Proposed tax breaks for US multinationals: implications for the USD

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Multinational US companies have been lobbying Congress for a one-year tax reduction on repatriated offshore earnings. The proposed tax reduction is similar to the 2004 Homeland Investment Act (HIA) which saw the (USD) rise 13% over the following year. A closer look however, suggests that the 2004 HIA legislation had a negligible effect on the USD in 2005 and if enacted, is likely to have a similar effect this time around.

The proposed Act

Foreign exchange market participants have been interested in the currency implications of any changes to US tax treatment of foreign earnings. Multinational US companies have been lobbying Congress for a one-year tax reduction on repatriated earnings. The proposed tax reduction is similar to the 2004 HIA and proposes a one-off 5.25% tax rate on repatriated earnings for multinational corporations for a defined 12-month period. This is a significant reduction on the current 35% tax rate for US company earnings.

In calendar year 2005, an estimated US$298bn of offshore profits was repatriated back to the US economy. The sum of US$298bn represented virtually all offshore profits earned that year by US companies and represented a 267% increase in repatriated profits compared to the previous year's repatriation of US$81.5bn (Exhibit 1).

A recent study from the Congressional Joint Committee on Taxation estimates that as much as US$700bn could be repatriated, if a similar tax holiday was passed through Congress today. This is more than double the US$298bn estimate of 2005's repatriated earnings and represents an amount equal to 150% of the US$461bn earned in offshore earnings by US companies in the 12 months leading up to the end of June 2011.


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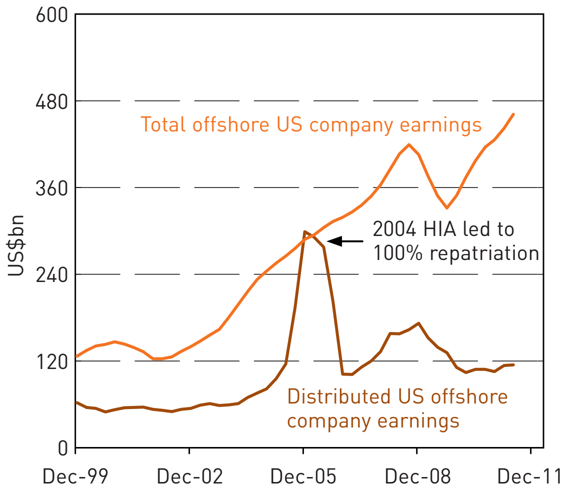
US offshore company profits (US$bn) **Exhibit 1**



Source: Commonwealth Bank of Australia

In calendar year 2005, the USD appreciated some 13% on a trade-weighted basis. The 12-month rise in the USD during 2005 was a noticeable upward correction in the long-run downward trend in the USD, which has been occurring since mid-2001 (Exhibit 2). There is little doubt some of the rise in the USD during 2005 was attributable to repatriation, but as outlined later in this chapter, the effect on the USD from the 2004 HIA legislation was likely to be negligible.

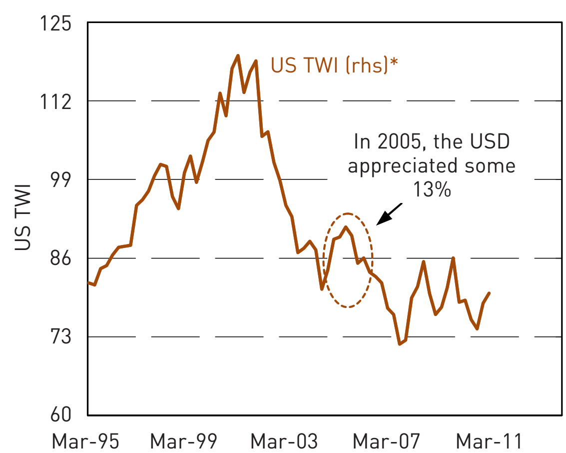
USD implications

If an equivalent 2004 HIA legislation is enacted in the near future, we expect extremely little direct upward pressure on the USD from such an event due to the following five reasons:

1. As a percentage of turnover in the foreign exchange market during 2005, the extra USD amount repatriated back to the US equates to around 0.04% of annual global USD turnover. We are doubtful that this additional increase in USD demand was enough to generate the 13% increase in the USD trade weighted index (TWI) that occurred during 2005.

   The maths works as follows: US corporates typically repatriate about 33% – 40% of their offshore profits back to the US every year. In the four years to the end of 2003, this amount averaged US$55bn. Furthermore in 2005, US corporates repatriated 104% of their annual offshore earnings (equivalent to US$298.7bn) in response to the 2004 HIA legislation (Exhibit 1). Hence, we witnessed US companies repatriate an extra 60%-67% of repatriated profits during 2005 over and above what they would typically repatriate. For 2005, this additional increase equated to US$217bn above what would otherwise have been repatriated in the absence of HIA legislation. As a percentage of annual global USD turnover in the foreign exchange market during 2005, this extra US$217bn in USD repatriation equates to around 0.04% of annual global USD turnover. Total US repatriated profits that year accounted for 0.06% of total USD global foreign exchange turnover (Exhibit 6).

US TWI **Exhibit 2**

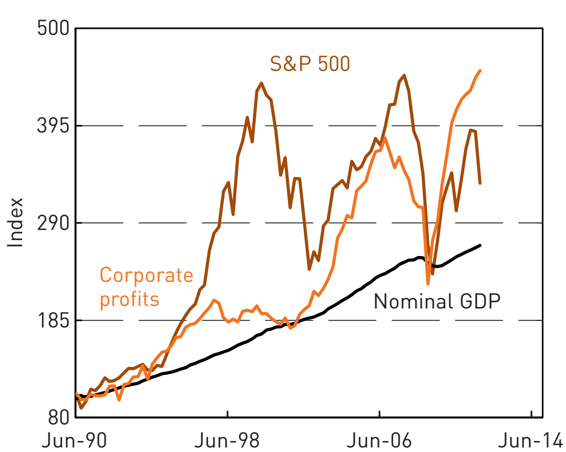


*right hand side

Source: Commonwealth Bank of Australia

2. A proportion of offshore earnings by US companies will already be held in USD, so there will be no currency impact if USD denominated earnings is repatriated back to the US. Two reasons why many US offshore companies hold USD are because, many international transactions are denominated in USD and many US companies have operations located in USD tax havens.
3. It is likely that the rise in the US real federal funds rate from negative territory into positive territory at the beginning of 2005 was a larger driver of the USD appreciation during 2005, than was the impact of the HIA. Real interest rates are an important driver of the USD exchange rate (Exhibit 4).
4. While the size of the repatriation, if it took place today, is estimated to be much larger (at US$700bn) than the estimated size of the repatriation in 2005 (of US$298bn), the size of the foreign exchange market is also much larger today than in 2005. On a comparable basis, today's size of the repatriation would be 0.08% of annual USD turnover in the global foreign exchange market. While this is bigger than 0.06% in 2005, it is not statistically significant (Exhibit 6).

US GDP, profits & S&P 500 (Base 100 = March 1993) **Exhibit 3**



Source: Commonwealth Bank of Australia

5. There is some doubt a sum as large as US$700bn would be repatriated in the event that an equivalent HIA legislation is passed. US companies are generally invested offshore because the investment returns are considered favourable; particularly for those companies invested in the developing economies. The arguments for repatriation to take advantage of a one-off tax break that may have strings attached, may appear less compelling than the longer run growth prospects that developing economies are forecast to achieve.

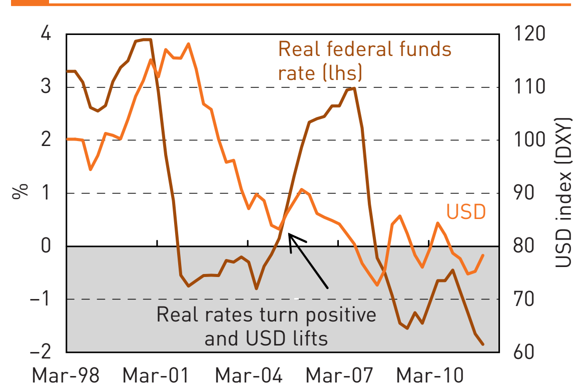
Outlook for the USD

We recently revised up our 2012 USD forecasts for three main reasons. Readers are encouraged to view our publication '*FX Strategy – Adjustments to the Forecasts*', published December 2, 2011.

Further details surrounding the politics of the proposed Act

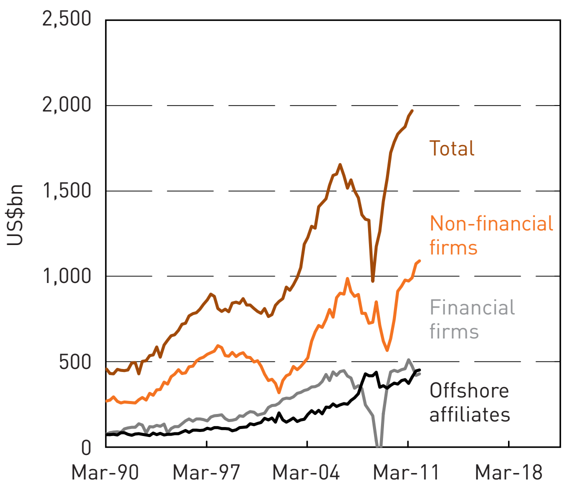
The Act being debated proposes a one-off 5.25% tax rate on repatriated earnings for multinational corporations for a defined 12-month period, if they increase hiring. This is a significant reduction on the current 35% tax rate for US company earnings.

USD and real interest rates **Exhibit 4**



Source: Commonwealth Bank of Australia

US corporate profits	Exhibit 5



Source: Commonwealth Bank of Australia

The Act is intended to allow US companies to repatriate global earnings for either the year the legislation is enacted or the year following enactment (but not both).

To ensure that companies use repatriated funds to promote job creation, penalties have been proposed on companies that reduce their average employment during the two-year period following repatriation. This is a significant difference to the 2004 HIA.

In a sign the proposed Act may not get passed, the Obama administration appears to oppose the idea of such a tax break. In May, the Assistant Treasury Secretary noted 'in 2004, when the US enacted a repatriation tax holiday...unfortunately, there is no evidence that it increased US investment or jobs and it cost taxpayers billions'. Furthermore, Obama's goal stated in 2010 of doubling US exports (currently equivalent to 12.7% of US GDP) by 2015 to US$3.6 trillion means the administration should prefer policies that do not run the risk of boosting the USD.

A study by the National Bureau of Economic Research (NBER) argued most of the repatriated funds in 2005 were used for share buy backs or paid out in dividends. The NBER study concluded that '*repatriations did not lead to an increase in* domestic investment, employment *or R&D – even for the firms that lobbied for the tax holiday*'. The NBER study showed none of the top 10 companies that repatriated profits following the 2004 HIA expanded their workforce.

US corporate offshore products	Exhibit 6

	US corporate offshore profits				Global FX market size annual turnover		US corporate profits offshore (as a % of global USD turnover)	
		Repatriated		Incremental				
Year	Total (US$tn)*	US$tn	% of total	change (US$tn)	Total (US$tn)	USD	Total profits	Repatriated profits
2001	0.12	0.05	0.43	–0.01	310	278	0.04%	0.02%
2002	0.14	0.05	0.39	0.00	369	328	0.04%	0.02%
2003	0.18	0.06	0.33	0.00	424	375	0.05%	0.02%
2004	0.24	0.08	0.33	0.02	484	425	0.06%	0.02%
2005	0.29	0.30	1.04	0.22	610	523	0.06%	0.06%
2006	0.32	0.10	0.32	–0.20	717	614	0.05%	0.02%
2007	0.36	0.13	0.37	0.03	831	711	0.05%	0.02%
2008	0.41	0.17	0.43	0.04	890	757	0.05%	0.02%
2009	0.35	0.11	0.32	–0.06	941	800	0.04%	0.01%
2010	0.43	0.11	0.25	–0.01	995	845	0.05%	0.01%

*tn – trillion

Source: BIS Triennial Survey, Bureau of Economic Analysis, Commonwealth Bank of Australia Research

For the reasons set out earlier, it is unlikely a legislation similar to the 2004 HIA legislation, would have the desired effect on the US economy and we think the Obama administration is unlikely to pass any tax break unless it is part of a broader tax overhaul.

Notes:

1. Ranked in July 2011 by Bloomberg as fifth overall for accuracy of Asian currency forecasts and ninth overall for G-8 currency pair forecasts out of 50 banks surveyed. Ranked first in USD/CNY forecast and second in USD/HKG forecast for six quarters ending Dec 2011.
2. Ranked first for 'FX Week' one-month and 12-month forecasting poll, (which covers 35 banks) in August 2011, and featured within top five banks for the past four and a half years.
3. Bloomberg. Ranked ninth by market capitalisation as at December 5, 2011.
4. Standard & Poor's, Outlook: Stable, December 1, 2011.

Ranked as one of the best currency forecasters by Bloomberg[1] and the 'FXWeek'[2], the Commonwealth Bank is well-positioned in the global foreign exchange market to provide a wide range of business banking solutions to customers globally. The largest Australian bank and one of the world's largest banks by market capitalisation[3], as well as one of the few AA-rated[4] banks in the globe, our in-depth knowledge of the Asian and Australasian markets has been a key strength for our clients globally. We continue to attract Asian and Australian clients who are keen to get exposure to offshore markets and global clients that have Australian interests.