THE ONE-TIME RECEIVED DIVIDEND DEDUCTION*

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THE NEW LAW

Congress created the one-time dividend received deduction in the Homeland Investment Act, incorporated into the American Jobs Creation Act of 2004, to encourage U.S. corporations to repatriate their foreign earnings and place them in investments that would promote U.S. job growth. The newly added Internal Revenue Code Section 965 outlines the provisions for this deduction while Notice 2005-10, Notice-2005-35, and Notice 2005-64 provide additional guidelines. These provisions permit U.S. corporations a one-time deduction of 85 percent of the extraordinary dividends received from their controlled foreign corporations (CFC), subject to certain limitations, from their U.S. taxable income, provided that the repatriated earnings are used to fund allowable domestic investments. A controlled foreign corporation is a corporation in which the U.S. shareholders own directly, indirectly, or constructively, more than 50 percent of either the total combined voting power or the total value of all stock on any day of the taxable year of the corporation. Generally, foreign earnings are not taxed until they are repatriated. Allowing the 85 percent deduction lowers the effective tax rate on qualifying dividends for corporations taxed at the highest rate from 35 percent to 5.25 percent (15 percent of taxable dividends X 35 percent). The deduction could be claimed either in the last tax year that begins before Oct. 22, 2004 or the last year that begins during the 1-year period beginning on Oct. 22, 2004.

Cash dividends eligible for the deduction included Section 302 and Section 304 redemptions of stock, Section 316 dividends, and cash from inbound liquidations considered a dividend by the provisions of Section 367(b). Other amounts treated as dividends under Section 367 as well as Section 1248 dividends, subpart F income from the earnings and profits of CFCs, and previously taxed income (PTI) were not eligible. Earnings could be repatriated from lower tier CFCs.

To qualify as extraordinary, the cash dividends received had to exceed the average dividend received from the corporations CFCs over a base period defined as the five tax years ending prior to July 1, 2003. The base period dividends included distribution of PTI under subpart F, dividends of property, and Section 956 distributions. To compute the average, the maximum and minimum annual dividends were discarded and the remaining three tax years were averaged.

Qualifying dividends were further limited to the greater of $500 million or either the amount of their earnings permanently reinvested outside the United States according to the corporation's balance sheet of their most recently audited financial statement as of June 30, 2003, or 35 percent of the specific tax liability attributable to earnings permanently reinvested outside the United States. To meet the domestic reinvestment qualification, taxpayers had to file a domestic reinvestment plan (DRP) with their financial statements. The investment has to be in the form of cash, not stock, and has to be paid to unrelated persons, with the exception of pension payments. Permitted types of investments included hiring of new employees or training of existing staff, increase in the employees' salary or benefits, excluding executives, research and development (if conducted within the United States), investments in infrastructure, intangible property and other capital investments, certain types of debt repayment, advertising or marketing, and acquisition of business entities, including foreign entities. Specifically not permitted investments included executive compensation, intercompany transactions, shareholder distributions, stock redemptions, portfolio investments, local, state or federal tax payments and purchases of Treasury bills, and municipal or corporate bonds. Of course, money is fungible. As long as corporations meet their investment plan as outlined in their DRP, they are free to spend an equivalent amount on something else.

Taxpayers were also required to reduce their qualifying dividends by any increase in their CFCs' debt to related persons. This requirement prevented taxpayers from loaning funds to their CFCs and including the payments in their cash dividends. An

*Please note: Views expressed in this paper do not necessarily reflect those of the U.S. Department of the Treasury or the Internal Revenue Service.

exception existed for banks and securities dealers and for intercompany trade payables.

Finally, U.S. corporations were not permitted to use the dividend deduction to eliminate all of their taxable income. In cases where their net operating losses or other deductions were greater than the nondeductible portion of the qualifying dividends, corporations had to set their taxable income equal to the nondeductible portion.

Taxpayers were permitted to specify which dividends qualified for the deduction. Ideally, corporations would specify dividends subject to low foreign taxes as qualifying and use the dividends received from countries with relatively high tax rates to satisfy the base period amount requirement. Such delineation was beneficial because withholding taxes could not be included in the dividend deduction and because foreign taxes paid on the deductible portion of the qualifying dividends were not eligible for the foreign tax credit, but all foreign taxes paid on non-qualifying dividends could be credited.

DATA SOURCES AND LIMITATIONS

Most of the statistics in this article are based on information reported on Form 8895 and related corporate returns selected for Statistics of Income's corporate sample for tax years 2004 through 2006. Industry codes and the country of incorporation of the controlled foreign corporations distributing the dividends were pulled from SOI's 2004 Form 5471 study, where a CFC with a matching name on Form 8895, Part V existed. SOI also examined Form 1118, Schedule C to determine the country of incorporation in cases where a match with the Form 5471 could not be made due to a lack of adequate information provided by the taxpayer.

The returns in this study were selected after administrative processing but prior to any amendments or audit examination. The estimates are based on a stratified probability sample of 784 returns selected from a population of corporations reporting the dividend deduction on their corporate return, so they are subject to sampling error. The sampling error is considered to be very small, as most corporations in the study are relatively large and large corporations are sampled at 100 percent. Each return in the sample was given a distinct weight, calculated by dividing the number of returns in a certain section of the study (industry, accounting period, etc.) by the number of sample returns for the same section. The purpose of these weights is to adjust for the various sampling rates used, relative to the population.

For the purposes of this article, weighted totals are used for all counts and numerical values. Data in this article, unless otherwise stated, refers just to those corporations claiming the dividend deduction.

THE RESULTS

Given that roughly 9,700 corporations had CFCs in 2004, a relatively small number of corporations—843—took advantage of the deduction. But these corporations repatriated almost $362 billion. Of that, $312 billion qualified for the deduction, creating a total deduction of $265 billion. In comparison, $804 billion of end-of-year, accumulated, nontaxable earnings and profits was reported for all controlled foreign corporations of all U.S. corporations for tax year 2004, the last tax year for which this statistic is available. Most corporations, 86 percent, reported the deduction for tax year 2005, while 7.7 percent reported it for tax year 2004 and the remaining 6.8 percent reported it for tax year 2006. Generally, corporations claiming the deduction were fairly large firms repatriating substantial amounts of their foreign earnings. The average total year-end assets were over $24 billion while the average amount repatriated was roughly $429 million and the average qualifying dividend was $370 million.

INDUSTRY COMPOSITION

Table 1 displays the frequency of returns, the cash dividends repatriated, the qualifying dividends and percentage of the total qualifying dividend, by selected major and minor industries. Manufacturing firms accounted for just over half the total returns, but 81 percent of the total qualifying dividend. Although corporations in the pharmaceutical and medicine manufacturing comprised a mere 3.4 percent of the filers reporting the deduction, they were responsible for 29 percent of the cash dividends repatriated and almost one-third of the qualifying dividends. This industry repatriated nearly $106 billion dollars and was able to deduct almost $84 billion. The computer and electronic equipment manufacturing industry also accounted for a substantial amount of the repatriation, with 19 percent of the total cash dividends.

Table 2 provides a look at the average end-of-year total assets, average cash and qualifying dividends, and the percentage of cash dividends that qualified for the deduction by the same industry groups. The finance, insurance, real estate, rental and leasing industry group had the largest average end-of-year total assets, but brought back less, on average, than the $429 million for all corporations. The manufacturing industry as a whole reported smaller average total assets, but repatriated an average of $622 million. Within manufacturing, the pharmaceutical and medicine manufacturing industry stands out, with an impressive average cash dividend of $3.6 billion dollars and an average qualifying dividend of $3.4 billion. The wholesale and retail trade industry group had the lowest average repatriation, with an average cash dividend of about $111 million, of which about 97 million, on average, qualified.

Differences in the average dividend repatriated between industry groups may be due to differences in the amount of accumulated earnings and profits, the ability to extract those earnings from CFCs in cash within the allotted time frame, and the

Table 1

Repatriated Dividends by Major and Selected Minor Industry

(Money amounts are in billions of dollars)

Major industry	*Number of retums (1)*	*% of total number of returns (2)*	*Cash dividends (3)*	*% of total cash dividends (4)*	*Qualifying dividends (5)*	*% of total qualifying dividends (6)*
All industries, total	**843**	**100%**	**$361.9**	**100%**	**$312.3**	**100%**
Manufacturing	465	55	289.4	80.0	252.2	81
Computer and electronic equipment	85	10	68.6	18.9	57.5	18
Pharmaceutical and medicine	29	3	105.5	29.2	98.8	32
Wholesale and retail trade	133	16	14.7	4.1	12.9	4
Information	49	6	14.6	4.0	13.2	4
Finance, insurance, real estate, rental & leasing	49	6	13.3	3.7	11.9	4
All other industries	147	17	29.8	8.2	22.1	7

Table 2

Repatriated Dividends by Major and Selected Minor Industry

(Money amounts are in millions of dollars)

Major industry	*Average total assets (1)*	*Average cash dividends (2)*	*Average qualifying dividends (3)*	*Qualifying dividends as a percentage of cash dividends (4)*
All industries, total	**$24,003.8**	**$429.3**	**$370.5**	**86%**
Manufacturing	12,744.8	622.4	542.5	87%
Computer and electronic equipment	4,950.9	806.7	676.3	84%
Pharmaceutical and medicine	27,187.7	3,638.0	3,406.2	94%
Wholesale and retail trade	2,320.4	110.5	96.7	87%
Information	24,692.1	297.7	269.4	90%
Finance, insurance, real estate, rental & leasing	71,553.1	271.9	243.2	89%
All other industries	63,158.3	202.9	150.3	74%

availability of foreign versus domestic investment opportunities.[1, 2] The pharmaceutical industry tends to have more cash on hand than other industries, due to high profit margins and minimal capital spending. Furthermore, industry experts speculate that the pharmaceutical industry plans to use at least some of their repatriated earnings to acquire small biotech companies that already have new drugs in the works.[3]

Overall, about 86 percent of cash dividends qualified for the deduction. The percentage for the pharmaceutical and medicine manufacturing industry was noticeably higher, at 94 percent.

The industrial makeup of the CFCs distributing the dividends differed somewhat than the makeup of the parent returns (see Table 3). Although CFCs engaged in the manufacturing of pharmaceuticals and medicine were responsible for about 24 percent of the cash dividends and 27 percent of the qualifying dividends, CFCs that produce computer and electronic equipment accounted for only 7.8 percent of the cash dividends. Bank holding and other holding companies, not surprisingly, however, accounted for 27 percent of the cash dividends.

THE EFFECT OF THE LIMITATIONS

Of all the various limitations that determine the amount of qualifying dividends, the requirement that qualifying dividends had to be extraordinary impacted the largest percentage of filers. Over half (56 percent), of the returns reported a base dividend. The total amount of base dividends was about $34 billion, approximately 9 percent of the total cash dividends. Only 38 corporations, or about 5 percent, reported qualifying dividends equal to the cap of the greater of $500 million or either their permanently invested foreign earnings or thirty-five percent of the tax liability attributable to earnings permanently reinvested. Roughly one-fifth, however, planned to reinvest less than their extraordinary dividends. Overall, these firms lowered their otherwise qualifying dividends by $14.6 billion, about 4 percent of total cash dividends for all firms claiming the deduction. Just 6 percent of corporations lowered their qualifying dividends by $0.2 billion due to increased debt of their CFCs to related persons.

PLANNED COMPLETION DATE

Most corporations planned to complete their domestic reinvestment in the near term. About one-third reported a planned completion date that fell within the taxable year in which the dividend deduction was claimed. Almost 70 percent of filers indicated their reinvestment would be completed by the end of 2007. Only 6 percent reported a completion date later than the end of 2009. See Table 4.

COUNTRY DISTRIBUTION OF REPATRIATED DIVIDENDS

Figure 1 provides a regional distribution of the cash dividends by the country of incorporation of the distributing CFC. CFCs incorporated in Europe were responsible for 62 percent of the total repatri-

Table 3

Repatriated Dividends by Major and Selected Minor Industry of Distributing CFC

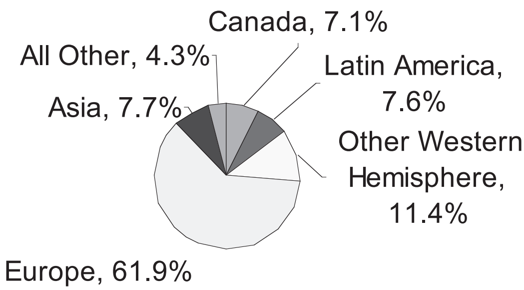
(Money amounts are in billions of dollars)

Major industry	*Number of returns (1)*	*% of total number of returns (2)*	*Cash dividends (3)*	*% of total cash dividends (4)*	*Qualifying dividends (5)*	*% of total qualifying dividends (6)*
All industries, total	**4,246**	**100%**	**$361.9**	**100%**	**$312.3**	**100%**
Manufacturing	1,361	32	168.8	46.6	156.5	50
Pharmaceutical and medicine	103	2	88.1	24.4	84.9	27
Wholesale and retail trade	739	17	23.1	6.4	16.6	5
Finance, insurance, real estate, rental & leasing	386	9	20.8	5.7	16.6	5
Management of companies and enterprises	509	12	97.7	27.0	82.6	27
All other industries	1,251	29	51.5	14.2	40.0	13

Table 4
Planned Completion Dates for Reinvestment

Planned date of completion	*Number of Returns (1)*	*Percentage of Total (2)*
By the end of		
2005	213	25.3%
2006	206	24.4
2007	171	20.3
2008	75	8.9
2009	97	11.5
After 2009	51	6.0
Not Specified	31	3.7
Total	843	100

Figure 1: **Cash Dividends from CFCs, by Country of Incorporation**



ated cash dividends while the Western Hemisphere, excluding Canada and Latin America, accounted for 11.4 percent. The latter figure is not surprising, since this country group includes many small Caribbean nations known to have favorable tax policies.

A closer look at the countries of incorporation with the largest percentage of cash dividends shows the dominance of Europe is due to a large percentage of cash dividends from a handful of European nations. Figure 2 below displays the percentage of CFCs and the percentage of cash dividends distributed, by the country of incorporation for the seven countries with the largest percentages of cash dividends. The Netherlands tops the list, with about 6 percent of the CFCs, but over 26 percent of the cash dividends. It is followed by Switzerland, Bermuda, Ireland, Canada, Luxembourg, the United Kingdom, and the Cayman Islands. We would expect firms to park considerable shares of their earnings and profits in the Netherlands, Switzerland, Bermuda, Ireland, Luxembourg, and the Cayman Islands, as these countries are known for their favorable tax policies. Canada and the United Kingdom, however, make the top seven list because a large number of CFCs exist in these two countries, as is evident in Table 5. This table lists the frequency of parent returns with CFCs incorporated in the seven countries previously mentioned, the average cash and qualifying dividend from each country, and the qualifying dividends as a percentage of the cash dividends. The countries are listed in descending order of largest average cash dividends. More corporations have CFCs incorporated in United Kingdom and Canada than in the other five selected countries, but the average cash and qualifying dividends are much lower than the average for all countries. In contrast, the number of returns with CFCs incorporated in Bermuda or Luxembourg is relatively low, just 5.6 and 4.7 percent respectively, but they have the highest average cash and qualifying dividends.

The dramatic differences in the percentage of cash dividends qualifying for the deduction between Canada and the United Kingdom on one hand, and the other countries in Table 5 is most

Figure 2: **Repatriated Dividends from CFCs**

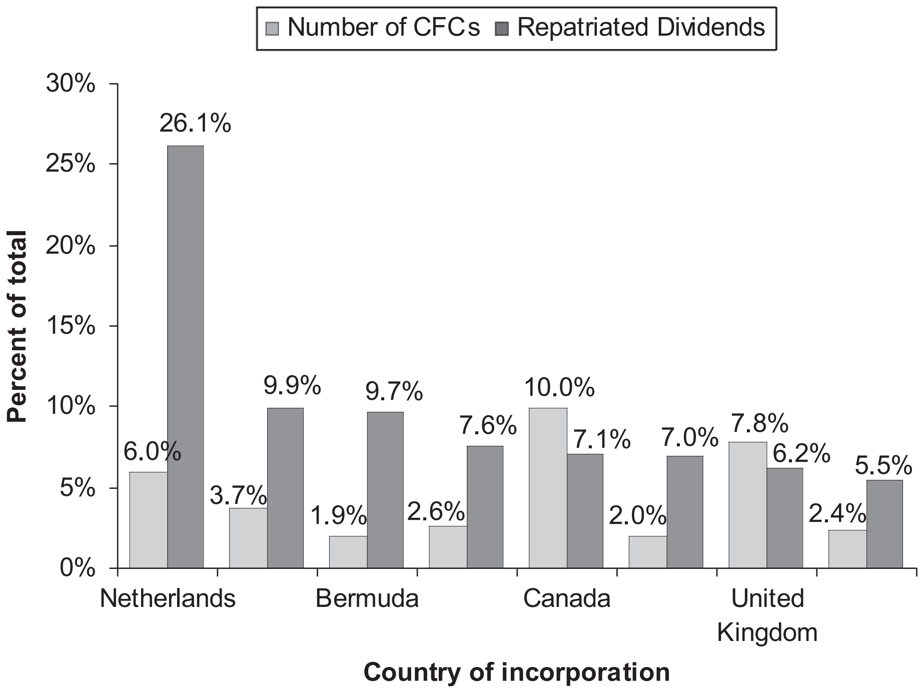


Table 5
Number of Returns and Average Repatriated Dividends, by Select Countries
(Money amounts are in millions of dollars)

Country	*Number of parent returns (1)*	*Average cash dividends (4)*	*Average qualifying dividends (5)*	*Qualifying dividends as a % of cash dividends (5)*
All returns, total	**843**	**$429,260**	**$370,492**	**86.3%**
Bermuda	47	744,130	676,572	90.9
Luxembourg	40	635,969	586,673	92.2
Netherlands	149	633,657	603,438	95.2
Switzerland	78	458,761	415,662	90.6
Ireland	68	405,699	376,180	92.7
Cayman Islands	55	361,700	335,522	92.8
United Kingdom	195	114,176	81,662	71.5
Canada	244	104,674	87,851	83.9

likely due to taxpayers maximizing their foreign tax credit by carefully designating their specifically qualifying dividends from each of their CFCs. A firm with dividends from the United Kingdom and Bermuda would most likely designate their Bermuda dividends as qualifying first, before any of their dividends from the United Kingdom, as Bermuda has a zero tax rate; and use their dividends from the United Kingdom, to the extent possible, to match their base dividend amount.

This “cherrypicking” of dividends is more obvious in Table 6, which lists the 10 countries of incorporation with the highest percentage of cash dividends qualifying for the deduction and the

Table 6
Percentage of Cash Dividends Qualifying for the Deduction, by Country of Incorporation[1]

Top Ten Countries		*Lowest Ten Countries*	
Singapore	97.9%	Brazil	52.0%
Malaysia	97.8	Philippines	50.8
Netherlands	95.2	Italy	43.1
Hong Kong	94.0	South Korea	42.1
Cayman Islands	92.8	Argentina	35.8
Ireland	92.7	South Africa	32.6
Luxembourg	92.2	Taiwan	28.2
Bermuda	90.9	Colombia	27.4
Switzerland	90.6	India	26.5
Sweden	90.3	Japan	9.9

[1]Does not include countries with low frequencies

Table 7
Foreign Taxes and Tax Credit, by Selected Major and Minor Industry
(Money amounts in billions of dollars)

	Foreign laxes paid on nondeductible dividends (1)	*Foreign tax credit from income categories with nondeductible dividends, prior to reduction (2)*	*Revised total foreign tax credit (3)*
All industries, total	**5.0**	**47.5**	**45.8**
Manufacturing	4.0	33.1	30.9
Computer and electronic equipment	0.8	5.8	4.8
Pharmaceutical and medicine	1.0	7.6	6.6
Wholesale and retail trade	0.2	1.5	1.4
Information	0.2	2.3	2.5
Finance, insurance, real estate, rental and leasing	0.1	1.3	1.6
Management of companies and enterprises	0.2	6.0	6.0
All other industries	0.2	3.4	3.4

10 lowest. A substantial difference exists in these percentages. While almost 98 percent of the cash dividends from CFCs incorporated in Singapore qualified for the deduction, less than 10 percent from those incorporated in Japan qualified.

REVISED FOREIGN TAX CREDIT

Although taxpayers could not credit any foreign taxes paid on the deductible portion of their qualifying dividends, they were permitted to credit those paid on the nondeductible portion. However, they were required to adjust their foreign tax credit on Form 8895 by computing an additional limitation based on the nondeductible portion. To compute this limitation, taxpayers subtracted the amount of the nondeductible dividends from each applicable income category from the original numerator and denominator of the ratio used to determine the original foreign tax credit limitation. Then taxpayers multiplied the new ratio by their U.S income tax, less 35 percent (the highest U.S. corporate tax rate) of the nondeductible portion of the qualifying dividends. This new limitation was added to the foreign taxes attributed to the nondeductible qualifying dividends. Where the result was less than the original credit for the income category, it became the new credit.

Overall, taxpayers claiming the foreign tax credit attributed almost $5 billion of foreign taxes to the nondeductible portion of their qualifying dividends. The ratio of these foreign taxes to the nondeductible portion of qualifying dividends for these returns is about 11.4 percent. Of the 582 taxpayers who reported a foreign tax credit, 168 or 28 percent reduced their foreign tax credit by a total of about $3.2 billion. This reduction, however, comprised only 6.5 percent of the total foreign tax credit that otherwise would have been claimed for all corporations claiming the deduction. The manufacturing industry as a whole as well as the wholesale and retail industry group reported total revised foreign tax credits that were smaller than the sum of the foreign tax credits reported for those income categories with nondeductible dividends prior to the additional limitation computation. (See Table 7).

CONCLUSIONS

A small number of mostly large corporations repatriated nearly $362 billion from their controlled foreign corporations and deducted about $265 billion of these dividends from their taxable income. The pharmaceutical and medicine manufacturing industry brought home roughly 29 percent of the repatriated dividends. CFCs engaged in pharmaceutical and medicine manufacturing or defined as bank holding or other holding companies together accounted for over half of the dividends, while CFCs incorporated in the Netherlands distributed over a quarter of the repatriated earnings. The differences in the percentage of cash dividends qualifying for the deduction from different countries of incorporation of the distributing CFC reflect the ability of taxpayers to specifically designate their qualifying dividends. Finally, much of the qualifying dividends have already been invested or will be invested shortly.

Notes

1 PricewaterhouseCoopers (2005).
2 Blouin and Krull (2006).
3 Brush (2005).

References

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