

The Effect of Financial Reporting on the Location, Reinvestment, and Repatriation Decisions of Multinational Companies

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Abstract:

We analyze survey responses of nearly 600 tax executives to better understand decisions related to location of operations, reinvestment, and profit repatriation. Prior literature does not examine how these decisions are affected by the ability to avoid recording for financial reporting purposes the U.S. income tax expense on foreign earnings. Our evidence indicates that avoiding financial accounting expense is an important factor in decisions about where firms locate operations, as well as whether to reinvest or repatriate foreign earnings. Indeed, the importance of avoiding expense recognition is statistically indistinguishable from the importance of avoiding real, cash taxes. This result is important in light of the decades of research on location and repatriation decisions that examines cash tax implications but has heretofore not investigated the importance of financial reporting effects. Our analysis suggests that financial reporting considerations could be one cause of “trapped” equity and high foreign cash holdings.

Keywords: investment, reinvestment, repatriation, tax expense, multinational

JEL classification: M40, H20, H25

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1. Introduction

Economic theory dictates that, in a perfect setting, corporate investment should occur if and only if it adds to firm value. In a multinational company, funds should be transferred between domestic divisions and foreign subsidiaries so as to permit this value maximizing investment to occur. In reality, the tax code introduces constraints that inhibit the flow of funds between business units, which in turn affects investment choices. For example, under some circumstances a U.S.-based multinational pays tax on profits transferred from a foreign subsidiary to the domestic parent (i.e., a repatriation tax). This repatriation tax often gives multinationals an incentive to defer the date of repatriation to avoid paying tax on these profits in the current period.

In addition to being able to defer these real, cash tax payments, multinationals can, by declaring earnings “permanently reinvested” overseas, avoid reporting on their financial statements the U.S. income tax expense related to these permanently reinvested earnings, resulting in lower reported GAAP effective tax rates and higher net incomes.¹ Traditional financial economics would argue that the “paper” income tax expense recognized on financial statements should not affect corporate decision-making. To the contrary, some research indicates that financial statement reporting considerations do in fact affect real corporate decisions (see Graham, Harvey, and Rajgopal, 2005 and the references therein). In addition, anecdotal evidence indicates that accounting income tax expense effects are important in the repatriation decisions. For example, James Tisch, CEO of Loews, wrote a letter to the editor of the *Wall Street Journal* stating that, “Unbeknownst to many (including legislators and Joint Committee on Taxation

¹ See Hanlon (2003) for a general discussion of the difference between cash taxes and the income tax expense for financial accounting purposes. In short, the income tax expense is an accrual based expense measure and rarely equals the cash taxes paid. We use GAAP ETR to represent the effective tax rate determined under Generally Accepted Accounting Principles (total worldwide income tax expense divided by worldwide pretax earnings).

estimators) GAAP allow corporations to avoid the accrual of taxes on foreign earnings...The results of the interaction of our repatriation tax laws and the GAAP accounting rules is that very little in the way of foreign earnings are repatriated....The accounting penalty for repatriating even a penny of foreign profits is so great that those foreign funds will not come back to the U.S....” (July 5, 2008).

There is a substantial body of work in economics, finance, and accounting that studies firms’ real investment and repatriation decisions.² However, due perhaps to data limitations, little research to date has examined whether financial reporting considerations related to the avoidance of income tax expense recognition affect corporate location and reinvestment and repatriation decisions. Shackelford, Slemrod, and Sallee (2008) discuss the need for research that examines both the tax and accounting implications of real corporate investment decisions. The authors argue that, because tax and accounting interact in important ways that affect real decisions, researchers should incorporate both tax and accounting choices and implications when analyzing and interpreting corporate behavior. In this paper, we take a step towards filling this void by surveying tax executives to obtain data about the importance of the financial expense deferral in these decisions.

Our survey evidence begins to answer this call for research and contributes to the prior literature in several ways. Among other things, we are able to directly inquire about 1) whether the financial accounting effects of being able to designate earnings as permanently reinvested under Accounting Principles Board Statement No. 23 (APB 23) affect firms’ decisions about operation location, reinvestment, and repatriation, and 2) the relative importance of the deferral of cash income taxes and the deferral of the income tax expense recognition for financial accounting

² See Hartman, 1985; Scholes et al., 2009; Hines and Hubbard, 1990; Altshuler and Newlon, 1993; Altshuler, Newlon, and Randolph, 1995; Desai, Foley, and Hines, 2001; Altshuler and Grubert, 2002; Blouin and Krull, 2008; Brennan, 2008; DeWaegeaere and Sansing, 2006; Oler, Shevlin, and Wilson, 2007; among others

purposes. Our survey evidence indicates that the ability to avoid or defer the recording of income tax expense for financial accounting is an important consideration in real corporate investment decisions regarding location of operations and whether to repatriate or reinvest earnings. For example, nearly one-third of the respondents rated income tax expense deferral under APB 23 as being important in their decision to locate operations outside of the U.S. Moreover, when we restrict the sample to firms we expect to be most concerned with financial reporting effects relative to all other factors (publicly traded, with foreign assets, and high intangibles), nearly 60 percent of these firms say financial accounting expense deferral is important or very important in their decision to invest in a foreign location. In addition, 44 percent of respondents stated that deferral of the financial accounting tax expense is important in their decision of whether to repatriate earnings or reinvest earnings outside of the U.S. Again, after restricting the sample (to firms that are publicly traded, with foreign assets, and have high intangibles), the data reveal that nearly two-thirds of respondents indicate that financial accounting expense deferral is important or very important in their decision about whether to repatriate earnings or reinvest earnings outside of the U.S. For both decisions – where to locate operations and whether to reinvest or repatriate foreign earnings – the importance of the financial accounting expense deferral is not statistically different than the importance of cash tax deferral when making these decisions.

These results are surprising in light of the decades of research on the location and repatriation decisions which tests the cash tax implications but has heretofore not examined the financial accounting implications. Furthermore, our evidence suggests that financial accounting effects lead to greater foreign direct investment by U.S. multinationals, all else constant. Finally, in addition to the evidence in Foley et al. (2007) about repatriation taxes contributing to large cash holdings of firms, our results suggest that financial reporting expense deferral is very likely to be another contributing factor. Indeed, we directly ask our respondents whether their firms would

repatriate more foreign earnings if APB 23 were repealed but cash tax deferral were retained. Approximately 60 percent of the respondents said yes (17 percent) or that their firm would consider it (42 percent). Thus, our results suggest that financial accounting expense deferral impacts “real” decisions.

An underlying question is *why* do firms care so much about the effective tax rate. We offer some conjectures and supporting evidence. First, a lower GAAP ETR increases after-tax accounting returns which affect stock price and thus shareholder returns. Second, Phillips (2003) provides evidence that some firms compensate managers based on after-tax earnings and thus the GAAP ETR may directly affect manager compensation. In addition, Armstrong et al. (2009) conclude that tax directors are provided with incentive compensation to generate favorable impacts to financial statement results. Third, in general, it is well documented that a lower GAAP ETR is important and that tax departments are profit centers for many firms (see Robinson et al. (2009)).

We note, however, that it is important to distinguish the focus on GAAP ETR in this case from conventional “earnings management” studies that investigate firms trying to meet or beat some established annual or quarterly earnings benchmark. Shackelford et al. (2008) argue that the permanently reinvested earnings (PRE) designation allows managers greater discretion and Krull (2004) provides some evidence consistent with managers using PRE to meet analyst forecasts; however, an alternative (or additional) explanation emerges from our conversations with tax executives. While not rigorously tested in our data, our conversations with the executives and other data indicate a potential explanation for why firms favor non-recognition of deferred tax expense on permanently reinvested earnings: this strategy reduces the reported effective tax rate so that it is more in line with the rates of foreign competitors and increases comparability of the firms’ financial statements. For example, in our interviews with respondents we heard comments

such as the following: “The designation of permanently reinvested earnings allows us to get our effective tax rate within striking distance of our international competitors’ rates” and “... puts us on a more even playing field with [our competitor]” and “Our main competitor is in [another country] and their financial statements do not have this effect because there is no residual tax.”³ Thus, managers indicate that they are concerned about the GAAP ETR because of its relation to having financials that are more comparable and competitive with their foreign competitors’. Indeed, in a letter to the International Accounting Standards Board, the Financial Executives Institute argued that effectively eliminating APB 23 would not “improve comparability of financial reports of U.S. preparers and non-U.S. preparers subject to IAS” and that in fact “comparability of financial reports will suffer...because many countries have a territorial tax system” and have no residual tax to record. The letter goes on to state that if taxes on permanently reinvested earnings were recorded for a U.S.-based company, “...earnings could be significantly affected relative to the foreign-based company when the companies are actually in essentially the same economic position...comparability would diverge rather than converge.”⁴

Thus, the GAAP ETR is an important metric to firms potentially because it affects stock prices, compensation contracts, and/or is an important benchmark relative to competitors (e.g., indicating efficiency). The specific portion of the GAAP ETR related to foreign operations and repatriations is especially important in an economic and policy sense, as the effect on the GAAP ETR from foreign operations influences firms’ *real* foreign direct investments. In other words, any actions taken by management to affect the GAAP ETR through foreign earnings are *real* investment actions not easily reversed and have possibly large macro-economic effects, such as

³ Phrases in brackets replace phrases the may identify the respondent firms.

⁴ See letter from the Financial Executives Institute to Sir David Tweedie, Chairman of the IASB dated June 14, 2004. The letter was a response to a deliberation on the conformity project, where the IASB concluded that “in principle, no exception should exist for temporary differences on investments in subsidiaries and associations or interests in joint ventures-domestic or foreign.” Effectively APB23 is now retained in IASB No. 12.

large cash balances on balance sheets, increased domestic debt levels, job creation overseas, and less tax revenue to the U.S. government.⁵

The remainder of the paper proceeds as follows. Section 2 discusses the tax and accounting rules related to the foreign earnings of a U.S. multinational. Section 3 discusses the prior literature regarding location decisions and the reinvestment or repatriation decision. Section 4 discusses our survey approach, how we obtained our sample, and descriptive data on the respondents. Section 5 analyzes the survey responses. Section 6 examines whether the importance of financial accounting expense deferral provides some explanation of why firms hold so much cash. Section 7 concludes.

2. Taxation and Accounting Rules for Foreign Earnings

2.1 Taxation of foreign earnings

The U.S. taxes its residents' (corporate and individual) income on a worldwide basis.⁶ This means that U.S. taxes are incurred on income earned in the U.S. as well as on income earned abroad. However, an important feature of the U.S. tax system is what is known as deferral. In general, a U.S. parent is taxed on its subsidiaries' foreign income only when it is repatriated back to the parent corporation.⁷ Until repatriation, earnings reinvested in foreign operations are allowed to grow U.S.-tax free.^{8,9}

⁵ See Foley et al. (2007) and Graham et al. (2008) for more discussion of these effects.

⁶ The U.S. system is really a "hybrid" tax system (as are most countries') because the U.S. taxes worldwide income but allows for deferral and foreign tax credits.

⁷ Deferral is only available for U.S. taxes on earnings of foreign subsidiaries of U.S. parents; it is not available for the earnings of a foreign branch.

⁸ There are provisions, such as the Subpart F rules, which aim to discourage U.S. firms from taking full advantage of deferral. Under these rules, certain foreign income of foreign subsidiaries is not eligible for deferral and is subject to immediate taxation in the U.S. Subpart F income includes, among other items, passive income of the foreign subsidiary.

⁹ The earnings for the foreign subsidiaries are not consolidated and taxed currently because for tax purposes the consolidation rules are different for domestic and foreign subsidiaries. For tax purposes, consolidation into a single return can be elected, but is not required, when direct or indirect ownership of a *domestic* subsidiary is at least 80

To avoid subjecting U.S. multinationals (and individuals) to double taxation, the U.S. allows a foreign tax credit against U.S. taxes for income taxes paid to foreign governments. These credits are limited, however, to the amount of U.S. tax liability on foreign income (before any foreign tax credit). Thus, in terms of taxes due upon repatriation of foreign dividends, in general, if a firm has an average foreign tax rate that exceeds the U.S. tax rate, then the firm will not owe any incremental U.S. tax upon repatriation (nor will it receive a rebate from the U.S. government). These firms are said to be in an excess credit position (or are said to have binding foreign tax credits).¹⁰ Conversely, if a firm has an average foreign tax rate that is less than the U.S. tax rate, the firm will receive full credit for the foreign tax paid (or deemed paid) and will have to pay U.S. tax in the amount of the differential between the U.S. tax rate and the foreign tax rate times the foreign earnings. These firms are said to be in a deficit credit position (or are said to have nonbinding foreign tax credits).

2.2 *Accounting for foreign earnings and the U.S. taxation of those earnings*

Generally Accepted Accounting Principles (GAAP) are not concerned with the source of a company's income. Thus, the deferral concept in tax is an important distinction from financial accounting. For financial accounting purposes, any subsidiary greater than 50 percent owned, whether incorporated in the U.S. or in a foreign location, is required to be consolidated on the financial statements. Thus, the financial statements will include the income or loss of foreign

percent in terms of voting power and value. Foreign subsidiaries generally cannot be included in the domestic tax consolidation, and thus neither are their earnings. If the foreign subsidiary had income effectively connected with a U.S. trade or business then that income would be subject to U.S. tax, however the foreign subsidiary still would not be part of the tax consolidation with the U.S. parent.

¹⁰ Excess foreign tax credits can be carried back and forward. Statistics of Income data for the year 2002 reveals that the excess foreign tax credit carryovers into the year 2002 were significant: the carryover was equivalent in amount to 42 percent of the total foreign taxes paid, accrued, and deemed paid for the year 2002. These data include 138,000 corporate returns sampled from over 5.3 million active corporate returns (Forms 1120, 1120-L, 1120-F, 1120-PC, and 1120-REIT).

subsidiaries that are more than 50 percent owned and the representative share of income or loss of foreign entities owned between 20 and 50 percent (under the equity method of accounting) while the tax return will not include any of these amounts.¹¹ Instead, the tax return will include any dividends received from these entities (while the financial statements will not include these dividend amounts).

A U.S. corporation must generally compute deferred tax assets and deferred tax liabilities for all temporary differences that exist between the book and tax bases of its worldwide assets and liabilities. For a multinational, the difference between current year foreign earnings and current year dividends repatriated from the foreign jurisdiction is a temporary difference on which incremental U.S. deferred taxes would normally be accrued. Such an accrual would increase the GAAP effective tax rate (defined as the total tax provision divided by pretax book income) and lower reported net income. However, an exception is provided in Accounting Principles Board Opinion No. 23 (APB 23), which states that the accrual for taxes that would be due on repatriation should not be recognized for undistributed earnings of subsidiaries if the indefinite reversal exception applies.¹² In other words, if a firm has foreign earnings in a foreign subsidiary that the company deems to be permanently reinvested (PRE) (i.e., the company does not plan to repatriate the earnings), the firm's financial statement tax provision will not include an accrual of U.S. taxes that would be due on repatriation of those earnings even though the earnings are included in income. Thus, all else equal, if a company has earnings in a low tax country that it reinvests and designates as permanently reinvested, the company will have a lower overall effective tax rate and

¹¹ Recent changes to the financial accounting rules will make this difference potentially larger with the option to adopt fair value accounting under SFAS 157 and SFAS 159. Under these standards a firm can choose to adopt fair value accounting for 20 percent – 50 percent investments in another entity. Further discussion is beyond the scope of this paper. However, the point that the fair value increases or decreases would be income for book purposes whether domestic or foreign, retains the point that GAAP (and International Financial Reporting Standards (IFRS)) do not distinguish between domestic and foreign income.

¹² SFAS 109 retains the indefinite reversal exception in APB 23.

higher earnings relative to what earnings would be if they were earned in the U.S. or earned in the foreign subsidiary but not designated as permanently reinvested. An example of a firm's disclosure is included in Appendix B which illustrates the effect of designating foreign earnings as PRE on the firm's GAAP ETR. Note for this company the effect of having \$21 billion in earnings overseas and designated as PRE reduces their GAAP ETR by 6.6 percentage points (because there is no incremental U.S. tax expense accrued).

3. Prior Literature on the Location of Operations and the Reinvestment or Repatriation of Foreign Earnings

3.1 Location decisions

In deciding where to locate operations, there are many factors to consider. For example, the infrastructure, labor supply, culture, economy, political risk, geographic location in terms of distance to customers and distance from the U.S., financing, and the tax rates and policies in the locations where operations might be located.

The extent to which foreign country taxes impact location decisions has been studied in prior literature. For example, Wilson (1993) investigates the role of taxes in location decisions through interviews with nine companies. Wilson's (1993) evidence leads him to conclude that tax considerations largely dictate location decisions for business activities where nontax costs are low, such as administrative centers. However, for manufacturing location decisions he reports that nontax considerations are very important, even when the final decision is to locate in a low tax country. Single (1999) asked sixty-six experienced tax executives of major U.S.-based multinationals in the manufacturing industry to review a case study involving a subsidiary plant location scenario and evaluate the relative importance of all the location-specific factors. Five of the factors were tax-related: Corporate tax rate, tax holidays, the presence of a treaty with the U.S.,

withholding rates, and accelerated capital write-off provisions. Single (1999) reports that all tax factors ranked among the lower half of all the factors listed in terms of importance in the decision for her sample of manufacturing firms.

Kemsley (1998) examines a much broader set of companies and tests whether the ratio of exports to foreign production varies with export incentives and foreign country tax rates. Kemsley (1998) reports that taxes matter such that greater export incentives are associated with higher exports and lower host country taxes are associated with a lower ratio of exports to foreign production.

There are a large number of studies in economics that attempt to estimate the effect of host country taxation on foreign direct investment in a country. For example, Grubert and Mutti (2000) use tax returns of 500 U.S. multinationals and estimate that a lower tax rate which increases the after-tax return to capital by one percent is associated with a roughly 3 percent higher rate of capital investment. Indeed, DeMooij and Ederveen (2003) compare the results of 25 empirical studies and conclude that the median value of the tax rate elasticity in the literature is around 3.3; i.e., a 1 percent reduction in the host country tax rate raises foreign direct investment in that country by 3.3 percent.¹³ Thus, there is substantial evidence regarding host country taxation and its effect on location decisions. However, to our knowledge, no empirical study has examined the importance of financial accounting income tax expense deferral in the location decision of a multinational corporation.

Shackelford et al. (2008) develop a model to formalize the idea that when managers value flexibility in their tax and financial reporting, they are more likely to make real decisions that create an environment that allows such discretion. For example, Shackelford et al. (2008)

¹³ See Altshuler, Grubert and Newlon (2001), Devereux and Freeman (1995), Hines (1996, 1997, and 1999), and Slemrod (1990). In earlier work, Hines (1999) surveys the literature to date and finds an overall elasticity of -0.6.

hypothesize that the discretion in financial reporting that a firm gains via foreign operations gives companies an incentive to locate in low-tax countries, e.g., tax havens. This incentive occurs because generally the less the foreign tax, the greater the U.S. tax due upon repatriation and thus the larger the financial accounting expense that can remain unrecognized by locating abroad, reinvesting foreign profits, and designating those profits as permanently reinvested. Because the non-recognition of the expense is valuable, GAAP rules could have the effect of encouraging investment in tax havens.

3.2 Reinvestment or repatriation decisions

Previous research has also investigated the effect of taxation on the decision to reinvest or repatriate foreign earnings. Throughout this literature, there has been some level of debate about the extent to which a home country repatriation tax is important. For example, Hartman (1985) demonstrates that, if the repatriation and U.S. taxation of foreign earnings is inevitable and tax rates are constant (and these are crucial assumptions), then U.S. repatriation taxes do not affect the decision of mature firms to either reinvest funds abroad or repatriate the earnings.¹⁴ Others argue firms can (easily) tax plan around the repatriation tax (Altshuler and Grubert, 2002) and thus the tax is not an important factor. In addition, there is the empirical observation that little U.S. tax is actually collected on foreign earnings (Grubert and Mutti, 1995; Altshuler and Newlon, 1993; U.S. Treasury, 2007; U.S. Government Accountability Office, 2008; Dyreng and Lindsey, 2008). However, the assumptions in Hartman (1985) are very specific and do not apply in many contexts. Empirical tests of firm actions in a cross-section where the repatriation tax varies (Desai et al., 2001), using specific matched tax return data for the parent and subsidiaries (Altshuler and

¹⁴ See Hartman (1985) and Scholes et al. (2009) for the model (and a discussion) of a firm's decision to reinvest or repatriate earnings.

Newlon, 1993), or in the case of a temporary tax price change such as the American Jobs Creation Act of 2004 AJCA (Blouin and Krull, 2008; Brennan, 2008; Graham et al., 2008) all provide evidence consistent with dividend repatriations being sensitive to changes in the repatriation tax price.¹⁵ Further, Foley et al. (2007) provide evidence consistent with the repatriation tax being a determinant of firms' large cash balances. All of these studies examine the importance of the home country repatriation tax; none examine the importance of the financial accounting effect related to the tax.

A concurrent paper by Blouin et al., (2009) examines capital market incentives on firm repatriations. The authors use Bureau of Economic Analysis survey data and report that public firms are more sensitive than private firms to tax costs of repatriation and less likely to trigger tax costs in the fourth quarter. From these results the authors conclude that public firms are influenced by APB 23 income tax expense recognition provisions in their repatriation decisions. We investigate a broader set of questions by examining both investment and repatriation decisions. Further, we ask respondents directly about the importance of financial accounting effects for their firms and we ask it as a distinct factor from the cash tax effects. Blouin et al. (2009) must infer the importance of the accounting effects through the use of proxies such as being publicly traded. In another concurrent paper, Klassen and Laplante (2009) provide evidence that firms with a financial reporting incentive to reduce reported tax expense shift more income into low tax foreign countries. Overall, we view our paper and these two concurrent papers as complementary.¹⁶

¹⁵ The AJCA granted a one-time dividend received deduction (DRD) against repatriated foreign earnings of U.S. multinationals. The DRD provision exempted 85 percent of qualified dividends repatriated from U.S. tax, which effectively reduced the rate of U.S. tax on the repatriated dividends to 5.25 percent (15 percent*35 percent statutory tax rate) before any foreign tax credits. This tax reduction constituted a temporary change in the tax price of dividend repatriation and thus, altered the incentives to repatriate earnings back to the U.S. We discuss this further below.

¹⁶ Three empirical studies investigate permanently reinvested earnings and its effect on firm actions or market pricing. First, Krull (2004) examines whether firms designate earnings as permanently reinvested in an attempt to manage earnings to meet analysts' forecasts and reports evidence consistent with firms doing so. Second, Collins, Hand, and Shackelford (2001) and Oler, Shevlin and Wilson (2007) report evidence consistent with current capitalization into

4. Survey Approach and Sample

We developed the survey document with the support of Tax Executives Institute (TEI) and PriceWaterhouseCoopers (PwC). We solicited feedback from members of both of the above groups as well as from academic researchers. Survey Sciences Group (SSG), a survey research consulting firm, assisted with the survey formatting and programmed an online version of the survey. SSG also professionally formatted a paper version of the survey to be distributed with the final reminder. We had two companies beta test the survey and we made revisions based on their suggestions. The final survey contained 64 questions, most with subparts. The paper version of the survey was 12 pages long. The survey contained many branching questions and as a result many firms were directed to answer only a portion of the questions. See www.ssgresearch.com/taxsurvey for the online version of the survey. The paper version is available from the authors upon request.

An initial email invitation was sent on August 9, 2007 to the 2,794 member firms of Tax Executives Institute (TEI). We examined the list of Fortune 500 companies and identified 45 firms that were not members of TEI. For these firms, PwC supplied the tax executive's name and email address. Three email invitations were returned as undeliverable. On August 15, 2007 we sent a letter via two-day express mail to fifteen companies for which we did not have email addresses. A total of 2,806 companies received invitations to complete the survey.

SSG sent three email reminders throughout August and September. We then sent a paper version of the survey (along with a letter with instructions of how to complete the

stock prices of the unrecognized deferred tax liability associated with unrepatriated foreign earnings generated in low-tax jurisdictions.

survey online) during the last week of September and the first week of October. We closed the online survey on November 9, 2007.

A total of 804 firms entered the online version of the survey or sent back a paper version. Sixty of these companies entered no more than one or two responses and thus we delete them from our sample leaving 744 usable responses. The response rate for our survey is 26.5 percent, higher than many prior survey studies. For example, Graham, Harvey, and Rajgopal (2005) obtain a response rate of 10.4 percent, Trahan and Gitman (1995) report a response rate of 12 percent in a survey mailed to 700 executives, Graham and Harvey (2001) obtain a 9 percent response rate, and Brav et al. (2005) report a 16 percent response rate. In addition, Slemrod and Venkatesh (2002) survey tax preparers and corporate taxpayers about compliance costs and obtain a 12 percent response rate from the tax professionals and 9 percent from the taxpayer corporations. Slemrod and Blumenthal (1996) obtain a similar response rate to ours. They survey large corporate taxpayers about compliance costs and obtain a response rate of 21.8 percent (365/1,672). Thus, our response rate compares favorably with other recent surveys.¹⁷

Because we are interested in U.S. companies' decisions with respect to corporate taxes and the accounting treatment of these taxes, we eliminate eleven firms that indicate they are an S-corporation or other type of flow-through entity and are thus not subject to the U.S. corporate income tax. We also eliminate 29 companies that state they did not file a form 1120 (under the assumption that these companies are also not C-corporations but

¹⁷ We believe the support of TEI was very helpful in increasing the response rate. In addition, there seemed to be genuine interest in the topics we asked about as evidenced by the respondents' comments. For example, one company wrote "Appreciate the survey. Interestingly, the survey touches on those tax management areas most important to our company at the moment..." Another commented "I rarely fill out surveys, but was impressed by your questions. The U.S. system for taxing foreign dividends is terrible in so many ways and doesn't even raise revenue." Another respondent just wrote, "Good survey!"

rather are some type of pass-through entity).¹⁸ We restrict the sample further by eliminating observations for subsidiaries of foreign parents (105 firms) and for responses that state in their comments that their foreign operations were insignificant and thus they were not sure how to respond to the foreign earnings questions (4 firms). We have 595 remaining firms on which we conduct the following analyses. The sample size varies across questions due to branching or incomplete responses for that particular question.

5. Descriptive Statistics, Research Questions, Results, and Inferences

5.1 Descriptive statistics

The survey was divided into four parts. Section A asked general descriptive questions about the companies.¹⁹ These data are summarized in Table 1, Panel A. In terms of ownership, 75 percent of the respondents are publicly traded on the NYSE, NASDAQ or AMEX, while 23 percent are privately held, and 2 percent responded that they were ‘other’ such as over the counter stocks. Our respondent firms represent a variety of industries, with roughly 30 percent being from manufacturing, 16 percent classified as holding companies, almost 7 percent from professional, scientific, and technical services, and 6 percent from retail trade (industry classifications are derived from the companies’ responses about their principal business activity code on Form 1120). In all, 19 different industry classifications are represented and 11 percent of the respondents did not enter an industry code.

¹⁸ There were 24 companies that actually answered that they filed zero 1120s. There were 5 companies that did not answer the question but were deleted from the sample because by analyzing the other questions in the survey we determined that these companies were likely not C corporations either.

¹⁹ The second part of the survey asked questions about general location and reinvestment and repatriation decisions, with some attention to the AJCA of 2004, the subject of the current paper. The third part focused on the AJCA of 2004 and the repatriation decisions in response to that Act (e.g., sources and uses of cash repatriated). The final part of the survey asked general questions about tax aggressiveness, tax rates, and tax planning. The data from the third and fourth parts of the survey are analyzed in separate papers.

It is difficult using publicly available archival data to obtain data on the location of a firm's assets. In contrast, we are able to gather this information. In our sample, 53 percent of the companies indicate they have 10 percent or less of their assets in foreign locations. Only slightly more than 8 percent of the firms have more than half of their assets in foreign locations.

We report tax return filing characteristics of the firms. These data reveal that our sample firms range from simple to complex in nature. For example, 94 percent of our sample files a consolidated tax return. Of these consolidated returns, 58 percent include more than 10 entities in the tax return filing. In addition, 80 percent of the sample firms file at least one Form 5471 indicating these companies have significant ownership interests in foreign subsidiaries. These data are not publicly available for a similar set of firms so we cannot compare to any established benchmark.

Because we are interested in the financial accounting effects of the location and repatriation decisions, we gather data on effective tax rates. We define the effective tax rate as the traditional GAAP effective tax rate (total worldwide income tax expense/ worldwide pretax book income). We ask privately held companies to report their effective rate and we compute the ratio using financial statement data for the publicly traded firms (the data are for the most recent year prior to completing the survey). Consistent with archival GAAP ETR data (e.g., Dyreng et al., 2008), most of the firms report an effective tax rate in the 30 percent to 40 percent range, with the distribution being asymmetric -- more firms report a relatively lower rate than a relatively higher rate. The data in Table 1 also reveal that 46 percent of the respondents indicate they have a U.S. net operating loss (NOL) carryforward, 50 percent report that they have foreign NOLs, and 69 percent have state tax NOLs. Finally, three-fourths of the sample firms indicate that they have foreign sourced earnings. Thus, collectively the descriptive data show that our sample does not

consist of simple firms—rather the majority have complex tax structures and international activities.

However, because we use survey data, we recognize that perhaps our results could still be subject to some type of non-response bias (e.g., only a certain type of firm answered our survey and/or some types of firms avoided our survey which would make the results less generalizable). We use data from Compustat to compare a) the surveyed firms to all Compustat firms to assess generalizability and b) within the surveyed firms, the responding firms to the non-responding firms. We recognize that Compustat is limited to publicly traded firms and hence our inferences are limited in these comparisons to public firms. We report these comparisons in Table 2. In columns (1) and (2), we find that our average sample firm is larger than the average Compustat firms in terms of assets (and our sample includes private firms for the asset measure), larger in terms of market value and sales. Our average sample firm has the same debt-to-asset ratio, a lower cash-to-asset ratio, and a lower market-to-book ratio relative to the average Compustat firm. Further, our sample firms have on average a higher return-on-assets, a higher effective tax rate, and lower growth measures (both assets and sales). Thus, our sample firms are not small, poorly performing firms and our results might not generalize to these firms.

The comparison of respondent to nonrespondent firms is shown in Table 2, columns (3) and (4). Our average respondent firm is marginally smaller in terms of assets but similar in terms of market value and sales to the average non-respondent firm. In addition, our respondent firms have, on average, lower debt ratios, higher cash ratios, and a higher return-on-assets. While there are some differences we cannot think of any obvious biases that arise because of the differences. Finally, in terms of industry composition, it appears that the respondent and non-respondent samples are similar. It does appear that our survey sample (TEI members) is overrepresented in

manufacturing industries and underrepresented in terms of financial services, insurance, and real estate.

5.2 *Research questions and survey responses*

5.2.a *Location decision- unconditional analysis*

We ask the following question to examine firm decisions of whether to locate operations in the U.S. or outside the U.S.: “Relative to all the factors your company considers when making a decision about whether to locate operations in the U.S. or outside the U.S., how important are the following?” The factors we list are 1) foreign tax rate, 2) U.S. cash tax deferral, and 3) financial accounting expense deferral under APB 23. The phrase “relative to all other factors” is intended to control for other factors such as the stability of the government, regulation, work ethic of labor force, utilities, proximity to target market, import/export restrictions, transportation costs, etc. (Wilson, 1993; Single, 1999).²⁰ What is missing in prior literature is whether financial accounting considerations such as expense deferral under APB 23 are important in the decision to locate operations in a foreign location.

The respondents are asked to rate each of the factors on a 5 point scale ranging from “Not at all important” (given a numerical representation of 0) to “Very important” (a numerical representation of 4). In our analysis of the data we interpret these ratings in several ways. First, we classify ratings of three or four on the zero to four scale as being “important” to the firm and ratings of zero and one as being “not important.” Second, we compute the average rating for each

²⁰ We acknowledge that by focusing on a subset of relevant factors it is possible that salience gives rise to respondents ranking these factors as more important than they would if confronted by a more comprehensive list. However, to mitigate this problem, we compare the rankings across the named factors and conduct conditional analyses within the sample; such comparisons are less affected by any potential salience.

factor. Finally, we interpret the ratings as a ranking of the relative importance of the various factors.

The easiest way to access our results is likely via the graphs in Figure 1. Panel A presents data for all respondent firms. The graph reveals that approximately 38 percent of firms respond that the foreign tax rate is important in their decision to invest in a foreign location. Slightly more than 35 percent of the respondents say that the availability of U.S. cash deferral is important or very important. In terms of the importance of financial accounting expense deferral under APB 23, a little more than 31 percent of firms say that this is an important factor in their decision making process when determining whether to make an investment overseas. While less than half the overall sample say the factor is important, for a factor not previously investigated in prior research and one that represents a “paper” deferral of one expense item, it is surprising that this many firms say the factor is important relative to all other factors when deciding whether to make a foreign investment.

We then parse the data into a subsample of firms where we would expect the accounting implications of foreign earnings to be important – publicly traded firms that have positive foreign assets (N = 284). We further subdivide these publicly traded firms into those with high research and development spending (lighter colored, top bar) and those with low research development spending (darker colored bottom bar) to proxy for the level of intangibles.²¹ The higher the intangible base of the business the expectation is that it is easier to shift income after locating in a foreign jurisdiction (Grubert and Slemrod, 1998). In addition, being close to customers is less of a requirement for this type of firm because in general it is easier to ship product across countries. For example, it would be more difficult for a heavy manufacturer of construction equipment to

²¹ We assign a high R&D indicator for those firms with greater than the median RD (scaled by sales) spending of those firms in our sample that had positive R&D spending.

move to Ireland and ship the heavy equipment to China than it is for an intangibles-based firm to locate in Ireland and ship software. Thus, the tax and accounting factors increase in importance for the intangibles-based firms relative to all other factors they must consider.

The data here are even starker (see Panel B of Figure 1). For example, nearly 60 percent of publicly traded firms, with foreign assets, and high research and development spending rate the accounting expense deferral under APB 23 as an important or very important factor in their decision to move investment to a foreign jurisdiction.

Table 3 presents the data in table format. In Panel A, we present the unconditional data. For each factor, we present the percent of respondents that answered that the factor was important (received a rating of 3 or 4 on the scale of 0 – 4) and the percent of firms that answered that the factor was not important (a rating of 0 or 1 on the scale of 0 – 4). The mean rating for foreign tax rate is 1.86, for US cash tax deferral is 1.76 and for financial accounting expense deferral under APB 23 is 1.65. Although none of these ratings is greater than 2 (medium importance), we note that this question is about a decision to locate operations overseas. We would not expect tax and accounting factors to, on average, rate as very important for a diverse sample of firms because there are many other factors to consider when deciding to operate overseas (e.g., labor force, political stability of the country, etc.). However, that 31 percent of the entire sample of respondents rate the financial accounting expense deferral factor as important or very important is surprising given the gravity of the decision. Further, when the importance rating of the cash tax deferral factor is compared to the importance rating of the financial accounting expense deferral factor, the importance of financial accounting expense deferral is statistically indistinguishable from the importance of cash tax deferral (t-statistic of 1.32). This implies a “paper” accounting expense is equally important as a factor that directly affects cash flows (cash tax deferral).

5.2.b *Location decision – conditional analysis*

We next investigate ratings based on a variety of firm characteristics. The graph in Panel B of Figure 1 indicates substantial cross-sectional variation in the importance of the ratings. We further probe this variation by examining conditioning variables based on prior research. For example, we explicitly test whether public firms are different than private firms in their rating of financial accounting effects because prior literature demonstrates that public firms are under greater financial reporting pressure than private firms and, as a result, are willing to incur costs to achieve a desired financial accounting outcome (Cloyd et al., 1996; Beatty and Harris, 1999; Mikhail, 1999). Thus, we predict that publicly owned companies will rate financial accounting expense deferral as more important than private firms.

We also condition on the level of the effective tax rate the firm reports. We predict that firms with a lower reported effective tax will be more likely to rank financial accounting concerns higher than firms with a high reported effective tax rate. We interpret the effective tax rate as a revelation of preferences for low or high rates (similar to Hanlon and Slemrod (2008)). Thus, firms with a low rate engage in actions to achieve that low rate and, as a result, should rank financial accounting expense deferral more highly. Finally, we condition on the amount of R&D expense as a proxy for the type of firm that can more easily shift income through intangibles (Grubert and Slemrod, 1998) as compared to locating heavy manufacturing operations abroad (Wilson, 1993). We predict that firms with large R&D expenditures will rate financial accounting concerns as being more important in location (and repatriation) decisions because employment and customer concerns for location decisions are not as great in relative terms.

The results of our conditional analysis are provided in Panel B of Table 3. The numbers in the table are the percentage of respondents that answered that the factor was important or very important (i.e., the respondent gave the factor a rating of three or four on the zero-to-four scale).

For example, 41.3 percent of the public firms responded that the foreign tax rate was important or very important among all the factors they consider when deciding to locate overseas.

Several interesting observations emerge from these data. Significantly more public firms rate the tax and financial accounting factors as being important than do private firms. Indeed, only 11 percent of the private firms in our sample rate financial accounting expense deferral as important compared to the 37 percent of public firms that rate the factor as an important consideration. This result is consistent with prior literature on public versus private firms that demonstrates the public firms are under greater financial reporting pressure (Cloyd et al., 1996; Beatty and Harris, 1999; Mikhail, 1999; Blouin et al., 2009).

Consistent with our stated prediction, more firms with a low GAAP ETR rate cash tax deferral and accounting expense deferral as being important when deciding where to locate operations. This result may seem counter-intuitive at first but as discussed above, we interpret the effective tax rate as a proxy for overall tax and financial reporting preferences with regard to the income tax expense. Firms that have a low GAAP ETR take actions to make it low and thus, it makes sense that these would be the same firms that are concerned about taxes and the financial accounting effects (in other words, firms with high rates reveal a preference of not worrying about effective rates or they would have taken actions to reduce their GAAP ETR in the first place).

Consistent with our stated prediction, firms with relatively high research and development spending (R&D; research and development expense scaled by sales) rate cash tax deferral and financial accounting expense deferral as being much more important than firms with low R&D. Firms with high R&D consist of proportionally more intangible assets and intangible assets are easier to source to (and ship from) a foreign location without investing heavily in manufacturing assets and labor. As a result, these companies rate tax and accounting concerns as more important

relative to all other concerns because they have fewer (at least different) other concerns (Wilson, 1993).²²

The data also reveal that firms with foreign source earnings and with a high percentage of foreign assets rate the tax and accounting effects as important more often than firms without much foreign activity. Thus, firms concerned with cash taxes and financial reporting effects more actively move overseas to minimize taxes and tax expense.

Overall, we document that the availability of accounting expense deferral under APB 23 is an important factor in location decisions and its importance is statistically indistinguishable from the importance of the availability of cash tax deferral. Furthermore, our data indicate that firm characteristics (e.g., public versus private ownership, having high or low R&D spending, etc.) are related to the importance assigned to both the tax and financial accounting factors as companies decide where to locate operations around the world.

In untabulated results, we also estimate multivariate regressions including the variables used in the univariate analysis in Panel B. We estimate separate regressions using the rating of cash tax deferral as the dependent variable and one with the rating of financial accounting expense deferral as the dependent variable. The results show that being publicly held, having foreign source earnings, high percentage of foreign assets, and having high research and development spending are significant predictors of the ratings. Thus, the univariate results do not appear to be driven by one underlying factor.

²² Indeed, in discussions with respondent companies one heavy manufacturer with low R&D spending said their decision is driven by the need to reach the local customer and nothing else. The respondent went on to say that the policy makers often say the decision for operation location for U.S. multinationals is U.S. or China (or elsewhere) but that is not the decision. If the companies are trying to reach customers in China, the decision is China or not building at all.

5.2.c *How much unremitted foreign earnings are designated PRE*

To get a sense of the importance of the APB23 PRE designation, we ask our sample firms how much unremitted foreign earnings (URE) their companies had on the relevant date for the AJCA provisions (as of the latest year-end for which the financial statements were filed on or before June 30, 2003 (or if not public, then when certified)). We use this date because we are also interested in firms' responses to the AJCA repatriation tax reduction.²³ We also ask how much of those earnings were designated as permanently reinvested (PRE) under APB 23 as of that same date.

These data are presented in Table 4. The average ratio of PRE to URE is 0.76. Table 4 also indicates that the median firm classifies all unremitted foreign earnings (URE) as PRE and the firm at the 25th percentile classifies 57 percent of unremitted earnings as PRE. That more than half the sample designates 100% of their unremitted earnings as permanently reinvested indicates that the APB23 deferral is an important accounting option available to firms.²⁴

5.2.d *Reinvestment vs. repatriation decision – unconditional analysis*

To view our results regarding the important factors considered when firms decide between reinvesting and repatriating earnings, it again is likely easiest to examine the graphs presented in Figure 2. The question in the survey was “In general, what factors are important in your company's decision to reinvest foreign earnings outside of the U.S.?” Panel A presents the data for the full sample that answered the question.²⁵ The factor that is most important unconditionally

²³ See section 5.2g below for a discussion of the AJCA of 2004 and Graham et al., 2008.

²⁴ The percentage of unremitted foreign earnings designated as PRE might be overstated if firms anticipated the AJCA tax holiday and the qualification rules – but even if some firms anticipated and increased the percentage PRE/URE, these data still suggest the classification is important to many firms.

²⁵ We include two additional factors for the repatriation decision relative to the location decision question discussed above. We include a factor for the relative rates of return because Hartman (1985) is very explicit that this is the most important consideration for the repatriation decision (in fact the only consideration under certain conditions). We

is the ‘rate of return outside the U.S. is higher than that in the U.S.’ with nearly 60 percent of respondents saying the rate of return is important or very important. The importance of this factor is consistent with the Hartman (1985) model. U.S. cash tax deferral is the second most important factor, with approximately half of the respondents saying cash deferral is important or very important.²⁶ Interestingly, nearly 45 percent of the respondents said that the financial accounting expense deferral under APB 23 is important, making it the third most important factor.

Panel B of Figure 2 presents the data from the subsample of firms that are publicly traded and that have foreign assets. Again the lighter colored bar on top for each factor represents the data for firms that have high research and development spending and the lower, darker bar are the data for the firms with relatively little research and development spending. Here, again, the responses for the importance of the cash tax and financial accounting expense deferral factors are even greater. Nearly 64 percent of these firms separately rate the cash tax deferral and the financial accounting expense deferral as being important or very important.

Table 5 Panel A, presents the data for the full sample in table form. For each factor, we present the percent of respondents that answered that the factor was important (received a rating of 3 or 4 on the scale of 0 – 4) and the percent of firms that answered that the factor was not important (a rating of 0 or 1 on the scale of 0 – 4). The mean rating is 2.58 for higher rates of return outside the U.S., 2.29 for U.S. cash tax deferral, 2.18 for financial accounting expense deferral under APB 23, and 2.15 for the foreign tax rate. We note that the average ratings for the tax and accounting factors for the repatriation question are higher than the ratings in the location of foreign operations question (1.76 and 1.65 for the location decision, respectively). This result is consistent with expectations because there are fewer operational, non-tax, non-accounting factors

include a factor “the need for foreign cash to service debt” because one of our beta test companies suggested that we include it.

²⁶ If all the assumptions in the Hartman (1985) model held, we would expect this factor to not be important. However, firms value deferral because all earnings are not repatriated as dividends and tax rates are not constant through time.

to consider once the decision to operate overseas has been made and thus, the importance of the accounting and tax factors rises.

Of note is that financial accounting expense deferral has an average importance rating that is not significantly different than U.S. cash tax deferral (t-statistic of the difference is 1.13). As before, a “paper” accounting consideration is statistically as important as a “real” cash deferral. This result is quite surprising given the prior literature which scarcely mentions financial accounting considerations as a driver affecting the decision of whether to reinvest or repatriate foreign earnings (with the exception of concurrent papers Shackelford et al., (2008) and Blouin et al. (2009)).

5.2.e Reinvestment vs. repatriation decision – conditional analysis

Panel B of Table 5 analyzes the data for various sub-samples of firms for the repatriation versus reinvestment decision. We use the same conditioning variables as for the location decision based on the same reasoning. Very similar patterns emerge for the repatriation question to what we observed above for the location decision question (Table 3). For example, publicly traded firms rate both cash tax deferral and financial accounting expense deferral as being more important than do private firms when deciding whether to repatriate earnings. The most striking difference is the rating of the financial accounting expense deferral – 51.4 percent of public firms rated this factor as important while only 14.7 percent of private firms do so. Again, this result is consistent with public firms being under more pressure to report higher financial accounting returns. While the financial accounting result is consistent with Blouin et al.’s (2009) interpretation, the fact that public firms rate *cash tax* deferral higher than private firms confounds Blouin et al. results because their research design requires them to assume public and private firms

value cash tax deferral equally (for tax purposes).²⁷ They require this assumption so that they can interpret any difference in public firm repatriations on a tax cost variable as being evidence of public firms being concerned with the financial accounting tax expense deferral.

In addition to the private/public results, the data show that larger firms, firms with a higher foreign asset percentage, firms that have a lower GAAP effective tax rate, and firms with relatively high research and development spending all rate the importance of cash tax deferral and the importance of financial accounting expense deferral more highly than their counterparts. We examine the effect of having a U.S. NOL on this decision because it could be that firms with a U.S. NOL are not concerned with the tax and accounting effects because the U.S. NOL would offset any incremental tax upon repatriation (and thus perhaps the inclusion of these firms would cause our results to be understated). However, we find no difference between firms with a U.S. NOL and firms without a U.S. NOL. We asked one company about this and the response was that a U.S. taxpayer would not use the U.S. NOL to offset fully taxable dividends that could be left offshore (i.e., the firm would rather use the U.S. NOL to offset other earnings).

In untabulated results, we also estimate multivariate regressions using the above conditioning variables. The factors that remain important in the presence of all the other factors are 1) being publicly traded, 2) having a high foreign asset percentage, and 3) having high research and development expenses.

²⁷ One conjecture as to why public firms rate cash tax deferral more highly than private firms is that the ratings are relative to all other considerations the firms have. Private firms have fewer opportunities to raise capital than public firms thus, quite likely need to use internal funds more often, even when subject to a costly repatriation tax. As a result, tax and accounting effects are less important in a relative rating of all other factors as the need for domestic financing may rate more highly.

5.2.f *What if APB 23 were repealed?*

To further investigate the importance of financial accounting expense, we evaluate responses to the following question “If the rule allowing the deferral of U.S. tax expense under APB 23 were repealed but the deferral of cash tax until repatriation was still allowed, would your company repatriate more foreign earnings as dividends (in other words, if your company had to immediately accrue the tax expense for financial accounting would your company repatriate more dividends?)?” As summarized in Figure 3, approximately 17 percent of the respondents said yes, they would repatriate more foreign earnings if APB 23 were repealed. In addition, 42 percent of the respondents responded “maybe” they would repatriate more if APB 23 were repealed. Thus, 60 percent of the respondents either would bring more cash back to the U.S. or would consider bringing more cash back to the U.S. and incur the U.S. cash taxes upon repatriation if their company had to record financial accounting tax expense on those earnings regardless of whether they actually repatriate the foreign profits. This result suggests that in addition to the cash tax costs for large balance sheet cash balances discussed in Foley et al. (2007), financial reporting considerations could be another cause of “trapped” equity or high cash holdings observed at many firms.

While it is novel that expense deferral is important in these decisions relative to all the other factors companies have to take into consideration, our results are consistent with recent research in other areas. First, the long line of book-tax tradeoff studies offers evidence generally consistent with financial accounting earnings being more important than tax savings in many settings (for a summary of this literature see Shackelford and Shevlin, 2001). For example, Erickson, Hanlon, and Maydew (2004) examine firms accused of committing financial accounting fraud and find that these firms paid an average of \$0.11 in excess taxes per dollar of overstated earnings, consistent with the firms sacrificing real value to overstate financial accounting earnings.

Thus, our finding that financial accounting earnings are important to firms and that they are generally just as important or more important than cash tax savings, complements other research. But that the financial accounting expense deferral can be important in real location decisions and the decision to repatriate earnings is beyond the implications studied previously. Furthermore, both of these investment decisions have important policy ramifications since these decisions directly determine the amount of foreign direct investment – investment leaving or remaining outside of the U.S.

5.2.g Discussion of the AJCA 2004 – one time dividend received deduction on repatriations

The American Jobs Creation Act was enacted into law on October 22, 2004. A portion of the Act was codified in Internal Revenue Code (IRC) Section 965. Subject to some limitations the AJCA provided that a corporation that is a U.S. shareholder of a controlled foreign corporation (CFC) may elect, for one taxable year, an 85 percent dividend received deduction (DRD) with respect to certain cash dividends it receives from its CFCs.²⁸ This deduction provision effectively reduced the applicable U.S. tax rate on qualified repatriations from 35 percent (less applicable credits) to 5.25 percent (less applicable credits) (15 percent times 35 percent). Our survey asked many questions about the AJCA and the repatriations under the Act. Results from these questions are in a companion paper, Graham et al. (2008). Several questions had parts that are relevant to our current paper about the financial accounting effects (APB23) upon repatriation under the AJCA. We discuss those results in this section.

The DRD in the AJCA was subject to several limitations. For the purposes of our paper, the only relevant limitation was that the amount of dividends eligible for the deduction was limited

²⁸ See IRS Notice 2005-10 for the definition of cash dividends (dividends defined in which IRC Sections qualify). The election could only be made for one of the following years 1) the last tax year that began after October 22, 2004 or 2) the first tax year that began during the one year period beginning on October 22, 2004.

to the greater of the following 1) \$500 million, 2) the amount shown on the taxpayer's applicable financial statement as being permanently reinvested outside of the U.S. (the applicable financial statement is the most recently audited financial statement which is certified on or before June 30, 2003 as being prepared in accordance with GAAP and if the taxpayer is required to file with the SEC is so filed on or before June 30, 2003), or 3) if only the tax attributable to the permanently reinvested earnings is disclosed then the limitation is the amount of tax divided by 35 percent.²⁹

This limitation (to PRE or \$500M) provided a limitation in terms of amount repatriated but the AJCA did not require funds to be repatriated *from* permanently reinvested earnings. Thus, the outcome for financial accounting purposes in terms of the effect on income could vary across firms. For example, if a firm repatriated permanently reinvested earnings for which no U.S. tax had been previously accrued, the repatriation would increase the firm's U.S. tax expense by the 5.25 percent tax on the repatriated earnings (less any available foreign tax credits on those earnings). On the other hand, if a firm repatriated earnings that were not designated as permanently reinvested, the repatriation of the funds and the associated 5.25 percent tax could decrease the firm's tax expense (and increase earnings) because those earnings would probably have had a higher rate of tax accrued than the 5.25 percent (less credits). Thus, the repatriation of dividends and payment of the 5.25 percent tax under the Act could have resulted in increased earnings.

Indeed, firm specific examples can be used to show this effect. For example, General Electric repatriated \$1.2 billion of foreign earnings, which had the effect of reducing their GAAP ETR by approximately 0.5 percent.³⁰ In an investor relations conference call where the question was asked about how repatriating earnings could *reduce* the GAAP ETR, the GE representative

²⁹ For more details on the AJCA and the DRD see IRC Section 965, IRS Notice 2005-10, Blouin and Krull (2008), Brennan (2008), Graham et al. (2008), and others.

³⁰ Data are from GE's 10-K.

explained that the “...majority of them (foreign reinvested earnings) are continually permanently reinvested in productive assets overseas...but that they had \$1.2 billion overseas that we thought we could repatriate which had been provided at rates above the repatriation rate of 5%.” Thus, GE repatriated non-PRE earnings but in an amount less than their PRE. The reversal of the previously recorded deferred tax liability down to the actual expense incurred under the AJCA resulted in a decrease in their GAAP ETR and an increase in earnings (of roughly \$107 million).

We discussed this GAAP ETR effect with one of our beta test companies. The tax executive said that there were two reasons that his company repatriated funds from non-PRE: 1) it avoided any hassles with their auditor over the company bringing back earnings that were previously designated as permanently reinvested, and 2) it avoided an income statement hit. In our sample, when we directly ask companies whether they brought earnings back from a non-PRE pool, 26 percent of the respondents (that answered this question) said that they did (untabulated).³¹

To evaluate the overall importance of the financial accounting expense deferral for firms that repatriated under the AJCA, we listed “Additional financial accounting expense that could result if earnings previously designated as permanently reinvested were repatriated” as a factor when we asked firms the following question “When considering whether and to what extent your company would repatriate earnings utilizing the AJCA one-time DRD, which of the following were of most concern/importance to your company (e.g., which items received the most attention in planning all aspects of the repatriation)?” In our sample, 43.2 percent of the firms reported that this financial accounting effect was important in their decision of whether and to what extent to

³¹ There are 31 firms in our sample that had non-PRE but did not repatriate those non-PRE earnings. The average (and median) firm that could have repatriated non-PRE but did not is smaller (in terms of assets, sales, and market value) and has much lower growth metrics (sales and asset growth and market-to-book ratios) than firms that repatriated non-PRE. Thus, on average these firms appear to be under less capital market scrutiny which may provide one explanation. However, we asked one of the larger companies that had non-PRE, why they repatriated only PRE. Their response was that they still planned future repatriations and thus needed to retain the tax accrual on the books for those future repatriations.

repatriate earnings under the AJCA (see Figure 4). For a factor not investigated previously in the literature, 43 percent is a surprisingly large proportion of firms to view this factor as important. In addition, the importance of the repatriation's effect on the financial accounting expense is statistically indistinguishable from the importance of the effect on the cash taxes (untabulated t-statistic of 1.19 for the difference in the average rating).³² In addition, it is important to remember that the importance of the financial accounting effects may be understated because some firms were able to decrease their tax expense through the AJCA provisions, thus increasing earnings (by repatriating earnings not designated as PRE).

6. Is There an Accounting Based Explanation for Why Firms Hold So Much Cash?

Foley et al. (2007) examine whether cash (repatriation) tax costs are an explanation of the large cash balances observed on multinational firms' balance sheets. Our evidence above suggests financial accounting expense deferral could be another explanation for the large observed cash tax balances. Because the expense deferral depends on the cash tax deferral, however, the two effects are somewhat difficult to disentangle in a regression setting (the correlation between the two ratings is around .80). Foley et al. (2007) examine the relation between the cash tax cost of repatriations and firms' consolidated cash balances and find a positive association. Using confidential BEA survey data they then document a positive relation between cash tax costs and foreign cash holdings and a negative but insignificant relation between cash tax costs and domestic

³² In addition, several companies responded to the "Other" category for the question about the factors important in whether and to what extent firms repatriated earnings under the AJCA provisions with comments that indicate it was very important to their company to repatriate earnings in a way that decreased the firm's effective tax rate and increased earnings. One such comment was "...5.25% tax applied to earnings on which a 35% deferred tax had been accrued." Another similar response was "All foreign earnings are expected to be repatriated so primary consideration was reducing the U.S. tax that had been provided and decreasing the effective tax rate." Another comment was that the main consideration was "Anticipated future effective tax rate benefits related to a reduction in future repatriations of low-tax foreign earnings." Thus, some of the "other" comments include financial accounting concerns as well. The fact that respondents took the time to write these comments in underscores the factor's importance.

cash holdings. The authors conclude that the cash tax costs of repatriation are a significant factor in firms holding so much cash on their balance sheet and that this cash is held overseas (but cannot definitely show that there is substitution of foreign cash for U.S. cash). Foley et al. (2007) include approximately 1,600 observations and a continuous measure of the cash tax costs of repatriations.

Our results above imply that the accounting effects of repatriation are another factor important in firms holding so much cash and holding the cash overseas. That some firms would increase repatriations (or consider it) if APB 23 were repealed but cash tax deferral retained supports this conclusion. To further examine this using our data we attempt to replicate the Foley et al. (2007) results in our sample firms using the financial accounting importance rating as our main test variable. If the accounting implications are important, we would expect that the relation between cash balances and our tax expense deferral (APB23) rating would be significantly positive. A limitation, however, is that we have a much smaller sample size (N=337 for our simplest regression) and an ordinal rating between 0 and 4 for our independent variable. In addition, while we would like to use the ratio of foreign cash/total assets we cannot because we do not have foreign cash holdings, only total worldwide cash for the subset of sample firms on Compustat.

Thus, we estimate two different regressions using different proxies for foreign cash to examine this issue. First, in untabulated tests we regress total cash scaled by assets on each of the ratings – the importance of cash tax deferral and the importance of financial accounting expense deferral – separately and then together. The coefficient on each of the ratings is positive and significant (p-value =0.0001) when each is in the regression alone. When both ratings are included in the same regression, both have a positive coefficient but both are insignificant at conventional levels (p-value =0.09 for the importance of cash tax deferral and p-value = 0.35 for the rating of the accounting expense deferral). We also estimate a regression including all the

control variables used in Foley et al. (2007) but requiring these variables reduces the sample size significantly. Neither of our test variables are significant (although both are positive in sign) nor are some of the control variables significant where they were in Foley et al. (2007).

As an alternative specification we use PRE scaled by total assets (PRE/TA) (where assets is defined as assets less cash) as our dependent variable and proxy for foreign cash holdings. We caveat is that a firm could have large PRE but low foreign cash if the firm is reinvesting overseas in operations.³³ We present these regression results in Table 6.³⁴

When the importance rating of APB23 deferral is included on its own (second column of results) or with cash tax deferral (third column), it is significant in explaining the PRE/TA dependent variable consistent with financial accounting effects trapping some foreign earnings overseas. When we add the additional control variables (taken from Foley et al.), the importance of APB23 tax expense deferral retains significance. We also note that the coefficient on foreign income is positive and significant and the coefficient on domestic income is negative and significant similar to the Foley et al. (2007) tests using foreign cash holdings as the dependent variable. Given the constraints of the data and sample, these results provide some evidence that APB23 tax expense deferral also leads to trapped foreign earnings and high cash balances.³⁵

³³ While some firms did have to borrow significant sums of cash to repatriate under the AJCA, Graham et al. (2008) document that 62 percent of all funds repatriated from their sample of firms repatriated the dividends from cash holdings and 13 percent of the funds were repatriated from foreign financial assets. Thus, there is likely a significant positive correlation between PRE and foreign cash holdings.

³⁴ This specification also provides external validation to our survey responses. Firms that say financial accounting expense deferral is important report more PRE.

³⁵ Recall that firms provided importance ratings for both the investment location decision and the reinvestment versus repatriation decision. We use the ratings from the investment decision in the regressions above in order to maximize the number of observations. We also estimate the same regressions described above but with importance ratings from the reinvestment versus repatriation decision. Very little is significant in explaining Cash/TA but in the PRE/TA regressions the results are similar to those described above except when all the control variables are included the importance of cash tax deferral and accounting expense deferral become insignificant.

7. **Conclusions**

Our main objective in this paper is to examine and explain firm behavior with respect to the location decision and the decision to reinvest or repatriate foreign earnings to gain a better understanding of the factors that are important in these decisions. Shackelford et al. (2008) predict and model that both cash tax deferral and financial accounting expense deferral may be important factors for firms as they decide where to locate operations. We support their claim with data and extend it to investigate the repatriation decision as well.

We examine survey responses from nearly 600 executives and find evidence consistent with the deferral of income tax expense for financial accounting being important in company decisions regarding location of operations and whether to repatriate or reinvest earnings. For example, 31 percent of the respondents rated deferral under APB 23 as being either very important or important in their decision to locate operations outside of the U.S. In addition, 44 percent of respondents stated that deferral of the financial accounting tax expense is either very important or important in their decision of whether to reinvest foreign earnings outside of the U.S. These percentages become markedly higher when we focus on a sample of firms which are publicly traded, have foreign assets, and have high research and development spending –firms where one might expect the financial accounting incentives to be highest. Interestingly, for both decisions – where to locate operations and whether to reinvest or repatriate – the importance of the financial accounting expense deferral is not statistically different than the importance of cash tax deferral when making these decisions.

This result is important in light of the decades of research on the location and repatriation decisions that considers the cash tax implications but has heretofore not examined the financial accounting implications. In addition, the results are important for U.S. international policy considerations. Our results show that the accounting expense deferral is important to firms and

appears to provide an incentive, along with the relatively high corporate tax rates in the U.S., to move operations (and potentially jobs) and investments overseas and to retain excess cash overseas as well. If the U.S. desires to retain more of these activities “at home” and to lift inefficient barriers to capital mobility, then the U.S. policies must consider the effects of *both* tax and accounting policies. At the same time, any potential changes must be mindful of the competitive position of U.S. firms relative to their global competitors. If changes to the tax and accounting policies reduce returns to shareholders relative to those of non-U.S. based competitors, U.S. multinationals will be placed at a competitive disadvantage.

Appendix A

Variable Descriptions

Public/Private = Company responses to a question that asks if the firm is public and traded on NYSE or on NASDAQ/AMEX or if the firm is private.

Size = Total assets of the firm in the most recent fiscal year prior to completion of the survey, self-reported by the respondents. Firms above the median are considered large firms and those below the median are considered small firms.

Foreign Asset

Percentage = Company responses to a question that asked the respondent for the percentage of foreign assets in foreign locations. Firms with a percentage greater (lower) than the sample median are considered to have a high (low) ratio.

Foreign Source

Earnings = Indicator variable representing responses to a question that asked the respondent whether their company has had foreign source earnings in the last ten years. The variable is set to one if the respondent answered their company did have foreign source earnings and zero otherwise.

GAAP ETR = The companies' effective tax rate (total worldwide tax expense/worldwide pre-tax book income) for the last fiscal year prior to completion of the survey. Obtained from reported survey answers for the private companies and from Compustat data for the public firms. A high (low) GAAP ETR is defined as being above (below) the sample median.

U.S. NOL = Company responses about whether the firm had a U.S. net operating loss (U.S. NOL) for tax purposes in the latest fiscal year-end before the completion of the survey.

R&D = The level of research and development spending scaled by sales. These data are from Compustat. We do not have data for the private firms for this item. Firms with an R&D spending amount above (below) the sample median are considered high (low). If R&D expense is missing on Compustat we replace with zero.

Appendix B
Example of Firm Disclosure of Foreign Earnings Tax Effects

Note 10: Income Taxes

Under SFAS 109, "Accounting for Income Taxes," income taxes are recognized for the amount of taxes payable for the current year and for the impact of deferred tax liabilities and assets, which represent future tax consequences of events that have been recognized differently in the financial statements than for tax purposes. Deferred tax assets and liabilities are established using the enacted statutory tax rates and are adjusted for any changes in such rates in the period of change.

Earnings before income taxes consisted of the following:

Years ended June 30	2008	2007	2006
United States	\$ 9,142	\$ 9,138	\$ 7,410
International	6,936	5,572	5,003
Total	16,078	14,710	12,413

The income tax provision consisted of the following:

Years ended June 30	2008	2007	2006
Current Tax Expense			
U.S. federal	\$1,016	\$2,667	\$1,961
International	1,546	1,325	1,702
U.S. state and local	227	125	178
	2,789	4,117	3,841
Deferred Tax Expense			
U.S. federal	1,267	231	226
International and other	(53)	22	(338)
	1,214	253	(112)
Total Tax Expense	4,003	4,370	3,729

A reconciliation of the U.S. federal statutory income tax rate to our actual income tax rate is provided below:

Years ended June 30	2008	2007	2006
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
Country mix impacts of foreign operations	-6.6%	-4.3%	-3.6%
Income tax reserve adjustments	-3.1%	-0.3%	-1.5%
Other	-0.4%	-0.7%	0.1%
Effective Income Tax Rate	24.9%	29.7%	30.0%

We have undistributed earnings of foreign subsidiaries of approximately \$21 billion at June 30, 2008, for which deferred taxes have not been provided. Such earnings are considered indefinitely invested in the foreign subsidiaries. If such earnings were repatriated, additional tax expense may result, although the calculation of such additional taxes is not practicable.

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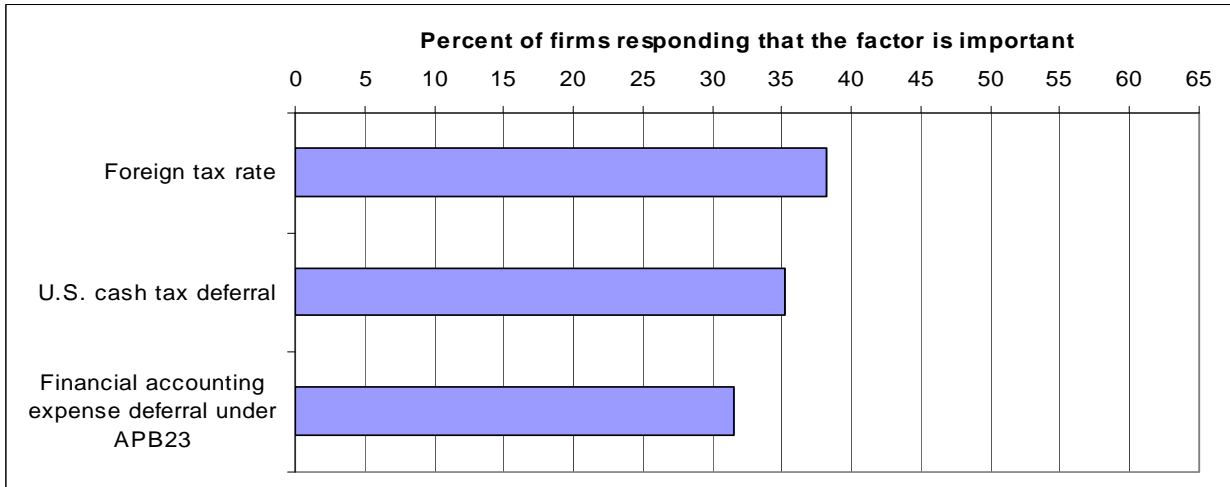
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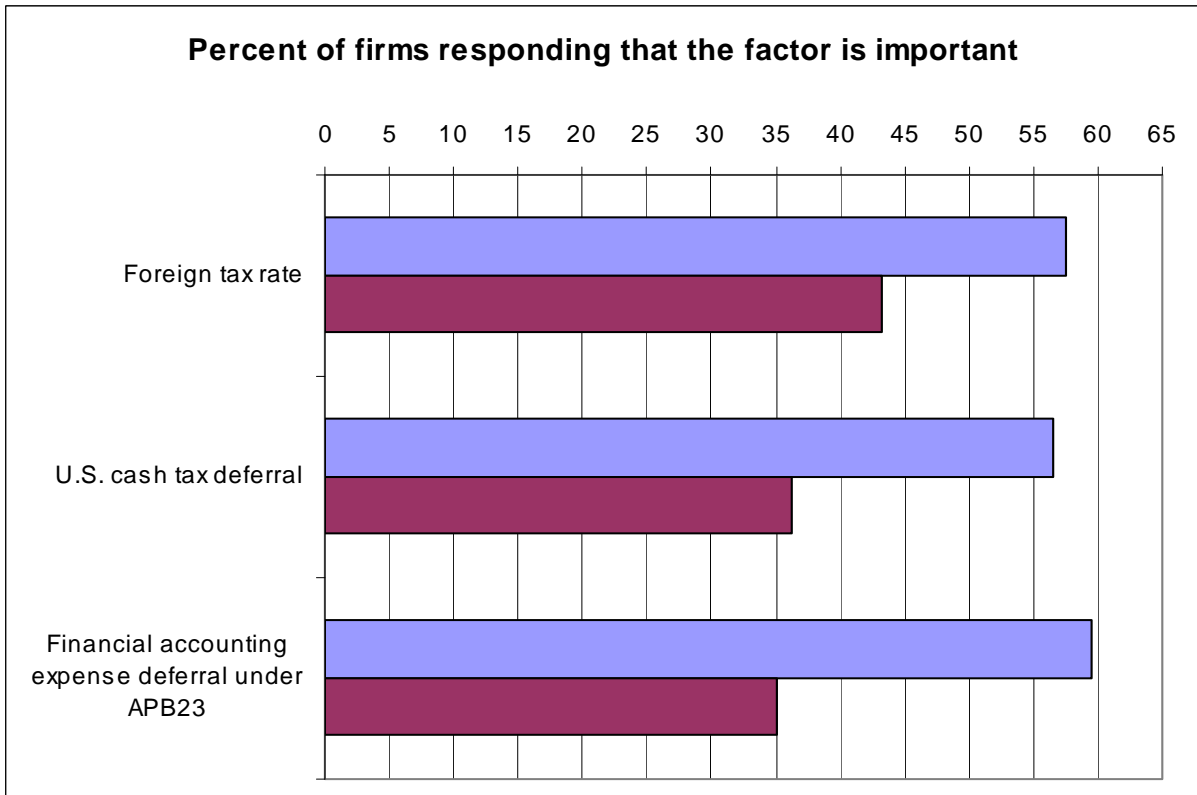
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Figure 1
Factors Important in the Decision of where to Locate Operations

Panel A: All firms



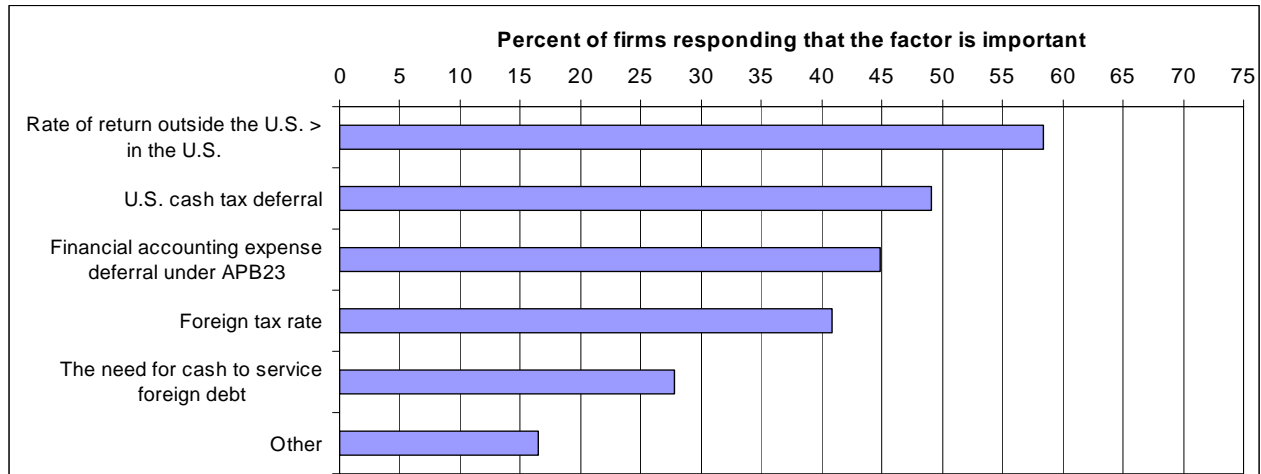
Panel B: Public Firms with Assets in a Foreign Location



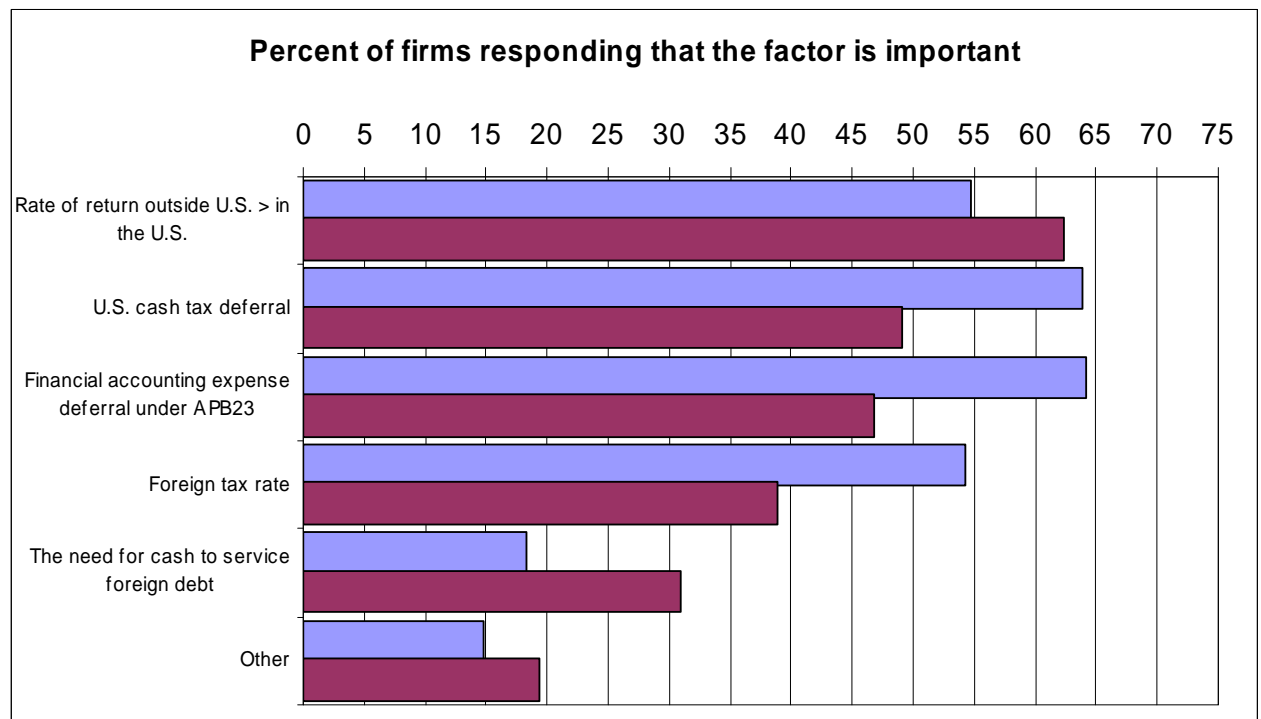
Notes: Survey responses to the question: Relative to all the factors your company considers when making a decision about whether to **locate operations in the U.S. or outside the U.S.**, how important are the following? All data are obtained from a survey of corporate tax executives. The survey provides a 5 point rating scale ranging from 0 to 4. The zero rating is labeled “Not at all important” and the rating of 4 is labeled “very important.” The data above are the percentage of firms that answered that the listed factor was important at either the 3 or 4 rating. In Panel B the top series are public firms with high R&D spending and the bottom series are public firms with low R&D spending.

Figure 2
Factors Important in the Decision of Whether to Reinvest or Repatriate Foreign Earnings Outside the U.S.

Panel A: All firms



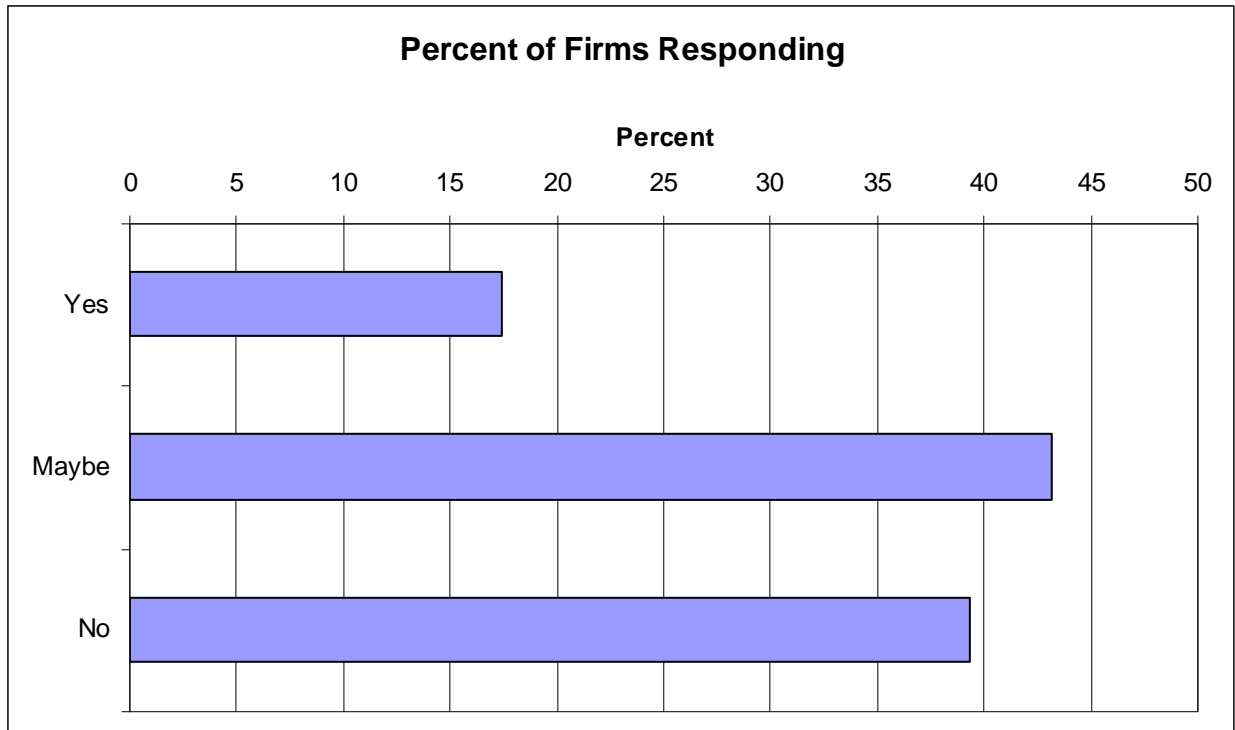
Panel B: Public Firms with Assets in a Foreign Location



Notes: Survey responses to the question: In general, what factors are important in your company’s decision to **reinvest foreign earnings outside of the U.S.**? All data are obtained from a survey of corporate tax executives. The survey provides a 5 point rating scale ranging from 0 to 4. The zero rating is labeled “Not at all important” and the rating of 4 is labeled “very important.” The data above are the percentage of firms that answered that the listed factor was important at either the 3 or 4 rating. In Panel B the top series are public firms with high R&D spending and the bottom series are public firms with low R&D spending.

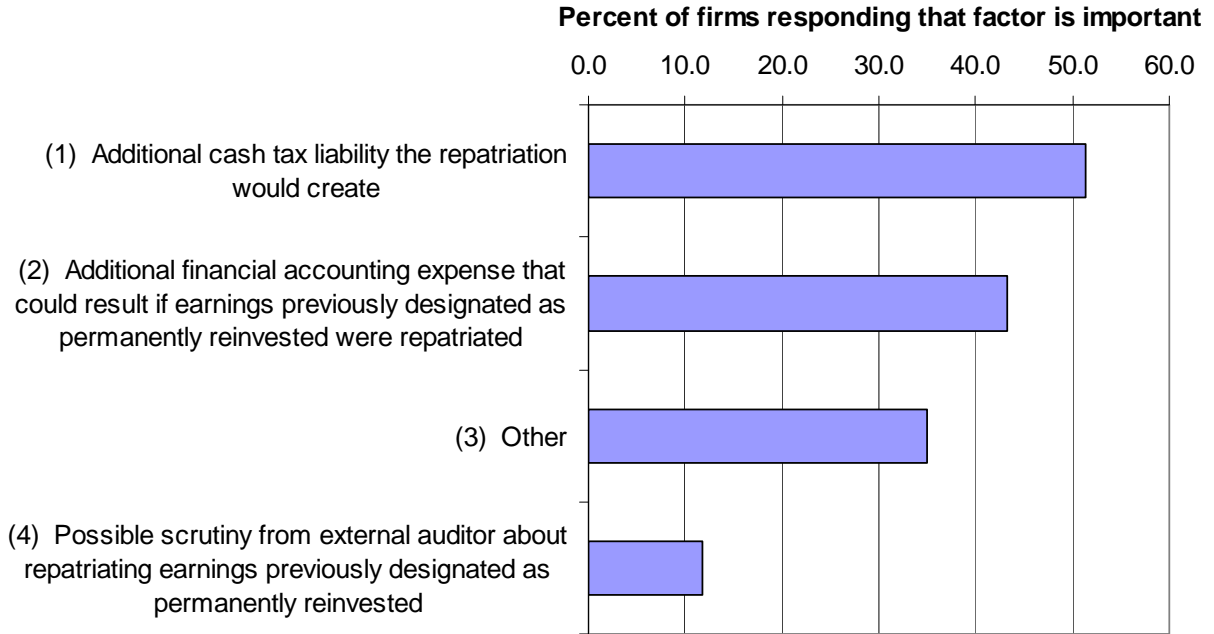
Figure 3
Response to a Hypothetical Repeal of Deferral under APB 23

(N=315)



Survey responses to the question “If the rule allowing the deferral of U.S. tax expense under APB 23 were repealed but the deferral of cash tax until repatriation was still allowed, would your company repatriate more foreign earnings as dividends (in other words, if your company had to immediately accrue the tax expense for financial accounting would your company repatriate more dividends)? “

Figure 4
Factors Important for Firms Taking Advantage of the One-Time DRD



Notes: Survey responses to the question: When considering whether and to what extent your company would repatriate earnings utilizing the AJCA one-time DRD, which of the following were of most concern/importance to your company (e.g., which items received the most attention in planning all aspects of the repatriation)? All data are obtained from a survey of corporate tax executives. The survey provides a 5 point rating scale ranging from 0 to 4. The zero rating is labeled “Not at all important” and the rating of 4 is labeled “very important.” The data above are the percentage of firms that answered that the listed factor was important at either the 3 or 4 rating.

Table 1
Descriptive Statistics

	Percent		Percent		Percent
Ownership (N=594)					
Public - NYSE	47	Assets (N=535)		Entities included in 1120 group (N=554)	
Public - Nasdaq/Amex	28	<\$500 million	26.9	1	0.54
Private	23	\$500 - \$999 million	16.3	2 - 10	41.52
Other (e.g., OTC)	2	\$1 - \$4.9 billion	32.7	11 - 50	42.24
		\$5 - 10 billion	7.5	51 - 100	8.48
		> \$10 billion	16.6	> 100	7.22
Industry (N=595)					
Agriculture, Forestry, Fishing, and Hunting	0.17	Percent of Assets in Foreign Location (N=538)		Number of Forms 1120 filed (N=582)	
Mining	1.85	0%	25.46	1	60.48
Utilities	1.01	0-10%	26.77	2 - 10	28.35
Construction	1.51	11%-20%	11.52	11 - 50	8.76
Manufacturing	29.92	21%-30%	10.97	51 - 100	0.52
Wholesale Trade	5.04	31%-40%	9.29	101 - 1,000	1.55
Retail Trade	6.22	41%-50%	7.62	> 1,000	0.34
Transportation and Warehousing	2.02	51%-60%	2.42	Number of Forms 5471 filed (N=580)	
Information	4.54	61%-70%	2.60	Zero	19.48
Finance and Insurance	5.04	71%-80%	1.67	1	7.59
Real Estate, Rental and Leasing	2.18	81%-90%	0.74	2 - 10	28.79
Professional, Scientific, and Technical Services	6.72	91%-100%	0.93	11 - 50	29.83
Management of Companies (Holding Companies)	15.80	Prior year GAAP ETR (N=439)		51 - 100	8.45
Admin., Support, Waste Mgt. and Remediation Services	1.51	<10%	10.9	> 100	5.86
Educational Services	0.50	10%-20%	4.8	Number of flow-through entities	
Health Care and Social Assistance	1.18	20%-30%	18.5	in which firm has some ownership (N=588)	
Arts, Entertainment, and Recreation	1.01	30%-40%	55.6	Zero	19.39
Accommodation and Food Services	1.68	40%-50%	6.2	1	9.52
Other services	0.67	>50%	4.1	2 - 10	45.24
No code reported	11.43	Percent of firms with NOLs		11 - 50	18.54
File a consolidated Form 1120 (N=590)					
Yes	93.9	U.S.	46.3	51 - 100	4.59
No	6.1	Foreign	49.8	> 100	2.72
		State	68.7		
Percent of firms with foreign source income in last 10 years (N=551)					
Yes	75.0				
No	25.0				

Notes: The above data are all obtained through survey questions, with the exception of the GAAP effective tax rate (total tax expense divided by pre-tax book income) and the current effective tax rate (current tax expense divided by pre-tax book income) for the publicly traded firms – those variables are obtained from Compustat. Form 1120 is the U.S. Corporate Income Tax form. Form 5471 is an informational return filed in the U.S. about the activities of a foreign controlled corporation owned more than 10 percent by a U.S. person (the definition of which includes a U.S. corporation).

Table 2
Descriptive Statistics of Compustat Firms, Nonresponders, and Responders
(Non-response bias tests)

	All Compustat (1)		All firms we contacted with available data (2)		Survey Non - Responders with available data (3)		Survey Responders with available data (4)		P-value			
	N	Mean	N	Mean	N	Mean	N	Mean	1 vs 2	1 vs 4	2 vs 4	3 vs 4
Assets	4,996	4,066.26	1,398	8,891.22	863	9,617.72	535	7,547.93	0.000	0.000	0.202	0.085
MVE	4,654	2,709.19	1,183	7,977.02	813	7,831.80	370	8,304.84	0.000	0.000	0.777	0.692
Sales	4,977	1,991.09	1,235	5,527.34	863	5,499.10	372	5,625.37	0.000	0.000	0.881	0.855
Debt	4,980	0.19	1,233	0.22	861	0.22	372	0.20	0.000	0.754	0.083	0.019
Cash	4,994	0.20	1,234	0.14	862	0.13	372	0.15	0.000	0.000	0.086	0.019
MB	4,653	3.75	1,183	3.28	813	3.26	370	3.29	0.000	0.005	0.946	0.891
ROA	4,976	-0.03	1,235	0.05	863	0.05	372	0.06	0.000	0.000	0.033	0.006
ETR	3,723	0.26	1,195	0.30	756	0.30	439	0.30	0.000	0.000	0.690	0.640
Asset growth	4,795	0.20	1,211	0.14	845	0.14	366	0.14	0.000	0.000	0.921	0.918
Sales growth	4,687	0.21	1,210	0.14	845	0.13	365	0.14	0.000	0.000	0.632	0.451
Industry												
0	12	0.2%	3	0.2%	3	0.4%	0	0.0%				
1	241	4.8%	58	4.7%	44	5.1%	14	3.6%				
2&3	1,802	36.1%	549	44.0%	376	43.6%	173	45.1%				
4	484	9.7%	141	11.3%	102	11.8%	39	10.2%				
5	404	8.1%	152	12.2%	102	11.8%	50	13.0%				
6	1,237	24.8%	142	11.4%	104	12.1%	38	9.9%				
7	563	11.3%	155	12.4%	103	11.9%	52	13.5%				
8	196	3.9%	43	3.4%	26	3.0%	17	4.4%				
9	57	1.1%	4	0.3%	3	0.4%	1	0.3%				

All Compustat data items are measured in the year 2006. All dollar amounts are in millions. All Compustat variables are winsorized at 1% and 99% of the distribution. Table 3 presents the mean values of each of the variables listed at left. Column (1) consists of all the firms on Compustat except for firms with a negative book value, firms whose name ends with LP, and firms incorporated outside of the U.S. Column (2) includes all the firms we contacted in our survey process (described earlier in the manuscript), which essentially are all the firms in the Tax Executives Institute organization. Those listed above are only those for which we could match to and retrieve the data on Compustat. Column (3) consists of the group of firms that are on Compustat and that we sent a survey to but did not receive a response. Column (4) includes the survey responders with data available on Compustat. *Assets* is defined as world-wide assets (Compustat data item 6). *MVE* is the market value of equity (data199 times data 25). *Sales* are total sales (data 12) divided by total assets (data 6). *Debt* is the ratio of long-term debt (data9) plus the debt included in current liabilities (data34) to total assets (data6). *Cash* is cash and marketable securities (data1) scaled by total assets (data6). *MB* is the market-to-book ratio (MVE/data60). *ROA* is return-on-assets defined as net income (data172) divided by total assets (data6). *GAAP ETR* is the GAAP effective tax rate defined as total tax expense (data 16) divided by pre-tax accounting income (data170). Industries are as follows: 0 = Agriculture, Forestry, and Fishing; 1 = Mining and Construction; 2 = Manufacturing (Food, Tobacco, Lumber, Furniture, Paper, Chemicals); 3 = Manufacturing (Rubber, Leather, Stone, Metal, Electronics); 4 = Transportation, Communication, Electric, Gas and Sanitary; 5 = Wholesale and retail trade; 6 = Finance, Insurance, and Real Estate; 7 = Hotel and Business Services; 8 = Health, Legal, and Educational Services; and 9 = Public Administration.

Table 3
Factors Important in Where to Locate Operations

Survey responses to the question: Relative to all the factors your company considers when making a decision about whether to **locate operations in the U.S. or outside the U.S.**, how important are the following?

Panel A: Unconditional Results

Factor	% important	% not important	Average rating
(1) Foreign tax rate	38.17	42.83	1.86
(2) U.S. cash tax deferral	35.21	45.32	1.76
(3) Financial accounting expense deferral under APB23	31.53	51.12	1.65

Statistical Test of Differences in the Average Rating of the Factors

Comparison

<u>Factors</u>	<u>t-statistic</u>
(1) = (2)	1.13
(2) = (3)	1.32
(1) = (3)	2.45

Table 3 (continued): Factors Important in Where to Locate Operations*Panel B: Conditional Results*

Factor	% important	Obs	Ownership		Size		Foreign Source Earnings		Foreign Asset Percentage		GAAP ETR		R & D	
			Public	Private	Large	Small	Yes	No	High	Low	High	Low	High	Low
(1)	38.2	537	41.3	26.7***	42.9	33.6*	45.2	15.1***	55.9	20.9***	27.6	48.1***	52.4	37.4***
(2)	35.2	534	38.5	23.3***	42.5	28.2***	41.9	14.3***	48.0	22.8***	25.2	44.3***	50.5	33.7***
(3)	31.5	536	37.1	11.2***	34.9	28.9	37.5	11.9***	46.5	17.9***	24.3	40.7***	51.9	31.0***

Notes: The survey provides a 5 point rating scale ranging from 0 to 4. The zero rating is labeled “Not at all important” and the rating of 4 is labeled “very important.” The percentages listed in Panel A of the table under “% important” are the percentages of respondents that gave a rating of 3 or 4 for that particular factor. The percentages listed in Panel A of the table under the column “% not important” are the percentages of respondents that gave a rating of 0 or 1 for that particular factor. The percentages listed in Panel B are only the percentages of firms that gave a rating of 3 or 4 for the factor (i.e., the company rates the factor as important). Statistical significance is based on tests of the average rating being different between factors in Panel A and tests of the average rating for the sub-samples being statistically different from each other in Panel B. ***, **, and * mark significance of .01, .05, and .10 respectively. See Appendix A for definitions of the conditioning variables.

Table 4
Information on Unremitted Foreign Earnings and Permanently Reinvested Earnings

Variable	N	Mean	Std Dev	25th Pctl	50th Pctl	75th Pctl	Sum
Unremitted foreign earnings	196	1,043	3,768	21	97	542	204,515
Permanently reinvested earnings	196	897	3,431	8	53	358	175,749
Ratio of PRE/URE	196	0.76	0.36	0.57	1.00	1.00	149.01

Notes: Unremitted foreign earnings (URE) are earnings in foreign subsidiaries that have not been repatriated to the U.S. parent company. Permanently reinvested earnings (PRE) is the portion of URE the firm designates as permanently reinvested and on which there is no U.S. income tax accrual provided.

Table 5
Reinvestment vs. Repatriation

Panel A: Unconditional Results

Survey responses to the question: In general, what factors are important in your company's decision to **reinvest foreign earnings outside of the U.S.**?

Factor	% important	% not important	Average rating
(1) Rate of return outside the U.S. > in the U.S.	58.4	19.9	2.58
(2) U.S. cash tax deferral	49.1	28.6	2.29
(3) Financial accounting expense deferral under APB23	44.9	31.9	2.18
(4) Foreign tax rate	40.8	26.7	2.15
(5) The need for cash to service foreign debt	27.8	54.9	1.48
(6) Other	16.5	70.0	0.95

Statistical Test of Differences in the Average Rating of the Factors

Comparison	t-statistic
Factors	
(1) = (2)	3.12
(2) = (3)	1.13
(3) = (4)	0.30

Table 5 (continued)
Reinvestment vs. Repatriation

Panel B: Conditional Results

Factor	% important	Obs	Ownership		Size		Foreign Asset Percentage		GAAP ETR		U.S. NOL		R & D	
			Public	Private	Large	Small	High	Low	High	Low	Yes	No	High	Low
(1)	58.4	387	59.8	52.1*	62.9	53.1**	65.1	47.5***	52.3	64.7*	56.2	59.0	53.5	63.0
(2)	49.1	385	52.7	32.9***	55.1	44.4***	56.4	38.1***	37.4	61.1***	48.4	51.1	64.3	45.8***
(3)	44.9	383	51.4	14.7***	49.5	41.2**	53.8	30.4***	32.8	58.1***	45.7	44.8	65.7	43.5***
(4)	40.8	382	44.9	22.9***	44.1	37.1	49.6	25.9***	29.0	50.6***	41.2	39.8	58.6	37.8***
(5)	27.8	381	28.5	24.6	32.1	24.1	32.8	20.6***	28.5	27.1	30.2	25.4	19.4	30.7**
(6)	16.5	237	17.3	13.0	14.4	18.6	19.7	11.6***	13.3	19.4	18.5	13.2	14.3	19.0

Notes: The survey provides a 5 point rating scale ranging from 0 to 4. The zero rating is labeled “Not at all important” and the rating of 4 is labeled “very important.” The percentages listed in Panel A of the table under “% important” are the percentages of respondents that gave a rating of 3 or 4 for that particular factor. The percentages listed in Panel A of the table under the column “% not important” are the percentages of respondents that gave a rating of 0 or 1 for that particular factor. The percentages listed in Panel B are only the percentages of firms that gave a rating of 3 or 4 for the factor (i.e., the company ranks the factor as important). Statistical significance is based on tests of the average rating being different between factors in Panel A and tests of the average rating for the sub-samples being statistically different from each other in Panel B. ***, **, and * mark significance of .01, .05, and .10 respectively. See Appendix A for definitions of the conditioning variables. The sample is smaller than in Table 3 because only firms with foreign source earnings were directed to answer this question.

Table 6
Tests of Association Between Survey Ratings and Permanently Reinvested Earnings

<i>Dependent Variable = ln(PRE/Assets)</i>												
Variable	N	Coefficient	t-stat	N	Coefficient	t-stat	N	Coefficient	t-stat	N	Coefficient	t-stat
	195			197			195			118		
Intercept		0.056	3.32		0.043	2.84		0.051	3.02		0.039	0.69
Importance rating of cash tax deferral		0.008	1.35					-0.011	-1.04		-0.031	-2.53
Importance rating of APB23 expense deferral					0.015	2.56		0.022	2.39		0.025	2.15
Domestic income											-0.525	-3.55
Foreign income											1.109	4.02
Log assets											0.005	0.70
Dividend dummy											0.006	0.26
Book to market											0.020	1.20
St dev operating income											-0.082	-0.43
R&D											-0.104	-0.39
Capex											0.541	1.54
Market Leverage											-0.112	-1.36
Adj R ²			0.0042			0.0275			0.0278			0.307

Notes: This table presents estimated coefficients from regressions of the natural logarithm of the ratio of permanently reinvested earnings to assets (where assets are measured as total assets less cash). Importance rating of cash tax deferral is the rating given to cash tax deferral in the question described in Table 3 (location investment decision). Importance rating of APB23 expense deferral is the importance rating given to tax expense deferral in Table 4 (reinvestment versus repatriation decision). Following Foley et al. (2007) Domestic income and Foreign income are scaled by total assets and are ratios of the two incomes to assets. Domestic income is from Compustat and is pre-tax income and foreign income is from Compustat and is also pre-tax. Log assets is the natural logarithm of total firm assets. Dividend dummy is a dummy equal to one if the firm pays cash dividends and zero otherwise. Book-to-market is the ratio of book value of common equity to market value of common equity. Standard deviation of operating income is the standard deviation of the ratio of operating income before depreciation to total assets measured over the five years prior to 2006. R&D is the ratio of research and development expenditures to total assets. Research and development is set to zero when missing. Capex is the ratio of capital expenditures to total assets. Market leverage is the ratio of long and short term debt to the sum of long and short term debt and the market value of equity.