Journal of Financial Economics 116 (2015) 179–196

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

The effect of repatriation tax costs on U.S. multinational investment☆

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ARTICLE INFO

Article history:
Received 1 May 2013
Received in revised form
21 March 2014
Accepted 18 April 2014
Available online 2 January 2015

JEL classification:
M40
G34
H25
F23

Keywords:
Cash
Investment
Tax

ABSTRACT

This paper investigates whether the U.S. repatriation tax for U.S. multinational corporations affects foreign investment. Our results show that the locked-out cash due to repatriation tax costs is associated with a higher likelihood of foreign (but not domestic) acquisitions. We also find a negative association between tax-induced foreign cash holdings and the market reaction to foreign deals. This result suggests that the investment activity of firms with high repatriation tax costs is viewed by the market as less value-enhancing than that of firms with low tax costs, consistent with foreign investment of firms with high repatriation tax costs possibly reflecting agency-driven behavior.

1. Introduction

U.S. multinational companies (MNCs) currently hold over $2 trillion in cash, with the majority of this amount held by foreign subsidiaries (Casselman and Lahart, 2011; Davidoff, 2011). One oft-suspected reason for this offshore cash is the U.S. tax treatment of foreign-sourced earnings. U.S. tax rules are such that the operating earnings of foreign subsidiaries are generally not subject to U.S. tax until the related cash is repatriated to the U.S. Foley, Hartzell, Titman, and Twite (2007) provide evidence that the U.S. tax due upon repatriation (i.e., the repatriation tax, which is the U.S. tax less a foreign tax credit for taxes paid to the foreign jurisdiction on the earnings[1]) partially

☆ We appreciate the comments of an anonymous referee, David Denis, Lisa Eiler (discussant), Jeff Hoopes, Nemit Shroff, and workshop participants at the Office of Tax Analysis at the U.S. Treasury, the 2012 AAA annual meeting, and MIT. We also thank Scott Dyreng for sharing Exhibit 21 data. The statistical analysis of firm-level data on U.S. multinational companies was conducted at the Bureau of Economic Analysis (BEA), Department of Commerce under arrangements that maintain legal confidentiality requirements. The views expressed in this study are those of the authors and do not reflect official positions of the U.S. Department of Commerce. Part of this research was conducted when Verdi was a Visiting Professor at Unisinos University. Rodrigo Verdi gratefully acknowledges financial support from the Sloan School of Management, the Sarofim Family, and the CAPES Foundation. Rebecca Lester gratefully acknowledges financial support from the Sloan School of Management and the Deloitte Foundation.

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http://dx.doi.org/10.1016/j.jfineco.2014.12.004
0304-405X/

[1] The details of the foreign tax credit are beyond the scope of this paper. In general, the credit is equal to the foreign taxes paid on foreign-sourced earnings, subject to limitations and expense allocation. See Scholes, Wolfson, Erickson, Hanlon, Maydew, and Shevlin (2014) for a more detailed discussion.

explains the high levels of U.S. MNCs' foreign cash holdings. In other words, to avoid the U.S. repatriation tax, U.S. multinationals do not repatriate foreign cash. While Foley, Hartzell, Titman, and Twite (2007) (and related studies) provide evidence that U.S. tax policy encourages the cash to be "locked out" of the U.S., the use, or economic consequences, of these tax-induced overseas cash holdings is not well understood.

Our paper examines one possible use of the tax-induced foreign cash by studying the investment policy of U.S. multinationals. Specifically, we investigate whether the tax-induced overseas cash holdings are associated with overseas investment. Harford (1999) shows that cash rich firms engage in more acquisitions than other firms. We investigate a similar research question in the context of cash held overseas due to the U.S. repatriation tax. Specifically, our research question is whether the locked-out cash due to repatriation tax costs (i.e., the tax-induced foreign cash) is associated with foreign acquisition activity. Cisco's Chief Executive Officer (CEO) John Chambers revealed sentiment consistent with this line of thinking when asked about Cisco's $40 billion overseas cash held because of the repatriation tax. He stated, "We leave the money over there, I create jobs overseas, I acquire companies overseas, I build plants overseas, and I badly want to bring that money back" (Chambers, 2011).

Although Foley, Hartzell, Titman, and Twite (2007) show that higher repatriation tax costs are associated with higher cash balances, and Harford (1999) demonstrates that higher cash balances are associated with acquisitions, there are reasons why higher tax-induced foreign cash would not be associated with greater foreign investment. Firms might retain the foreign cash for precautionary reasons (Opler, Pinkowitz, Stulz, and Williamson, 1999; Bates, Kahle, and Stulz, 2009), in anticipation of a tax policy change or holiday, or spend it on other activities such as increased compensation, selling, general, and administrative (SG&A) expenses, etc. (e.g., Core, Guay, and Verdi, 2006). In such cases, we would not expect a relation between tax-induced foreign cash and foreign investment activity.

Our analyses focus on the investment behavior of U.S. MNCs and use both Compustat data as well as confidential data on foreign cash holdings and foreign investment from the Bureau of Economic Analysis (BEA). In our first set of tests, we follow Harford (1999) and focus on acquisitions because acquisitions represent a large fraction of foreign investment (Dunning, 1998), and data on acquisitions are available for a large sample of U.S. multinationals. The sample consists of foreign deals of U.S. multinational firms from 1988 to 2004. We stop our sample period in 2004 to avoid the effects of the American Jobs Creation Act (AJCA or the Act). The AJCA effectively lowered the tax rate on repatriations of foreign earnings for a one-year period (starting for the most part in 2005), during which some firms repatriated large amounts of cash from foreign subsidiaries at a low tax price (we discuss the AJCA in more detail below).

We use two proxies for tax-induced foreign cash. First, we use Foley, Hartzell, Titman, and Twite's (2007) measure of repatriation tax costs, which captures the amount of incremental taxes a company would have to pay if it repatriated foreign earnings to the U.S. Foley et al. show that this measure is associated with the foreign cash balances held by U.S. multinationals and thus serves as an indirect proxy for the amount of cash held overseas due to the repatriation tax. An advantage of this proxy is that it is available for all firms on Compustat. Second, we collect foreign cash holdings using BEA data and estimate a predicted amount of foreign cash held due to the repatriation tax. While this proxy directly uses data on foreign cash, the disadvantage is that it is only available for a subset of firm-years and, consequently, must be estimated for the remaining firm-years in our sample.

We find that both proxies for tax-induced foreign cash are positively and significantly related to the probability and frequency of foreign acquisitions (i.e., the acquisition of a foreign target by a U.S. company). In economic terms, a one-standard-deviation increase in either proxy for tax-induced foreign cash is associated with a relative increase of approximately 5% in the probability of a foreign acquisition. These results are robust to controlling for other factors that influence firm acquisition behavior, such as free cash flow, growth opportunities, and the firm's existing foreign and domestic presence. Further, we use the firm as its own control by comparing foreign and domestic investment and find that our results exist only for foreign acquisitions, but not for domestic deals, consistent with our predictions. Overall, these results are consistent with the hypothesis that locked-out cash due to repatriation tax costs leads managers to invest overseas.

We next examine whether the acquisitions are value-increasing or value-decreasing to the firm. Jensen's (1986) agency theory suggests that managers have incentives to grow the firm beyond its optimal size, i.e., to "empire build." Under this theory, managers retain cash under their control and grow the firm rather than pay the cash to shareholders. Consistent with Jensen's theory, Harford (1999) shows that higher cash balances are associated with agency-driven acquisitions. Specifically, the announcements of acquisitions by cash-rich firms have lower stock returns around the acquisition announcement date. Harford concludes that cash-rich firms are more likely to engage in value-decreasing investment activity.

A positive association between a firm's tax-induced foreign cash and foreign investment activity in our research setting does not necessarily indicate that the investment is value-destroying. For example, investing in foreign acquisitions could maximize the firm's after-tax cash flows compared to repatriating the foreign cash and paying the U.S. tax. In other words, foreign acquisitions might simply reflect firms exploiting foreign growth opportunities in an efficient after-tax manner. If this were the case, U.S. multinationals would engage in more foreign acquisitions because such investments would be value-enhancing to shareholders (relative to paying the U.S. tax under the current rules) and thus, investors would react positively to the announcement of such deals.[2]

[2] Hartman (1985) also models the foreign reinvestment vs. repatriation/domestic investment decision. If the firm invests overseas, the