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Repatriation taxes, repatriation strategies and multinational financial policy

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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 effect 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.

Keywords: Multinational; International taxation; Investment policy; Financial policy; Dividend repatriation

JEL classification: H25; H87

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

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financial flows between foreign affiliates and parents.[1] 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.

[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.