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ELSEVIER Journal of Accounting and Public Policy 26 (2007) 376–384
Journal of Accounting and Public Policy
www.elsevier.com/locate/jaccpubpol

Income repatriation decision for multinational corporations: Tax issues ☆

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Abstract

This paper analyzes the existing asymmetry in the US corporate tax law governing the determination of foreign tax credits earned by US firms with foreign subsidiaries. The existing asymmetry results in the US government *de facto* holding foreign currency put options against US firms with foreign subsidiaries. Combined with the exchange rate volatility, this tax law asymmetry reduces the effective foreign after-tax rate of return and, thus, makes it profitable for US firms to repatriate their foreign source income earlier even when the foreign after-tax rate of return is higher than the domestic rate. Although this paper identifies this asymmetry in the tax law and analyzes its potential effect on the timing of foreign source income repatriation, it is an open question as to the economic significance of this tax code feature provided the firms' ability to curry the unused tax credit forward for up to 10 years.

JEL classification: H25; F39

Keywords: Corporate taxes; Subsidiary; FDI; Income repatriation; Options

☆ We are especially grateful to Roger Gordon and James Hines for their advice and numerous detailed comments.
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doi:10.1016/j.jaccpubpol.2007.03.003

1. Introduction

Hartman (1979) argues that US firms should delay the repatriation of income from foreign subsidiaries if the US after-tax rate of return is lower than the after-tax rate of return abroad. The analysis of the existing US tax system, presented in this paper, shows that this is not always the case. In particular, when the exchange rate is highly volatile or the foreign corporate tax rate is high, then US firms should repatriate their foreign source income sooner even if the US after-tax rate of return is lower than abroad.

This paper examines one of the remaining (after the Tax Reform Act of 1986) asymmetries in the US tax treatment of foreign source income, namely, the way how the exchange rate for calculation of foreign tax credits is determined. Under the current tax law, US firms pay home taxes on the income of their subsidiaries at the time of income repatriation. The taxes are calculated using the exchange rate at the time of repatriation. However, foreign tax credits are calculated using the exchange rate at the time foreign taxes were paid. Since foreign tax credits can be used only to offset tax liabilities on repatriated income, in the event of foreign currency depreciation some of the tax credits may be lost. Therefore, under the current tax law, a US firm that does not repatriate its foreign source income has a short position in a foreign exchange put option.[1] The value of this option increases with the exchange rate volatility and with the foreign corporate tax rate.[2] The existence of this implicit option reduces the effective foreign after-tax rate of return, which makes US firms willing to repatriate their foreign source income sooner. The paper shows that this reduction can be quite significant for realistic parameter values.

Previous research in this area has focused primarily on the expected component of the exchange rate movement.[3] In this paper, we present a model to analyze how exchange rate uncertainty impacts the firm's income repatriation decision. We show that the existing asymmetry in the US tax law results in substantial costs of income deferral and makes firms willing to repatriate the income of their foreign subsidiaries earlier. Consistent with the literature on real option (e.g., Dixit and Pyndyck, 1994), we find that exchange rate volatility is an important factor even when all parties are risk-neutral.

[1] See also Goldberg and Kolstad (1995) and Campa (1993) who use the "option-style" models to study the investment decisions of foreign subsidiaries based on non-tax motives.

[2] The size of the implicit options is determined by the value of the foreign tax credits that are exposed to this tax asymmetry, and this value positively relates to the foreign corporate tax rate.

[3] See, e.g., Hansson and Stuart (1986); Howard and Johnson (1982); Hartman (1979); Wahl (1989).