Repatriation taxes, repatriation strategies and multinational financial policy

Rosanne Altshuler\textsuperscript{a,*}, Harry Grubert\textsuperscript{b}

\textsuperscript{a}Department of Economics, Rutgers University, 75 Hamilton Street, New Brunswick, NJ 08901-1248, USA
\textsuperscript{b}US Treasury Department, Washington, DC, USA

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Abstract

Several investment-repatriation strategies are added to the standard model of a multinational in which an affiliate is located in a low-tax country and is limited to two alternatives: repatriating taxable dividends to the parent or investing in its own real operations. In our model, affiliates can invest in passive assets, which the parent can borrow against, or in related affiliates which can be used as vehicles for tax-favored repatriations. We show analytically how the availability of alternative strategies can affect real investment throughout the worldwide corporation. We use firm level data for US multinationals to test for the importance of alternative strategies. The evidence is generally consistent with the theory, particularly the strategies using related affiliates.

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In spite of the widespread interest in globalization, the literature on the behavior of multinational corporations (MNCs) tends to focus on a limited range of
financial flows between foreign affiliates and parents. In the standard model, the
MNC is subject to a credit and deferral tax system at home and typically operates
one affiliate in a low-tax country. After capitalizing the affiliate the MNC chooses
between direct dividend remittances to the parent and further real investment in the
foreign affiliate. Paying dividends is a costly alternative from a tax perspective
since these remittances are subject to the higher home country tax rate when
received by the parent. However, real investment in the foreign affiliate, which
may generate inferior returns relative to investment at home, is only one of many
alternatives to direct dividend repatriations. The MNC can engage in a variety of
other strategies that have the effect of achieving the equivalent of repatriation
without incurring the home country tax on direct repatriations of low-tax income.

One alternative to direct repatriation and investment in its real operations is
investment in passive assets such as Eurodollar deposits. Depending on the size of
the interest yield compared to the MNC’s equity return, this may be as good as
direct remittances. Beyond that, even if after-tax interest rates are low compared to
equity returns, the MNC can achieve the complete equivalent of a tax-free direct
repatriation if the parent can borrow against the passive assets held by the
subsidiary. Once borrowing is an option, direct flows between affiliate and parent
are no longer necessary — the earnings in the low-tax country can support
investment at home without bearing the burden of the US corporate tax.

Instead of investing in passive assets or reinvestment, the low-tax affiliate with
potentially high taxes on direct repatriations can invest in, or lend to, a related
foreign affiliate. This keeps the funds within the worldwide corporation and
generates a triangular flow of funds within the MNC. Further, as long as the
related downstream affiliate is not located in a low-tax country, it can become the
vehicle for tax-free repatriation by the low-tax subsidiary. To achieve this result,
the low-tax subsidiary invests in the related affiliate which then repatriates all of
its income to the parent. Equity injections from the low-tax subsidiary are then
used to fund the operations of the related affiliate. As will be explained further
below, under credit and deferral tax systems remittances from countries with tax
rates greater or equal to home country rates generate no residual home country
taxes. This ‘triangular’ strategy therefore allows the parent to effectively convert
the income earned in the low-tax subsidiary into high-tax income which can be
costlessly repatriated.

Another ‘triangular’ strategy that links the operations of related affiliates is one
in which the low-tax affiliate is initially capitalized by an equity injection from an
upper-tier subsidiary facing a higher host country tax rate. Then any dividend from
the low-tax affiliate up the tier obtains a ‘blended’ higher tax rate for the purpose
of tax credits against the home country tax when the dividend reaches the parent.

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1 See the theoretical models in Sinn (1984) and Hartman (1985). The empirical work by Hines and
Hubbard (1990), and Altshuler, Newlon and Randolph (1995), also focus primarily on dividend
repatriations.
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