a variety of industries, including pharmaceuticals, petroleum manufacturing, electronic components, and beverages. Affiliates in the manufacturing, finance and insurance, and wholesale trade industries also paid large dividends in 2005.

By geographic area, the large dividends were concentrated in Europe, particularly the Netherlands, Luxembourg, Switzerland, and Austria. There were also substantial dividends from the United Kingdom Islands-Caribbean and Bermuda, which caused reinvested earnings for "Latin America and Other Western Hemisphere" to be negative.

Conclusions

BEA's data confirm the responsiveness of MNCs to tax incentives, using recently available data on U.S. international transactions and international investment positions.[7] U.S. parent companies caused their foreign affiliates to substantially increase payments of dividends, so that the parent companies could take advantage of tax incentives available under the American Jobs Creation Act of 2004.

Direct investment dividends and reinvested earnings are both included in direct investment income in the current account of the balance of payments. Although receipts of direct investment dividends increased sharply in 2005, the net effect on the current account balance was small, as it was offset by a decrease in reinvested earnings.

[6] See Koncz and Yorgason, "Direct Investment Positions for 2005: Country and Industry Detail," July 2006 *Survey of Current Business*, 20-35.

[7] This paper has focused on responses to the AJCA, but this conclusion is more broadly supported by other research using BEA data. See, for example, Desai, Foley, and Hines, 2006.

Under existing international standards, the rationale for including direct investment reinvested earnings in the current account is that direct investors can control or substantially influence the payment of dividends; the U.S. experience in this case clearly supports this rationale. The inclusion of total direct investment earnings (rather than just distributed earnings) in income in the balance of payments current account allows the current account to more completely reflect current income at the disposal of direct investors, and allows the current account to more accurately reflect the profitability of investments, rather than a direct investor's decisions regarding the timing or size of dividends.

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