

Where in the World Are “Permanently Reinvested” Foreign Earnings?

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June 2010

Proposal for the International Tax Policy Forum

Funding Amount Requested: \$15,000
Use of Funding: Travel Expenses
Estimated Completion Date: Prior to June 2011

The statistical analysis of firm-level data on U.S. multinational companies will be conducted at the Bureau of Economic Analysis, Department of Commerce under arrangements that maintain legal confidentiality requirements. The views expressed in this proposal are those of the authors and do not reflect official positions of the U.S. Department of Commerce. The authors thank Ed Abahoonie for a helpful discussion regarding development of this proposal.

1. *Introduction*

In response to U.S. multinational firms' growing foreign operations, existing studies investigate financial statement disclosures about foreign operations including foreign earnings (Bodnar and Weintrop 1997), foreign taxes (Dyreng and Lindsay 2009), repatriations under the temporary tax holiday created by the 2004 Tax Act (Blouin and Krull 2009; Oler, Shevlin, and Wilson 2007), and permanently reinvested earnings (Krull 2004; Collins, Hand, and Shackelford 1999; Bryant-Kutcher, Eiler, and Guenther 2009). While these studies find evidence that these disclosures provide information relevant to firm value, they tend to agree that little information about foreign operations is disclosed in the financial statements. Despite the fact that foreign operations accounts for 35% of pre-tax earnings for the S&P 500, the only required disclosures in financial statements are aggregate foreign earnings, taxes, sales and fixed assets, permanently reinvested foreign earnings, and a list of subsidiaries and their locations.

The lack of information about foreign activity is surprising given the importance of foreign operations for U.S. multinational firms. To illustrate, Brumbaugh (2003) estimates that U.S. multinational corporations had \$639 billion of unremitted foreign earnings at the end of 2002, and Zion, Varshney, and Cornett (2010) estimate this figure to be \$840 billion at the end of 2008.¹ Given the scale of international activity and the lack of information about these activities in publicly available financial statements, gaining a better understanding of required financial statement disclosures would clearly add value to researchers, investors, and policy-makers interest in understanding foreign operations of U.S. multinational firms.

This study conducts a detailed investigation of one required disclosure about foreign operations, permanently reinvested earnings (PRE). Permanently reinvested earnings are foreign

¹ Brumbaugh (2003) uses data at the Bureau of Economic Analysis to construct this estimate. Zion et al. (2010) use permanently reinvested earnings reported in the financial statement footnotes to construct their estimate.

subsidiary earnings for which a firm has not recognized the residual U.S. tax expense due upon repatriation of these earnings. Firms can delay recognizing an expense for the U.S. tax on foreign subsidiary earnings until repatriation under Accounting Principles Board Opinion No. 23 (APB 23) if they are indefinitely reinvested abroad. If firms designate foreign subsidiary earnings as PRE, they must disclose the amount of earnings designated as PRE in the footnotes to the financial statements along with an estimate of the U.S. tax that would be due upon repatriation. If the firm is unable to calculate the taxes due, it can state that the U.S. tax on PRE is not practicable to estimate. However, firms only disclose the cumulative amount of PRE aggregated across all foreign subsidiaries and seldom report the related tax liability, making it difficult for investors to understand the implications of this disclosure for future earnings.

We intend to combine firms' PRE disclosures or SEC filings with detailed survey data compiled by the Bureau of Economic Analysis (BEA) on the earnings, equity, and assets of individual foreign affiliates to identify where PRE are located, as well as in what type of assets the PRE are held (i.e., the 'composition' of PRE). To this aim, we will estimate firm-level regressions of the amount of PRE on the sum of retained earnings for affiliates located in haven and non-haven tax jurisdictions. Similarly, we will estimate firm-level regressions of the amount of PRE on the sum of retained earnings for affiliates located in low and high tax countries. Due to multiple motivations for designating foreign earnings as PRE, we surmise that a portion of retained earnings in non-haven (high tax) countries are designated as PRE, however, because of capital market pressure, we expect that a significantly higher portion of retained earnings in haven (low tax) countries are designated as PRE.

This study has the potential to make three significant contributions. First, our study can help policy makers and investors understand firms' motivations for designating earnings as PRE.

A firm may designate earnings as PRE because a) it has no intention of remitting the foreign earnings to the U.S. in the foreseeable future, b) it does not want to induce an undesirable financial statement effect, or c) it is too difficult to estimate the residual tax liability. Each motivation has a different implication for the earnings potential of those reinvested earnings, the size of the unrecorded tax cost associated with the remittance of those earnings, and/or the agency costs of underinvestment associated with those earnings. Identifying and assessing the relative importance of each of these motivations can help investors understand the implications of PRE on firm value.

Second, our study of PRE can shed light on the extent to which firms use the PRE designation and the accuracy of PRE as an estimate of unremitted foreign earnings. The business press describes permanently reinvested earnings as if it is a proxy for unremitted foreign earnings (Zion et al. 2010) while existing academic literature has been reluctant to use PRE as a proxy for foreign retained earnings (Krull 2004; Albring 2007). Our detailed investigation of the location and source of PRE can provide evidence on the reliability of PRE as an estimate of unremitted foreign earnings and how this reliability varies across industries and over time.

Third, by shedding light on the location of U.S. MNC's PRE, we can help policy makers better estimate the potential revenue impact of changes in international tax legislation. Many press reports suggest that PRE represents large pools of cash "parked" in haven countries which represents a significant untapped source of tax revenue. Although some PRE is likely located in haven jurisdictions (in affiliates with high levels of cash), we believe that there is a significant amount of PRE located in affiliates with significant operating assets and/or high-tax jurisdictions. By documenting the proportion of PRE in these locations, we hope to illustrate the need to caution when interpreting the potential revenue impact of taxing PRE.

2. Methodology

2.1. Location and Composition of PRE

To investigate the location and composition of PRE, we intend to use a methodology similar to Dyreng and Lindsay (2009), modified to reflect our primary interest in PRE rather than tax rates. Specifically, we will estimate the following series of regressions:

$$PRE = \alpha_0 + \alpha_1 RE + \alpha_2 LowTax_RE + \varepsilon \quad (1a)$$

$$PRE = \alpha_0 + \alpha_1 RE + \alpha_2 Haven_RE + \varepsilon \quad (1b)$$

$$\Delta PRE = \alpha_0 + \alpha_1 \Delta RE + \alpha_2 LowTax_ \Delta RE + \varepsilon \quad (2a)$$

$$\Delta PRE = \alpha_0 + \alpha_1 \Delta RE + \alpha_2 Haven_ \Delta RE + \varepsilon \quad (2b)$$

$$PRE = \alpha_0 + \alpha_1 Cash + \alpha_2 PPE + \alpha_3 OtherAssets + \alpha_4 LowTax_Cash + \alpha_5 LowTax_PPE + \alpha_6 LowTax_OtherAssets + \varepsilon \quad (3a)$$

$$PRE = \alpha_0 + \alpha_1 Cash + \alpha_2 PPE + \alpha_3 OtherAssets + \alpha_4 Haven_Cash + \alpha_5 Haven_PPE + \alpha_6 Haven_OtherAssets + \varepsilon \quad (3b)$$

PRE equals the amount of permanently reinvested earnings disclosed in the firm's 10-K, ΔPRE equals the change in PRE from year t-1 to year t, RE equals total foreign retained earnings in all affiliates, ΔRE equals total foreign earnings minus dividends in all affiliates, Cash equals total cash in all foreign affiliates, PPE equals total property, plant, and equipment in all foreign affiliates, and Other Assets equals total assets in all foreign affiliates minus Cash and PPE.² All LowTax variables in Equations (1a), (2a), and 3(a) equal the total of that variable for the subset of foreign affiliates that face an effective tax rate that is lower than or equal to the U.S. statutory rate of 35%. All Haven variables in Equations (1b), (2b), and 3(b) equal the total of that variable for the subset of foreign affiliates that are located in haven countries.

In Equation (1a) the coefficient on RE, α_1 , estimates the proportion of retained earnings in high tax foreign affiliates designated as PRE. The coefficient on LowTax_RE, α_2 , estimates

² All variables will be scaled by total firm assets.

the *incremental* proportion of retained earnings in low tax affiliates designated as PRE, relative to high tax affiliates ($\alpha_1 + \alpha_2$ represents the total proportion of retained earnings in low tax foreign affiliates designated as PRE). In Equation (1b), the coefficient on RE, α_1 , estimates the proportion of retained earnings in non-haven foreign affiliates designated as PRE. The coefficient on Haven_RE, α_2 , estimates the *incremental* proportion of retained earnings in haven affiliates designated as PRE, relative to non-haven affiliates. The coefficients in Equation (2a) and (2b) can be interpreted in a similar manner. A positive coefficient on ΔRE would suggest that firms designate current earnings in high tax rate countries as permanently reinvested. A positive coefficient on Low-Tax_ ΔRE would suggest that firms designate a relatively higher proportion of current earnings in low tax affiliates as PRE. In addition, we can modify equations (1a) and (1b) ((2a) and (2b)) to incorporate an interaction between RE (ΔRE) and an indicator variable for each country in order to more precisely estimate where PRE are domiciled.

Equations (3a) and (3b) investigate the composition of PRE. The coefficients on Cash, PPE, and OtherAssets estimate whether PRE are comprised of financial, tangible, or other assets in high tax and non-haven affiliates, respectively. The coefficients on LowTax_Cash, LowTax_PPE, and LowTax_OtherAsset estimate whether PRE are comprised of financial, tangible, or other assets in low tax affiliates. Similarly, the coefficients on Haven_Cash, Haven_PPE, and Haven_OtherAsset estimate whether PRE are comprised of financial, tangible, or other assets in haven affiliates.

2.2 *Motivations for PRE Designations*

Next, we wish to explore firms' motivations for designating foreign earnings as PRE. This analysis is related to, but distinct from, our analysis of the composition and location of PRE in that the location and composition of PRE are outcomes of the various motivations. In the

accounting literature, evidence suggests that PRE designations are an earnings management tool (Krull 2004). Here, we wish to document whether firms appear to designate PRE for reasons other than deferral of the income tax expense accrual. We will follow the same empirical strategy in this analysis, however, we will bifurcate retained earnings, current earnings, and assets into groups using measures which capture the underlying motivations for designating foreign earnings as PRE.

Recall that possible motivations for designating foreign earnings as PRE include avoiding an undesirable financial statement impact,³ having no intention of remitting the foreign earnings to the U.S., or finding the computation of the residual tax liability too complex. Therefore, we estimate how these various motivations help explain the location and composition of PRE documented in the previous analysis by estimating the following series of regressions:

$$PRE = \alpha_0 + \alpha_1 RE + \alpha_2 MotiveX_RE + \varepsilon \quad (4a)$$

$$PRE = \alpha_0 + \alpha_1 RE + \alpha_2 MotiveX_RE + \varepsilon \quad (4b)$$

$$\Delta PRE = \alpha_0 + \alpha_1 \Delta RE + \alpha_2 MotiveX_ \Delta RE + \varepsilon \quad (5a)$$

$$\Delta PRE = \alpha_0 + \alpha_1 \Delta RE + \alpha_2 MotiveX_ \Delta RE + \varepsilon \quad (5b)$$

$$PRE = \alpha_0 + \alpha_1 Cash + \alpha_2 PPE + \alpha_3 OtherAssets + \alpha_4 MotiveX_Cash + \alpha_5 MotiveX_PPE + \alpha_6 MotiveX_OtherAssets + \varepsilon \quad (6a)$$

$$PRE = \alpha_0 + \alpha_1 Cash + \alpha_2 PPE + \alpha_3 OtherAssets + \alpha_4 MotiveX_Cash + \alpha_5 MotiveX_PPE + \alpha_6 MotiveX_OtherAssets + \varepsilon \quad (6b)$$

MotiveX represents measures such as organizational complexity, currency volatility, withholding taxes, and the liquidity of the parent – all reasons for designating earnings as PRE. The coefficients in Equations (4a) through (6b) can be interpreted in a manner similar to Equations (1a) through (3b).

³ There can be earnings consequences in high tax affiliates resulting from withholding taxes and foreign currency translation.

3. *Data*

We intend to use confidential data compiled by the Bureau of Economic Analysis (BEA) to conduct our analysis, combined with public information contained in SEC filings.⁴ The BEA surveys provide data on the financial and operating characteristics of U.S. MNCs operating abroad. A U.S. MNC is the combination of a single U.S. entity, called the U.S. parent, and at least one foreign business enterprise, called a foreign affiliate. The BEA requires U.S. MNCs to complete survey forms that cover both domestic and foreign operations. The information captured by each survey varies by year, affiliate size, and the U.S. parent's percentage ownership in the affiliate. We obtain information on the amounts firms designate as permanently reinvested by hand collecting PRE data from SEC 10-K filings.

⁴ These surveys require respondents to file detailed financial and operating items for each foreign affiliate and provide information on the value of transactions between U.S. parents and their foreign affiliates. The International Investment and Trade in Services Survey Act governs the collection of the data and the Act ensures that "use of an individual company's data for tax, investigative, or regulatory purposes is prohibited." Willful noncompliance with the Act can result in penalties of up to \$10,000 or a prison term of one year. As a result of these assurances and penalties, BEA believes that coverage is close to complete and levels of accuracy are high. See <http://www.bea.gov/surveys/diaturv.htm> for online versions of e<http://www.bea.gov/surveys/diasurv.htm> for online versions of each survey. The quarterly survey is Form BE-577, the annual survey is form BE-11, and the benchmark survey is form BE-10. The BEA defines U.S. direct investment abroad as direct or indirect ownership or control by a single U.S. legal entity of at least ten percent of the voting securities of an incorporated foreign business enterprise or the equivalent interest in an unincorporated foreign business enterprise. Mataloni (2003) provides a detailed description of the BEA data.

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