ADVANCES IN TAXATION

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Since 2011, Dr John Hasseldine has been a Professor of Accounting and Taxation in the Peter T. Paul College of Business and Economics at the University of New Hampshire. Previously he was a Chair and Head of the Accounting and Finance Department at the University of Nottingham Business School. John, a Kiwi, qualified as a Chartered Accountant in New Zealand and is a Fellow of the Association of Chartered Certified Accountants (FCCA) based in London.

John has served on three government committees in the United Kingdom and was a contributor to the Mirrlees Review of the UK tax system conducted by the Institute of Fiscal Studies. He has been an external expert at the International Monetary Fund, a Visiting Professor at the University of New South Wales, Sydney, and a Keynote Speaker at several international tax conferences. He travels widely, speaking at national and global conferences, including one on VAT organized by the OECD, World Bank and IMF, and a conference on dealing with the national tax gap held at the US Library of Congress in Washington, DC. He is a coauthor of *Comparative Taxation: Why Tax Systems Differ* (Fiscal Publications, 2017), and an International Fellow at the University of Exeter Tax Administration Research Centre.

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INTRODUCTION

Tax researchers have an important role to play in conducting and publishing rigorous quality research in the uncertain times facing the world's tax systems. There are many research questions to be addressed and *Advances in Taxation* invites submissions on a broad range of tax topics. I wish to thank the editorial board for their continued support. They have been called upon to promote *Advances in Taxation* and to engage in the reviewing process. And, importantly, I am also pleased to thank the 14 ad-hoc expert reviewers listed below for their valuable and timely reviewing activity during 2018−2019.

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In Volume 26, there are seven chapters. In the lead chapter, Anthony Billings, Francis Kim, and Cheol Lee examine whether APB 23−asserting firms that declared their foreign earnings as permanently reinvested abroad are less likely to repatriate those foreign earnings under the American Jobs Creation Act (AJCA) of 2004, compared with similar non-asserting firms. The authors show that asserting firms are more likely to repatriate their foreign earnings than non-asserting firms and also find that the probability of making an election to repatriate permanently invested foreign earnings under the AJCA of 2004 is higher for firms with nonbinding foreign tax credit (FTC) limitations that have made an APB 23 declaration to permanently invest foreign earnings abroad.

Next, Howard and Massel use financial statement disclosures of reductions in reserves due to a lapse in the statute of limitations to investigate whether Schedule UTP has been an effective audit tool to the IRS. They find that the probability of a Lapse is 3.4 percent lower after Schedule UTP. However, this result is driven by domestic firms; they do not find evidence that Schedule UTP has been effective in the audit of multinational firms.

In the third chapter, Swenson examines the employment impacts of US Environmental Protection Agency brownfield grant sites. Using establishment data, employment within close proximity to such sites is found to increase during cleanup periods following grants. The employment increase was from non-brownfield establishments, that is, a "spillover" effect. These employment effects were concentrated in certain industries.

In the fourth chapter, Cleaveland, Comer Jones, and Epps conduct a 2x2 experiment using nonprofessional investor proxies to examine the effects of Compliance Assurance Process (CAP) participation and corporate tax risk profile on judgments about financial statement credibility. Their results suggest both CAP program participation and tax risk influence nonprofessional investors' perceptions of the *certainty* of the income tax provision, and tax risk also influences nonprofessional investors' perception of the *accuracy* of the income tax provision.

The next three chapters in this volume have an international focus. Inasius investigates whether the impacts of power and trust dimensions previously found in developed countries also exist in Indonesia. Survey results show that trust significantly influences voluntary tax compliance, but neither trust nor power promotes enforced tax compliance. Nurunnabi then examines the determinants of tax evasion in Bangladesh and how the interests of state actors influence tax evasion. Lastly, in a practice-related contribution, Schutte and Van der Zwain evaluate the effectiveness of the turnover tax system in South Africa, finding that turnover tax is not necessarily beneficial for small business.

John Hasseldine
Editor, Advances in Taxation

ARE EARNINGS REPATRIATION ELECTIONS UNDER THE 2004 AMERICAN JOBS CREATION ACT INFLUENCED BY APB 23 DECLARATIONS?

B. Anthony Billings, Chansog (Francis) Kim and Cheol Lee

ABSTRACT

In view of the recent enhanced concerns of the SEC and PCAOB that Accounting Principles Board Opinion No. 23 (APB 23)–asserting firms do not comply with the "sufficient evidence" criteria of APB 23, we examine whether APB 23–asserting firms that declared their foreign earnings as permanently reinvested abroad are less likely to repatriate those foreign earnings under the American Jobs Creation Act (AJCA) of 2004, compared with similar non-asserting firms. The asserting firms are required to disclose sufficient evidence that validates an ability to meet their domestic cash needs with only earnings generated in the United States and their plans to indefinitely reinvest foreign earnings outside the United States. Estimates show that asserting firms are more likely to repatriate their foreign earnings than non-asserting firms. In addition, we find that the probability of making an election to repatriate permanently invested foreign earnings under the AJCA of 2004 is higher for firms with nonbinding foreign tax credit (FTC) limitations that have made an APB 23 declaration to permanently invest foreign earnings abroad. These findings suggest that asserting firms' declarations to indefinitely reinvest foreign earnings abroad are not well grounded, thereby indirectly validating the SEC's and PCAOB's increased scrutiny for supporting evidence for APB 23 assertion. The estimates also

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show that the likelihood of making an election to repatriate foreign earnings under the AJCA of 2004 increases with asserting firms' liquidity constraints and financial distress: the financial characteristics listed as part of APB 23 criteria of sufficient evidence and highlighted by the SEC and PCAOB comment letters, indicating that asserting firms raid permanently reinvested foreign earnings to satisfy their financial needs and constraints.

Keywords: Accounting Principles Board Opinion No. 23; permanent reinvestment of foreign earnings; American Jobs Creation Act of 2004; temporary tax holiday; foreign earnings repatriation; financial constraint

INTRODUCTION

This study investigates the validity of US multinational firms' decisions regarding their Accounting Principles Board Opinion No. 23 (APB 23) assertions to permanently reinvest earnings of foreign affiliates abroad. APB 23 assertions to permanently invest earnings of foreign subsidiaries abroad allow such firms to avoid recording deferred taxes for financial reporting purposes. Both the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have been increasing regulatory scrutiny of asserting firms' APB 23 disclosure practices and compliance with APB 23. For instance, the sharp increase in the number of SEC comment letters related to the legitimacy of firms' APB 23 assertion demonstrates the regulators' concern on the income tax issues for multinational corporations.[1]

The heightened scrutiny for supporting evidence intends to ensure that US multinational firms live up to their promise to indefinitely invest foreign earnings abroad by requiring external disclosures of the "sufficient evidence"[2] to validate asserting firms' ability to generate domestic earnings that are adequate to meet domestic business needs including liquidity and investment funds without resorting to permanently reinvested foreign earnings abroad. The onetime temporary tax respite under the American Jobs Creation Act (AJCA) of 2004 to repatriate foreign earnings otherwise permanently invested abroad provides an opportunity with which to validate asserting firms' intent and ability to indefinitely invest foreign earnings abroad. By doing so, we indirectly examine the sufficient evidence criteria of APB 23 and test cogency to the SEC's and PCAOB's recent enhanced scrutiny for supporting evidence.

The AJCA of 2004, which was signed into law on October 22, 2004, provided a temporary tax holiday in the form of a reduced tax on certain repatriated foreign earnings (U.S. Joint Committee on Taxation, 2004). Electing corporations were able to deduct 85 percent of cash dividends received from foreign subsidiaries, which resulted in a 5.25 percent tax rate on repatriated earnings.[3] The repatriation election under the AJCA of 2004 reduces the federal tax burden on repatriated foreign earnings, but it comes at the expense of increased tax expenses for APB 23−asserting firms for financial reporting purposes. Stated differently, firms that declared permanent investment of foreign earnings abroad have to report increased tax expenses for financial reporting purposes due to the election, but these asserting firms are able to reduce tax payments to revenue authorities. As such, APB 23–asserting firms face a tradeoff between the favorable tax treatment under the AJCA of 2004 and the unfavorable financial reporting consequences. Conversely, non-asserting firms that did not previously declare indefinite investment of foreign earnings abroad do not confront such a tradeoff between favorable tax savings and unfavorable financial reporting consequences. The rationale is that non-asserting firms have accrued US taxes on foreign earnings, and thus these firms would not experience reduction in reported accounting earnings. As such, one may postulate that these non-asserting firms may be more prone to remit foreign earnings to the United States under the AJCA of 2004.

However, we find that these asserting firms are more likely to repatriate their foreign earnings than non-asserting firms. We further find that the likelihood of making an election to repatriate foreign earnings under the AJCA of 2004 increases with asserting firms' liquidity constraints and financial distress, suggesting that the severe financial needs of asserting firms are responsible for their repatriation decisions. Moreover, our results show that firms with binding foreign tax credit (FTC) limitations that made an APB 23 declaration had a lower probability of making asset repatriation elections than other firms. This finding suggests that the tendency of APB 23–asserting firms to repatriate foreign earnings is mitigated by the assertion firms' binding FTC limitations.

We conjecture that non-asserting firms may have their own reasons not to seek deferral of corporate tax on the remittance of foreign earnings back to the United States. These non-asserting firms may have used alternative tax-avoidance strategies by investment in passive assets or in related affiliates that can be used as a means for tax-avoiding repatriations, evidenced by lower values of cash effective tax rates for non-asserting firms than for asserting firms in the pre-AJCA period.[4] These aggressive tax positions of non-asserting firms in the pre-AJCA period reduce the benefits of avoiding US taxes by declaring permanent investment of foreign earnings abroad, thereby decreasing the benefits of electing to repatriate foreign earnings under the AJCA of 2004.

Both the SEC and PCAOB are quite concerned that there is widespread noncompliance with the sufficient evidence criteria of APB 23 and have stepped up their regulatory scrutiny of APB 23–asserting firms.[5] APB 23 requires asserting firms to disclose sufficient evidence that validates an ability to meet their domestic cash needs with only earnings generated in the United States and their plans to indefinitely reinvest foreign earnings outside the United States. Contrary to their assertion, we find that these asserting firms tend to repatriate their foreign earnings more than non-asserting firms. Our findings suggest that asserting firms' declarations to indefinitely reinvest foreign earnings abroad are not well grounded, thereby indirectly validating the SEC's and PCAOB's increased scrutiny for supporting evidence for APB 23 assertion. We also focus on the elements of sufficient evidence criteria of APB 23 by evaluating financial characteristics, liquidity constraints, and financial distress, highlighted by both the

SEC and PCAOB in recent comment letters regarding compliance with APB 23 within the context of firms' AJCA of 2004 repatriation elections.

We find that the probability of foreign earnings repatriation increases with asserting firms' liquidity constraints and financial distress: the financial characteristics listed as part of APB 23 criteria of sufficient evidence. These findings suggest that asserting firms remit permanently reinvested foreign earnings back to the United States in response to their domestic financial needs and constraints. Our findings have implications for asserting firms' compliance with the sufficient evidence criteria of APB 23. That is, our findings are consistent with the notion that accounting method choices with no valid disclosure of sufficient evidence for asserting firms' intent and ability to permanently reinvest foreign earnings abroad were improperly used by firms to lower US tax liability in times of APB 23 declarations. Our results also indirectly indicate that the SEC's and PCAOB's concerns regarding firms' compliance with APB 23 are well grounded and suggest a need for additional monitoring of asserting firms' compliance with the sufficient evidence criteria of APB 23.

Finally, we conduct additional analyses to evaluate a possible endogeneity issue on managerial repatriation decisions under the AJCA of 2004. Using determinants of the choice of repatriation of foreign earnings in prior literature (Blouin & Krull, 2009), we construct the propensity score−matched non-repatriation sample. The tenor of our main findings is unchanged even after controlling for the potential endogeneity issue. In addition, other robust analyses reveal that APB 23−asserting firms' liquidities increase, and those levels of tax aggressiveness are higher across the pre- and the post-repatriation periods. These results strengthen the inference of our main findings that firms' liquidity constraints and financial distress are plausible drivers of the repatriation decision of the permanently reinvested foreign earnings under the AJCA of 2004.

Our study makes three contributions. First, our investigation contributes to the literature by facilitating the debate of whether financial reporting and accounting methods (e.g., APB 23 adoption) affect firms' real decisions such as repatriation election decisions under the act, though we are not the first to examine whether firms' APB 23 assertions influence their repatriation decisions under the AJCA of 2004 (Blouin & Krull, 2009; Dharmapala, Foley, & Forbes, 2011; Faulkender & Petersen, 2012). Our research setting provides a natural experiment in testing economic consequences of accounting method choices, because the repatriation election under the AJCA of 2004 reduces the federal tax burden on repatriated foreign earnings, but it comes to APB 23−asserting firms at the expense of increased tax expenses for financial reporting purposes. Thus, APB 23−asserting firms face a tradeoff between the favorable tax treatment under the AJCA of 2004 and the unfavorable financial reporting consequences.

Second, this study also offers an insight into the validity of APB 23 assertion and regulators' enhanced concerns about insufficient supporting evidence for APB 23 assertion. APB 23−asserting firms explicitly declared in their financial statements that their foreign earnings will be permanently reinvested abroad, thereby easing their tax burden. We find that APB 23−asserting firms are more likely to repatriate foreign earnings under the AJCA of 2004, compared with similar non-asserting firms. This finding provides evidence that is consistent with the notion that asserting firms' declarations to indefinitely reinvest foreign earnings abroad are not well grounded, thereby indirectly validating the SEC's and PCAOB's increased scrutiny for supporting evidence for APB 23 assertion.

Third, this study further identifies the importance of the two important factors (i.e., liquidity and financial constraints) of the sufficient evidence criteria of ABP 23 in repatriation decisions. We find that APB 23−asserting firms are influenced by domestic liquidity and financial constraints in making repatriation decisions of the onetime tax respite under the AJCA of 2004.

The remainder of this chapter is organized as follows. Section 2 discusses the background of the AJCA of 2004 tax relief on asset repatriation, APB declarations, and the SEC's and PCAOB's concerns regarding firms' compliance with APB 23 assertions. Section 3 provides related research and our hypotheses development. Section 4 presents the research design and sample selection. Section 5 provides our empirical results, followed by conclusions and limitations of our study in Section 6.

BACKGROUND OF THE AJCA OF 2004, APB DECLARATIONS, AND REGULATORY CONCERNS

The AJCA of 2004

Among other provisions, the AJCA of 2004 legislation enacted a temporary tax holiday on repatriated earnings of foreign subsidiaries by allowing a onetime 85 percent dividend received deduction (DRD) on extraordinary dividends received by US corporate shareholders. The 85 percent DRD reduced the effective tax rate on a temporary basis from a maximum statutory rate of 35−5.25 percent (i.e., 35 percent * (1 − 0.85)). To take advantage of the tax reprieve under the AJCA of 2004, companies were required to present a plan that was approved by their board of directors or chief executive officer for reinvesting such foreign earnings in the United States. The source of funds repatriated includes earnings invested abroad by way of an APB 23 assertion to permanently invest such earnings abroad.

APB 23 Declarations

An APB 23 declaration to permanently invest foreign earnings abroad (codified as Financial Accounting Standards Board (FASB) "ASC 740-10-25-3") allows companies to omit recognition of any deferred tax liabilities in their financial statements on the unrepatriated earnings. Companies are, however, expected to classify these unremitted foreign earnings on their financial statements as being "indefinitely reinvested earnings" in a foreign location. Broadly speaking, under APB 23, *Accounting for Income Taxes—Special Areas*, which was issued in April 1972, companies that are not willing to repatriate foreign-based earnings are required to meet the following conditions as a basis for not recognizing applicable deferred taxes: (1) the companies must show a well-designed plan in which they intend to reinvest these foreign earnings in the foreign country, and

(2) the plan must be approved by the chief executive officer of the company, board members, or any qualifying authority (Blouin & Krull, 2009).

The APB 23 exception, however, is applicable only if US multinational firms meet a significant burden – the "sufficient evidence" requirement. Under FASB ASC 740 (2009), a US multinational firm is exempted from immediate recognition of tax expenses related to the repatriation of undistributed foreign earnings if it can offer "sufficient evidence." To do so, the firm must not only demonstrate an ability to exclusively meet its domestic cash needs with US earnings but also demonstrate its plan to indefinitely reinvest foreign earnings abroad, as follows:

> no income taxes shall be accrued [...] if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. (ASC 740-30-25-17)

Therefore, as this standard indicates, the APB 23 exception applies only if specific facts and circumstances show that the firms will indefinitely reinvest foreign earnings outside the United States.

Although the FASB permits companies to avoid applicable deferred taxes on unrepatriated earnings, companies are encouraged to determine a value for the deferred tax liability. Because of the complexity of determining a value for the applicable deferred taxes, the FASB does not punish companies that are unable to determine a value, but it does require such companies to discuss the complexities in their financial statements (Blouin & Krull, 2009; FASB Staff Position No. 109-2).

Regulatory Concerns

Both the SEC and PCAOB have significantly increased regulatory scrutiny of the sufficient evidence criteria of APB 23 assertions. The enhanced regulatory scrutiny is evidenced by the increased number of comment letters issued regarding disclosure requirements on where companies are holding cash and additional disclosure requirements on where and how companies plan to invest cash pertaining to APB 23 assertions. Recent comment letters seek detailed reinvestment plans with sufficient information to assess the validity of investment plans. The central theme of the SEC approach is to determine if APB 23–asserting firms meet the sufficient evidence criteria and whether the evidence is valid.

RELATED RESEARCH AND HYPOTHESIS DEVELOPMENT

This section reviews the literature related to asset repatriation and taxes. In addition, the effect of an APB 23 declaration on deferred taxes is examined. There are two streams of literature that categorize asset repatriation and taxes. The first stream focuses on the effect of home country taxes on earnings repatriation. The second one focuses on a firm's response to a temporary tax holiday, which in this case is the AJCA of 2004.

Asset Repatriation and Taxes

The first stream of literature related to home country taxes and earnings repatriation analytically showed that repatriation taxes do not affect a mature subsidiary's choice between reinvesting its foreign earnings abroad and repatriating such earnings (Bradford, 1981; Hartman, 1985). Altshuler, Newlon, and Randolph (1995) also analytically examined the effect of taxes on dividends changes over time to provide evidence on an incentive for firms to time their repatriation decisions. However, these authors find that permanent changes in the host and home country taxes do not affect repatriation. Their empirical results support conclusions by Hartman (1985) that repatriation taxes do not affect the investment and dividend payout decisions of mature foreign subsidiaries but appear more likely to attract new equity investment.

Contrary to the results found in the previous studies, Hines and Hubbard (1990) investigated the sensitivity of dividend payouts of foreign affiliates to US taxes on repatriated foreign earnings prior to the AJCA of 2004 and reported that a 1 percent decrease in repatriation taxation is associated with a 4 percent increase in dividend payouts by foreign subsidiaries in a sample of US multinational firms. The authors concluded that dividend payout decisions are influenced by both domestic and foreign tax rates. Desai, Foley, and Hines (2001) also reported that a 1 percent decrease in repatriation tax rates is associated with a 1 percent increase in dividend payments, suggesting that an exemption of US repatriation taxes would increase annual dividend flows from foreign affiliates to US parent companies by about 12.8 percent. The disparate findings in this stream of literature suggest that more refined empirical studies are needed to determine under what circumstances taxes impact a firm's decision to repatriate earnings.

The second stream of more recent studies examines the characteristics of firms that repatriated earnings subsequent to passage of the AJCA of 2004. By comparing firms that repatriated earnings with firms that did not, Blouin and Krull (2009) reported that repatriating firms had lower investment opportunities abroad and higher levels of free cash flow leading up to the AJCA of 2004 than non-repatriating firms. These authors further reported that firms repatriating under the AJCA of 2004 increased repurchases of their own stocks after enactment of the AJCA of 2004 relative to non-repatriating firms but did not significantly increase dividend payouts.

More recently, several other authors have studied the characteristics of repatriating firms under the AJCA. Blouin, Krull, and Robinson (2016) investigated what motivated US firms to designate their foreign earnings as permanently invested earnings (PRE). In their article, the authors examined what PRE can show about the tax policy, financial reporting, and investment implications of firms' foreign operations by investigating both the location and composition of PRE. Furthermore, the authors argued that financial reporting incentives and investment opportunities motivated repatriating firms to designate their foreign earnings as PRE. The authors concluded that financial reporting incentives and investment opportunities drive firms' PRE designations.

In addition, Blouin, Krull, and Robinson (2012) examined how the accounting for repatriation taxes affected repatriation decisions. In detail, the authors investigated whether reporting incentives to defer recognition of a repatriation tax expense affects managers' decisions to repatriate foreign earnings to the United States. The authors found that firms' incentives to report strong earnings reduced repatriations by approximately 17–21 percent annually. The results indicate that the financial reporting rules deter repatriation.

Some scholars examined the use of funds repatriated under the AJCA. Dharmapala et al. (2011) indicated that the tax holiday under the AJCA had little impact on domestic investment of firms. In this article, the authors claimed that repatriation of foreign earnings did not increase domestic investment, R&D, or employment – in stark contrast to what Congress had intended. Rather, repatriation under the tax holiday increased a value in shareholder payouts. Prior to the passage of the AJCA, US firms had expressed their plans to use the repatriated funds to finance R&D and capital spending, but it was found that US firms used the repatriated funds to instead pay their shareholders. The authors' results indicate that US multinationals use the majority of repatriated funds to increase payments to their shareholders rather than domestic investment.

Similar to Dharmapala et al.'s article, Faulkender and Petersen (2012) also examined whether the tax holiday in the AJCA encouraged domestic investment. Specifically, the authors questioned whether investment increased for US firms that repatriated their foreign income relative to those firms that did not repatriate under the AJCA. However, unlike Dharmapala et al., the authors found that the AJCA allowed US firms to increase investment, but only among those firms that were capital constrained. The authors also found that a decrease in US firms' tax expenses did not have an impact on leverage and equity payouts. These results indicate that only capital-constrained firms take on investment opportunities.

The evidence from Blouin and Krull (2009) supports prior findings that repatriation taxes are a binding constraint on firms' decision to repatriate foreign earnings. Albring, Mills, and Newberry (2011) reported that as the number of financial covenants in private debt contracts increased, firms repatriated a lower percentage of eligible funds. Consistent with Blouin and Krull (2009), Albring et al. (2011) found little evidence of debt repayment, suggesting that firms primarily used the repatriated funds (or freed-up cash) for stock repurchases.

Graham, Hanlon, and Shevlin (2011) examined firms' response to the one-time election to repatriate earnings under the AJCA of 2004 using a survey of tax executives. They reported that nearly 31 percent of the executives responded that the APB 23 deferred tax exemption is important in their decision to invest in foreign locations. In addition, Graham et al. (2011) noted that 44 percent of respondents to their survey stated that deferral of the financial accounting tax expense was important in their decision of whether to reinvest foreign earnings outside the United States.

Based on the results of their survey, Graham et al. (2011) then examined firms' sources and uses of the cash repatriated and concluded that US tax policy has a lockout effect and is an impediment to capital mobility based on the fact that repatriated funds already were being held in liquid form and not repatriated