

A FESTSCHRIFT IN HONOR OF HARRY GRUBERT: HARRY'S INFLUENCE ON THE RESEARCH OF ACADEMIC ACCOUNTANTS

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Harry Grubert's influence on tax accounting research began by calling attention to the finer details of repatriation techniques and foreign tax credits, and evolved over time into the complexities of multinational firms' tax minimization strategies, ownership structures, and income-shifting behavior. The depth of knowledge he created will continue to shape our research as we revisit his studies to find questions and answers in the wake of major corporate tax reform.

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I. INTRODUCTION

Benjamin Franklin is quoted as saying, “In this world nothing can be said to be certain, except death and taxes.” Yet it was clear, at least to Harry, that taxes were not certain, and in many cases not even particularly difficult to avoid. Indeed, most of Harry’s work touched on multinational corporations’ (MNCs’) attempts at avoiding taxes — i.e., the incentives to do so, the strategies and techniques that firms use, and the estimates of the outcomes of using these strategies. While MNCs argued that the U.S. tax system was burdensome and uncompetitive, Harry often tried to convince us that these firms did not pay enough tax. We recall many conferences when everyone else in the room was lambasting the U.S. system for its inequity and he was the lone voice arguing that the data suggested otherwise.

It is not every day, or even every decade, that the work of an international tax economist, executed with such an immense focus on institutional details, appeals to such a variety of readers. Indeed, the mere existence of someone like Harry Grubert is a rare

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event. He wrote widely on the role of the U.S. system of taxation in the behavior of U.S. MNCs. He worked on answering the question of whether the worldwide system of taxation is truly an impediment to U.S. MNCs' competitiveness in the global economy. In his role at the Treasury Department, he had access to the holy grail of tax research: confidential corporate tax return data. He became a sort of messenger to the academic profession, telling us all kinds of things we wanted to know and speculated about but could rarely observe.

As accountants, we like the details. Whether it be detailed accounting rules or complex tax law, we value the precision in knowing all of the particulars of our institutional settings. In Harry, we found our proverbial academic soulmate. He recognized that understanding the details of measurement or law is very necessary to our research. We recall many tax symposiums at the University of North Carolina and the University of Oxford (both well attended by accountants) where Harry asked very focused, on-point questions that zeroed in on the specifics. Each of us was on the receiving end of a detailed Harry question regarding a data measurement issue or nuanced institutional fact. Like many others, we both feared and delighted in his presence.

It is bittersweet that just four months after Harry's passing on August 10, 2017 the United States passed the most dramatic changes to the U.S. tax code in 30 years. The Tax Cuts and Jobs Act of 2017 (TCJA) elevates his work to a level of epic importance. However, the international tax community is somber because the new legislation seems to highlight his absence. Everyone is asking, "Now what?" and the man best equipped to answer this question is no longer with us. Our aim in this piece is to talk about how Harry's work has influenced, and will continue to influence, the work of academic accountants. We are contributing to Harry's *Festschrift* because we believe in his work, we believe that there is so much more to do, and we want to encourage our field to draw from Harry's work in trying to understand this new post-tax reform era in the United States, and to understand more broadly the impact of the ever-changing global tax landscape of the behavior of MNCs.

In what follows, we first discuss Harry's work, and in particular a handful of our favorites. His work often showed that firms can and do employ a variety of techniques and strategies to avoid or defer the burden of taxation, and so provides useful insights into many of the underpinnings of research that attract tax accountants. For instance, the tax implications and related strategies for moving financial assets through affiliated companies, or opportunistically allocating income across jurisdictions, are important in understanding how tax planning interacts with other firm objectives. In the second section, we talk about how Harry's work pervades so much of the existing accounting literature. In trying to understand how corporations interpret, apply, and sometimes bend and twist the law to pay less tax, Harry often focused on what the tax law ought to be. With this deep institutional knowledge so readily accessible from his work, tax accountants have explored how tax planning interacts with firms' information environments and how to detect and measure in financial statements some of the phenomena that Harry illustrated using his rich set of confidential tax return data. Finally, in the third section, we speculate on what Harry might say about the TCJA and what sort of

work we think Harry would like to see us tackle over the next few years. Although he is sorely missed, we will let his work guide us as we seek to understand MNCs' behavior in this new era. Indeed, it is an honorable obligation to our friend and colleague.

II. SELECTIONS FROM GRUBERT'S GREATEST HITS

A. Financial Policy of Controlled Foreign Corporations

In a field of research where MNCs' financial policies of their foreign subsidiaries — termed controlled foreign corporations (CFCs) under the U.S. tax code (and the only type of entity eligible for tax deferral) — are frequently characterized as single decisions that entail choosing between repatriation or reinvestment, Grubert introduces complexity by adding multiple choices, induced by sophisticated tax planning strategies, to firms' decision sets. He is able to do this, in part, because of his privileged access to tax returns. He also thinks carefully about how to present each option and integrates these ideas into his model to provide a complete (albeit complex) picture of how MNCs fund foreign operations and invest the resulting income.

Before his 1998 paper "Taxes and the Division of Foreign Operating Income among Royalties, Interest, Dividends and Retained Earnings," research on U.S. MNCs' use of foreign earnings typically gave these firms just two options: reinvest in the CFC or repatriate to the U.S. parent. Grubert takes a more comprehensive look at how U.S. MNCs deploy CFC operating earnings by estimating the extent to which firms use operating income either to make interest, royalty, and dividend payments or to hold as retained earnings. This comprehensive analysis is important and informative because firms might substitute dividend repatriations with other types of payments, e.g., royalties or interest, rather than deciding to retain the funds in the CFC. The consequence of this substitution is that, when tax laws change, retained earnings may not.

To this comprehensive decision set, Grubert adds a careful depiction of how taxes affect each possible decision. Here, he makes the astute observation that the tax rate at which firms benefit from interest and royalty deductions differs from that of the relevant tax rate for the U.S. foreign tax credit. Firms can deduct interest and royalties at the statutory tax rate of the CFC, whereas the foreign tax credit will accrue at the effective tax rate. This distinction is important because the foreign statutory tax rate will often be higher than the foreign effective tax rate, which affects the choice between dividend repatriation versus interest and royalties.

Grubert also carefully incorporates withholding taxes and the foreign tax credit position of U.S. MNCs into the decision. Firms in an excess credit position have relatively high foreign tax rates so no U.S. tax is due upon repatriations.¹ However, firms may still owe withholding taxes to the foreign country on dividends, royalties, and interest paid by its CFCs. In this case, the tax price on dividends is the foreign withholding rate and the tax price on interest and royalties is the foreign withholding rate minus the

¹ This was not his first examination of foreign tax credit positions (e.g., Grubert and Mutti, 1991).

foreign statutory rate. Since this estimate results in a negative tax rate on interest and royalties, the MNCs will choose these types of payments over dividends to the extent allowed by other restrictions, such as the arm's length principle that applies to royalties and the thin capitalization rules that apply to interest.

Firms in an excess limit position have relatively low foreign tax rates, so U.S. tax is due upon repatriation. If the foreign statutory and effective rates are the same, the firm is indifferent between dividend, interest, and royalty payments. Likewise, if the U.S. parent remits all foreign earnings in one form or the other, the firm is indifferent as to the mix of payments because all foreign taxes generate a foreign tax credit. However, if the foreign effective rate is less than the foreign statutory rate and the firm retains some earnings in the CFC, royalties are tax preferred because the tax savings of the deduction for royalties exceeds the loss of the foreign tax credit. This result differs from prior theoretical work because it allows dividends, interest, royalties, and other payment forms to be substitutes. If firms respond to tax changes by substituting royalties for dividend payments or vice versa, retained earnings remain the same. Thus, the relevant decision is not repatriate versus reinvest, but a choice between forms of repatriation.

Grubert tests these ideas using tax return data on U.S. MNCs' foreign earnings, payments, and retained earnings. He estimates a series of equations with each payment/reinvestment option interchangeably on the left-hand side. The results suggest that the tax price of dividends has a negative effect on dividend repatriations. The tax prices of royalties and interest also have a negative effect on the respective form of payment. However, the results also suggest that retained earnings do not significantly change, suggesting that, as the tax price of each option changes, firms distribute foreign operating earnings in a different form.

Many accounting studies draw on Harry's analysis of retained earnings to study a related accounting concept: permanently or indefinitely reinvested earnings (PRE). His discussion of excess credit and excess limit firms inspired accounting researchers to partition foreign tax credit status — relabeled in the accounting literature as “binding” and “nonbinding” foreign tax credit firms (e.g., Collins, Kemsley, and Lang, 1998).

In his 2003 paper with Rosanne Altshuler, “Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy,” hereafter AG, Harry and Roseanne introduced yet another complex, but very realistic, decision set to the traditional model that allows only two choices — reinvest foreign earnings in real assets abroad or repatriate them to their U.S. parent. Specifically, AG allows the CFC three additional options: (1) retain earnings and lend them to other affiliates of the domestic parent, (2) reinvest foreign earnings in passive (financial) assets, and (3) repatriate earnings using tiered ownership structures. This expanded decision set allows him to take a closer look at the well-known Hartman–Sinn result that, in the presence of repatriation taxes, multinational firms will contribute less initial capital to their foreign affiliates.²

² Essentially, the parent is better off reducing the initial investment and funding the “underinvestment” through unremitted earnings over time. See Hartman (1985) and Sinn (1991, 1993) for a discussion of this phenomenon.

AG recognizes that a high repatriation tax burden increases the likelihood that a U.S. MNC could defer or eliminate any repatriation tax burden through tax planning activities, thereby providing additional uses of foreign retained earnings beyond investment in “real” assets. The resulting model suggests that, by allowing tax planning, U.S. MNCs could effectively circumvent the underinvestment problem highlighted by Hartman–Sinn. AG then uses Treasury data to help illustrate that the elegantly simple and intuitively appealing Hartman theory is not descriptive of the reality faced by U.S. MNCs. With passive investment and tax planning, repatriation taxes can be inconsequential, and shifting income out of the United States to low-tax CFCs is as beneficial as shifting income into the United States from high-tax CFCs.

The paper is also groundbreaking because it provides empirically testable predictions about the association between repatriation taxes and particular attributes of MNC consolidated groups. AG provides researchers with a solid theoretical underpinning for explaining why tax planning undermines the underinvestment identified in the standard repatriation theory. It provides the impetus for many papers to explain why intercompany debt, tiered ownership structures, and investment in passive assets are so prevalent in the data. Interestingly, many studies examining the consequences resulting from the relaxing of the theory are conducted by accounting academics.

B. The Location of Reported Income

Consistent with Harry’s focus on important tax policy issues, much of his work sought to gain a better understanding of income shifting. For instance, an important U.S. tax policy issue in the late 1980s and early 1990s was the concern that foreign-controlled companies (FCCs) operating in the United States were able to escape U.S. taxation through transfer pricing. Abnormally low rates of return of FCCs, relative to domestic-controlled companies (DCCs), fueled this concern. Harry and his co-authors documented that low profits earned in the United States were at least partly tax motivated, and his research was influential in providing empirical support for a tightening of transfer pricing rules in the United States. Indeed, “Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States,” by Grubert, Goodspeed, and Swenson (1993), hereafter GGS, became a handbook for thinking about performance differentials between DCCs and FCCs in subsequent work.

Harry had a true talent for acknowledging data limitations while, at the same time, being creative about how he used the available data in order to draw inferences about the underlying behavior of firms. For instance, recognizing that it was difficult to identify tax-motivated transfer price distortions directly with U.S. tax return data, GGS employed a residual approach to understanding the performance differentials. That is, using 1987 tax data for 600 FCCs and 4,000 DCCs, he and his co-authors examined the extent to which the differentials between FCCs and DCCs could be explained by nontax factors. Any unexplained difference, they argued, was likely due to taxes. They found that special characteristics and circumstances of FCCs, such as the effects of mergers and acquisitions, exchanges rates, and maturation, explained about 50 percent

of the differential, and they attributed the other half to income shifting. Extending GSS several years later, he found that nontax factors explained more than half of the difference (Grubert, 1998).

Recognizing that this was only indirect evidence, GGS tried other angles with the data. For instance, they examined the proportion of FCCs reporting near-zero taxable income and found that 37 percent of the FCCs in their sample reported near-zero income on a persistent basis. Conversely, only 27 percent of domestic firms fell in the same range. The authors also anticipated that transfer pricing might explain an unusually low reported rate of return for those FCCs whose parents are resident in countries with lower tax rates. However, they found virtually the same low reported rate of return regardless of the parent's home country. Finally, GGS found that companies with foreign ownership between 25 and 50 percent exhibit the same low profitability as 100 percent owned companies. As these companies may experience resistance by other shareholders, this evidence calls into question the relative role of tax and nontax factors in explaining profitability differences. Harry's early work suggested income shifting by FCCs operating in the United States, but his work was equally important in demonstrating that economic nontax factors play a role and that these factors must be controlled for in future empirical work.

Harry also examined the income-shifting behavior of U.S.-controlled MNCs by examining the reported profitability of their CFCs. That is, instead of focusing on foreign firms shifting income out of the United States, he looked at whether U.S. firms with foreign subsidiaries shifted income out of the United States. In the early 2000s, however, researchers began to focus less on *whether* MNCs shifted income and more on *how* they shifted income. For instance, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," by Grubert (2003), used 1996 tax data to determine that about half of the difference in profitability between CFCs operating in low-tax versus high-tax countries of U.S. MNCs was due to intangibles. He detected this by finding that evidence of profit shifting is stronger in multinationals with high intellectual property (IP) holdings and high R&D intensities. His findings confirm what was widely believed: intangible assets represent an exceptionally mobile source of income, and difficulty assessing the transfer prices associated with these assets facilitates income shifting.

Grubert (2003) also extended our understanding of income shifting by analyzing the links between intangible income, intercompany transactions, income shifting, and the location of investment. For instance, he finds evidence that more related-party transactions occur with countries where such transactions are attractive for tax reasons. That is, R&D intensive U.S. MNCs whose profit shifting opportunities are higher than average choose locations with either extremely low or extremely high tax levels. The preference for low-tax countries stems from the need to shelter income from taxation, while the preference for high-tax countries stems from the competitive advantages associated with profit shifting opportunities. Finally, his model demonstrates that the incentive to shift income is positively related to tax rate differences but negatively related to costs, such as those associated with engaging in excess intercompany transactions. By exploring these

links, Harry set the stage for future research examining how opportunities for income shifting affect real decisions, such as where to locate real operations, the propensity to engage in intercompany transactions, and the costs of shifting income.

Following on Harry's earlier work, he again reminds us in his 2012 paper, "Foreign Taxes and the Growing Share of Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized," that both location decisions and income-shifting decisions affect foreign effective tax rates of U.S. MNCs. These decisions reinforce each other; i.e., it is easier to shift profits abroad if you have more assets abroad. In this study, he attempts to disentangle decisions about the location of investment from decisions about the location of reported income in CFCs of U.S. multinationals using 1996 and 2004 tax data. He recognized that this was an important research question to answer in order to understand the potential impact of eliminating deferral on active income. Showing that the increased share of worldwide income abroad occurred largely through changes in domestic and foreign profit margins rather than a shift in sales, his work suggests that allowing deferral on active income does not promote competitiveness, as intended. Harry estimates, in a variety of specifications, that the effect of a 10-percentage-point domestic-foreign tax differential on the percentage change in the share of foreign income ranges from 2.5 to 9 percentage points, with 7 percentage points as his preferred estimate.

III. HARRY'S FINGERPRINTS ON ACCOUNTING RESEARCH

Accounting research is the study of the production and dissemination of information about firms' economic activities to their internal and external stakeholders. As financial information is a key input for internal stakeholders (e.g., setting compensation) and external stakeholders (e.g., setting price), there can be a feedback effect of reported information on economic events. What, then, is tax accounting research? In general, tax accounting research aims to understand how information about firms' tax payments and tax planning — i.e., economic events — is reflected in their tax returns and financial statements. Moreover, we are interested in how the reporting of those economic events can affect firms' tax planning. Thus, our work often combines detailed institutional knowledge about tax reporting with an understanding of financial reporting. It is also worth noting that, while financial reporting is typically publicly available, tax return information is not. So, while we can conjecture about firms' tax planning, we have limited means to observe it. Harry's work often provided us support for our anecdotes. In addition, he was (surprisingly) knowledgeable about detailed financial accounting issues. Harry seemed to know a bit about everything!

Accountants generally take a microview of the role of taxation in firm behavior. For instance, because taxes can affect the reported profitability of the firm, we recognize that extensive tax planning affects not only firms' cash flows but also their capital market incentives (Graham, Hanlon, and Shevlin, 2011). Before the early 2000s, the United States was not considered a high-tax jurisdiction and so early accounting work focused little on the repatriation incentives of tax planning. However, as time passed, U.S. MNCs argued that the U.S. repatriation tax became burdensome and uncompetitive.

Although MNCs perceived the worldwide regime to become uncompetitive, Harry's work highlighted that MNCs had the ability to mitigate much of the investment disincentive described in the early theory. Much of his research suggested that perhaps MNCs undertook too much tax planning. As other jurisdictions' tax rates declined over the course of the late 1990s and 2000s, MNCs' repatriation tax burdens naturally increased. It was from this point that accountants took up the proverbial baton. We wanted to learn why there was variation in MNCs' tax planning and how their tax planning interacted with their capital market incentives.

Harry's work provided some of the first large scale empirical evidence of what accounting researchers, many of whom are former practitioners, knew was going on inside MNCs. Harry had at his fingertips the most detailed information on U.S. MNCs' foreign activity available—Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. As accountants, we view tax return data as faithfully representing the best source of information on tax-related financial flows within a firm. It is the gold standard to which we have occasionally tried to compare and validate other data sources. Relying on Harry's groundwork, accounting academics began to extend the ideas developed in AG by using financial statements (Donohoe, McGill, and Outslay, 2012; Mills and Newbury, 1999) or survey data collected by the Bureau of Economic Analysis (BEA) (e.g., Blouin, Krull, and Robinson, 2012). Accountants' unique role as the preparers of tax returns had provided us many anecdotes about MNCs' tax planning opportunities, but Harry's work highlighted the pervasiveness of such activity and inspired us to dig into the data.

A. Foreign Retained Earnings

One key influence of Harry's work on accounting research is his analysis of retained earnings in conjunction with various forms of repatriation. "Foreign retained earnings" is a concept very similar to the accounting concept referred to as permanently reinvested earnings, or PRE. The concept of PRE was established in 1972 in Accounting Principles Board Opinion No. 23 (typically referred to as APB 23). This opinion notes that the potential U.S. tax on unremitted foreign earnings is difficult to estimate; so difficult, in fact, that trying to do so might introduce an unreasonable amount of error into accounting earnings. Thus, APB 23 allows firms to forego the estimation and recognition of a tax expense related to unremitted foreign earnings if they declare those earnings indefinitely reinvested. It also requires firms to disclose the amount of earnings on which an expense for the potential U.S. tax liability has not been recognized in the footnotes to the financial statements. Statement of Financial Accounting Standards (SFAS) 109 later required firms to also report an estimate of the unrecognized tax expense or report that the expense is not practicable to estimate.³ PRE is similar to retained earnings in that it is largely composed of earnings of the foreign subsidiary that have not been distributed

³ The designation is now referred to as "The Indefinite Reversal Exception" and is included in ASC 740 in the most current codification of accounting standards.

to shareholders.⁴ It differs in that it is only the portion of foreign retained earnings on which a U.S. tax liability has not been accrued for financial reporting purposes.

Harry's 1998 paper is novel in that it studies the determinants of foreign retained earnings; i.e., it puts foreign retained earnings on the left-hand side of a regression equation. Thus, it became a starting point for research attempting to study and model the determinants of PRE. Krull (2004), inspired by Collins, Hand, and Shackelford's (2001) study of the valuation implications of PRE, was the first accounting study to attempt to understand the determinants of PRE and followed Grubert (1998) by including measures of the foreign tax credit position and profitability as potential determinants. In addition to finding that changes in PRE are increasing in the average foreign tax rate and the difference between foreign and domestic after tax returns, Krull (2004) finds evidence that this accounting assertion is used to manage earnings because of its magnitude and subjectivity. Blouin, Krull, and Robinson (2012) further analyze this accounting disclosure and find that capital market disincentives created by having to recognize income tax expense for the potential U.S. tax liability are just as important in explaining the lack of dividend repatriations as the cash tax payment. Though Harry's work did not explore the interaction of capital market incentives and repatriation, he nicely laid the ground work for us to do so.

B. Reinvestment in Financial Assets

Though Grubert (1998) inspired and informed accounting studies on the valuation implications of foreign retained earnings categorized as PRE in firms' financial statements, until his 2003 paper, AG, the accounting literature had only examined the direct effect of potential U.S. taxes on the value of PRE. Bryant-Kutcher, Eiler, and Guenther (2008) and DeWaegenaere and Sansing (2008) extended these studies to examine the indirect effect, noting that the negative valuation effect of taxes on PRE is higher when PRE is likely to be reinvested in financial assets relative to operating assets. This further reduction in firm value arises due to the limited uses, as well as agency costs, that firms have in holding cash abroad to defer U.S. repatriation taxes. These studies suggest that PRE invested in financial assets will be valued less than PRE invested in operating assets.

In addition, the AG study suggests that, as the potential repatriation burden increases, the tax benefits of reinvesting foreign earnings into passive assets increase, contributing to the notion that earnings are "locked out" of the United States. In Harry's mind, these large accumulations represented an implicit tax cost associated with the repatriation tax because there were efficiency losses at the firm level. Blouin and Krull (2009) document a substantial response by U.S. multinationals to the temporary 85 percent reduction in the tax on repatriated foreign earnings enacted as part of The American Jobs Creation

⁴ Though it is still referred to as PRE, FAS 109 changed the concept to an asset basis difference (the difference between the book and tax bases of assets). Unremitted foreign earnings, among other things, create such a difference.

Act of 2004. The willingness of multinationals to pay up to a 5.25 percent tax on repatriated foreign earnings suggests rather strongly that techniques for deferring the repatriation tax, such as those described in AG, do not fully eliminate the burden of the tax.

Accounting research has further demonstrated a number of consequences arising from the tax-related constraints of excess cash holdings abroad. Blouin, Krull, and Robinson (2018) estimate the amount of PRE held in cash and find evidence that holding more PRE in cash suggests relatively less domestic investment sensitivity to internally generated cash flows. They also document that this effect is more pronounced in a sample of MNCs facing greater financial constraints.⁵ Hanlon, Lester, and Verdi (2015) and Edwards, Kravet, and Wilson (2016) find a negative association between proxies for reinvestment in financial assets abroad and the market reaction to foreign acquisitions. These studies suggest that the market views these deals as less value enhancing, possibly reflecting agency-driven behavior. Campbell et al. (2018) and Dhaliwal et al. (2018) find that U.S. taxes on foreign earnings contribute to a lower valuation and higher cost of debt associated with foreign cash. Almost all the accounting literature in this area has its genesis in AG's theoretical insight that MNCs are incentivized to reinvest foreign earnings in financial assets.

C. Tiered Ownership Structures

AG's insights regarding tiered ownership structures have led to several working papers by accounting academics on the role of organizational form. In particular, AG notes that, by organizing high and low taxes in the same tier of ownership (i.e., a high-tax affiliate invests in a downstream low-tax affiliate), an MNC can effectively increase the amount of foreign tax credit on an intercompany dividend, thereby reducing the amount of tax owed upon repatriation. Murphy (2017) studies the role of the tax costs of moving capital in the use of foreign holding companies by multinational firms. He finds that the use of these structures increased when U.S. tax legislation decreased the tax cost of moving capital across countries. Dyreng et al. (2015) and Lewellen and Robinson (2014) study ownership chains using Orbis data and BEA data, respectively, and find tax motivated structures, such as those with holding companies, are located in countries that lightly tax equity distributions. Accountants have pushed this line of work further, suggesting that tiered ownership structures could even provide further tax benefits by mitigating the effects of the United States' CFC regime. Noting the findings of AG (2003), Altshuler and Grubert (2013), Mutti and Grubert (2009), and Blouin and Krull (2017) capitalize on Harry's insights and document that having a greater number of affiliates organized in tiered structures is associated with lower foreign tax burdens.

⁵ Financial constraints matter because, e.g., De Simone and Lester (2018) find that firms with more tax-induced foreign cash holdings abroad have substantially more U.S. debt.

D. International Debt Policy

Although the association between the location of debt and tax planning is typically the domain of our finance colleagues, we would be remiss if we did not briefly mention AG's role in the work involving accountants and international debt policy. Consistent with AG's theory, Mills and Newberry (2004) find evidence that U.S. MNCs with relatively low foreign tax burdens have greater amounts of debt in their foreign affiliates. Accounting academics extend this line of research by investigating the limits to the earnings stripping activity proposed in AG and documented in Mills and Newberry (2004). In particular, several papers find evidence that countries' thin capitalization rules constrain foreign debt levels. Accountants (e.g., Blouin et al., 2014; Buettner et al., 2009; Buettner et al., 2012; Overesch and Wamser, 2014) have collected detailed information regarding specific thin capitalization rules and find that MNCs appear particularly sensitive to the limits imposed on internal debt.

E. Income-Shifting Studies Using Public Data

Accountants were the first to recognize opportunities to examine income shifting using publicly available data (Mills and Newberry, 2000). This paved the way for many more studies examining income shifting. With Harry's existing empirical models and approaches, researchers could apply, extend, and improve upon his ideas using new datasets. For example, Klassen, Lang, and Wolfson (1993) and Harris (1993) recognized that geographical disclosures of income by region and aggregate foreign taxes provided opportunities to investigate the effects of taxes on income shifting (albeit not without caveats). Jacob (1996) notes that SFAS No. 14 requires firms to disclose the amount of intrafirm sales between geographic areas and to account for them on the basis used by the firm to price the intrafirm transfer. His insight was that these disclosures in public financial statements could be used as a proxy for intercompany transactions, allowing researchers to explore with public data the extent to which these intercompany transactions afforded more opportunities to shift income. Using debt placement decisions for foreign bond offerings, Newberry and Dhaliwal (2001) find evidence that U.S. multinationals source interest deductions in different tax jurisdictions in response to income-shifting incentives.

Indeed, accountants have studied the type of cross-jurisdictional income shifting that Harry examined at the international level at the state and province level. Klassen and Shackelford (1998) use aggregated American state and Canadian provincial data to examine strategies through which corporations avoid state- and provincial-level income taxes. Petroni and Shackelford (1999) examine firm-level data, collected from the publicly available, statutory reports filed with each state government, to provide evidence of income shifting to avoid state taxes by insurers. Petroni and Shackelford (1995) use publicly available data from property-casualty insurers and U.S. states to examine how property-casualty insurers structure their cross-state expansion (e.g., subsidiary versus license) to mitigate both state tax and regulatory costs.

F. Income Shifting and IP

Harry's work on income shifting (GGS, 2003; Grubert, 2012) has also heavily influenced tax accounting research in several ways. First, his research finds that the shifting of R&D derived intangible income accounts for approximately half of the profitability disparity between operations in high- and low-tax countries. This result laid the foundation for work that would consider the location of intangible property within the multinational group to be a choice variable. For instance, Lewellen and Robinson (2014) find that subsidiaries higher up in firms' ownership chains are more likely to perform R&D and be located in low-tax countries. These findings make sense in the context of Harry's work by suggesting that royalties flow up from lower tier subsidiaries, payments that could be excluded under check-the-box regulations.

Other subsequent studies examine the location of intangible assets and patent ownership, all extending Harry's work on the role of intangibles in income shifting. For example, using patent inventor location, De Simone, Huang, and Krull (2018) find that income is shifted to low-tax and low-wage countries in which the firm lists inventors on its patents. De Waegenaere, Sansing, and Wielhouwer (2012) investigate how taxes affect the level and efficiency of R&D investments, and how these effects depend on whether the winner of the patent race uses it by producing either in the country in which the patent was developed (the domestic country) or in a foreign country.

The AG study on foreign investment has also, albeit indirectly, motivated some accounting research on income shifting. With the AG model of passive investment, along with financial assets that allow the parent to borrow for domestic investment or permit triangular repatriation strategies on foreign investment, accounting researchers were motivated to examine outbound income shifting in U.S. MNCs. Klassen and Laplante (2012) find that, for observations with foreign tax rates lower than the U.S. rate, a 10 percent decrease in average foreign tax rates translates into an additional \$38 million of income shifted out of the United States per firm year (and when foreign tax rates are higher, a 10 percent increase in average foreign tax rates is associated with \$20 million more income shifting into the United States per firm year). The idea that outbound income shifting appears to be more sensitive to tax rates than inbound income shifting is consistent with Harry's theoretical work showing that repatriation taxes are inconsequential. Another, more recent study by De Simone, Mills, and Stomberg (2018) uses Form 5471s to observe actual outbound income shifting in U.S. firms, in an effort to construct a firm-year measure of outbound income shifting using publicly available data.

G. Income-Shifting Costs

Another influential aspect of Harry's work on income shifting is the notion that there are costs of shifting that firms must weigh against the benefits. Harry's work helped to lay the groundwork for exploring various avenues of income-shifting costs. For instance, the excess costs of excessive intercompany transactions considered in Grubert (2003), or the tiered ownership structures considered in AG, create organizational complexity. As accountants, we recognize that this complexity can affect firms' information environ-

ments. Balakrishnan, Blouin, and Guay (2018) find that the extent of firms' tax planning, in turn, can reduce the quality of their external information environment. Chen et al. (2018) extend Balakrishnan, Blouin, and Guay to show that MNCs that aggressively income shift have particularly poor information environments.

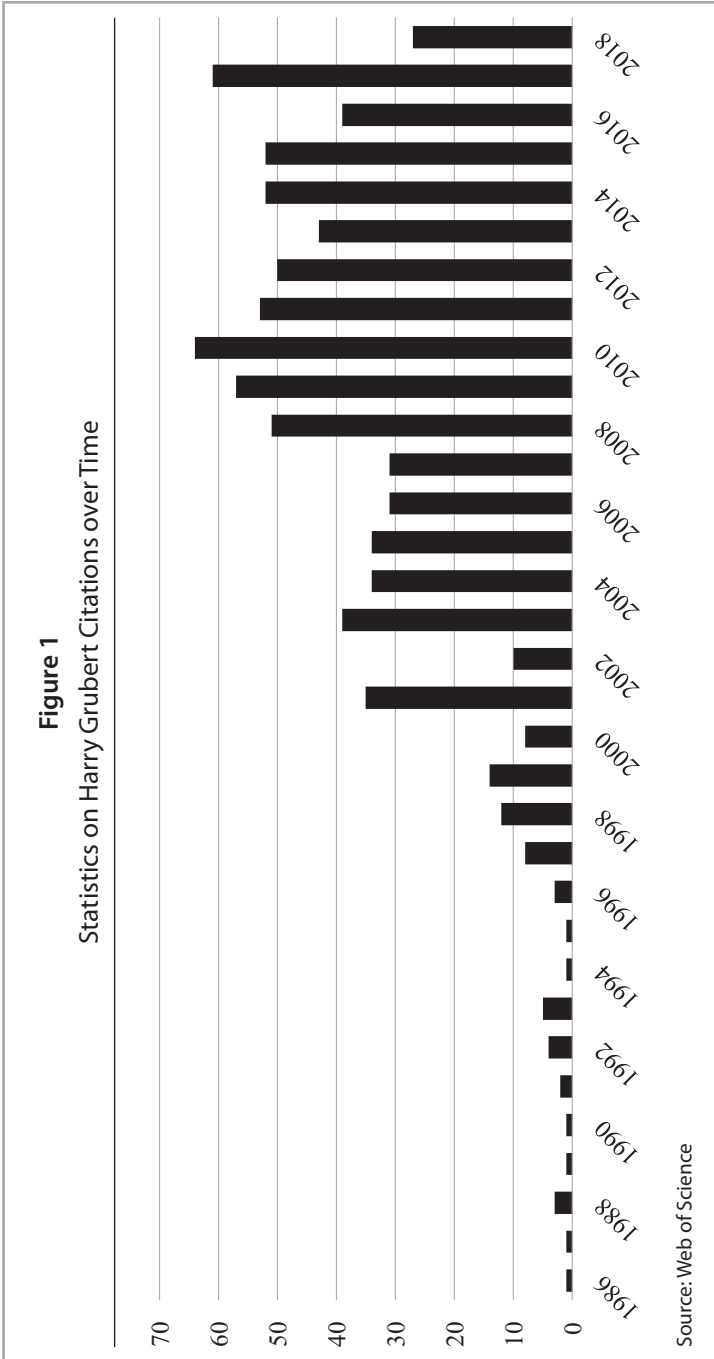
Indeed, accountants have studied many other costs associated with income shifting, such as those associated with capital market incentives (Blouin, Krull and Robinson, 2012; Beuselinck, Deloof, and Vanstraelen, 2015), regulatory reporting (e.g., Beatty and Harris, 2001), nonincome tax burdens (e.g., Blouin, Robinson, and Seidman, 2018), financial constraints (Dyreng and Markle, 2016), security price distortions (Collins, Kemsley, and Lang, 1998), minority ownership (e.g., Schindler and Schjelderup, 2012), reduced shareholder payouts (Nessa, 2017), and changes in enforcement costs (De Simone, 2016). For example, De Simone and Sansing (2018) show theoretically that MNCs are more likely to use a cost sharing agreement if the tax authority cannot cost effectively impose a retroactive devaluation of the IP. Mescall and Klassen (2018) develop a measure of transfer pricing risk based on the likelihood of transfer prices being challenged by tax authorities. They find that transfer pricing risk is associated with lower bid premiums in cross-border mergers and acquisitions. Based on this measure, De Simone, Huang, and Krull (2018) find that U.S. MNCs shift more income when transfer pricing risk is lower. This literature continues to grow, and its growth was encouraged by Dharmaphala (2014) in his recent survey paper on income shifting. Harry's work did not assume one-size-fits-all income shifting. He allowed for heterogeneity in transfer pricing incentives and did not assume income-shifting activities to be homogenous across firms, a theme that is stronger than ever in the literature.

H. Comparisons of Domestic- and Foreign-Controlled CFCs

Harry's early work showing that many foreign-controlled firms pay no or small amounts of U.S. taxes, relative to U.S. domestic firms, paved the way for several subsequent studies by accounting researchers. Collins, Kemsley, and Shackelford (1995) examine whether the U.S. Tax Reform Act of 1986 significantly enhanced the competitive advantage of foreign firms in the U.S. acquisition market. In a similar vein, Blouin, Collins, and Shackelford (2005) examine whether the acquisition of a U.S. firm by non-U.S. shareholders causes the U.S. firm to pay less tax post acquisition. Kinney and Lawrence (2000) and Collins, Kemsley, and Shackelford (1997) re-examine the issues in GGS using public financial statements rather than Internal Revenue Service (IRS) data. More recently, and drawing on Harry's insights and empirical model, Markle and Robinson (2018) examine whether state aid in the European Union systematically favors FCCs over domestic firms.

IV. HARRY'S CONTINUING INFLUENCE ON TAX ACCOUNTING RESEARCH

Harry produced nearly four decades of research on the effects of U.S. tax law on the behavior of U.S. MNCs. He experienced first-hand the Tax Reform Act of 1986 and contributed significantly to the policy debates leading up to the TCJA. Indeed, Figure 1



shows that Harry's work increased in importance (measured by citations) over the last decade, in part because of the ongoing debates over U.S. tax policy (and, of course, in part because Harry continued to publish interesting and important papers). The TCJA was the biggest change to tax law from an international perspective since the current offshore tax regime was enacted by the Kennedy Administration in 1962. The most significant changes enacted under the TCJA apply to U.S. corporations. Of these reforms, the one with the most obvious and direct international impact is the change in the taxation of U.S. corporations' foreign subsidiaries. This was Harry's bread and butter. Consequently, most of us are asking ourselves, "What would Harry think?" Here, we speculate on what he might say and offer some ideas about how we think accounting researchers can help sustain and extend the important research topics he spent his professional life exploring.

A notable aspect of the U.S. tax system prior to the TCJA in evaluating incentives for foreign investment and the location of income was the repatriation tax burden on CFC dividends. Yet, as Harry noted in his work, the actual tax paid on dividend repatriations was relatively small because U.S. MNCs became so adept at tax planning. Instead, he pointed out, the more germane issue is that firms incur costs from actions taken to avoid tax, which he termed "implicit taxes." Thus, there are at least three clear questions on the table as a result of the changing incentives in 2018. First, how will the TCJA affect deemed repatriation tax collections as well as actual dividend repatriations and the movement of cash back to the United States? Second, will the TCJA result in the "unwinding" of real decisions, such as investment in foreign assets, ownership structures, or intercompany transactions, initially created to facilitate avoidance of the repatriation tax? Third, what will tax planning, and in particular income shifting, in U.S. MNCs look like going forward?

Regarding the first issue, the TCJA creates a deemed repatriation tax called a "transition tax." Corporations are required to pay 15.5 percent on earnings and profits related to foreign cash assets and 8 percent transition tax on the rest of the earnings and profits. The Joint Committee on Taxation (JCT) estimates that the deemed repatriation measure will generate \$338.8 billion in tax revenue over 10 years, more than two and half times the amount currently being reported (albeit provisionally) by the Fortune 500's top 55 companies, according to a Bloomberg Analysis. The top 55 companies on the 2017 Fortune 500 list, including Apple, Alphabet, and Pfizer, who account for half, expect to pay about \$131 billion in taxes on their earnings stockpiled overseas.⁶

Tax accountants are in a good position to help understand how financial statement tax provisions relate to the expected one-time revenue collection and bridge the gap between the JCT and Bloomberg estimates. However, investigating this issue is complicated by the variation in how companies report the expected tax effects of the new law. Blouin, Krull, and Robinson (2018) provide a good starting point as they combine BEA data and accounting disclosures to estimate the amount of PRE (which can be a

⁶ The total figure was calculated by Bloomberg by compiling the repatriation amounts companies have disclosed in their annual and quarterly earnings reports, as well as associated earnings calls and news releases.

reasonable proxy for foreign earnings and profits) held abroad in cash versus noncash for a large sample of MNCs. They find that approximately 55 percent of PRE is held in financial assets subject to the 15.5% rate. Aggregate PRE for their sample firms at the end of 2015 is \$2.277 trillion, and they estimate an aggregate transition tax liability of between \$450 and \$570 billion (depending on how they measure financial assets).

However, there is a great deal more to learn here. For example, deemed repatriation and an actual repatriation of cash are different things. Therefore, another interesting question is whether firms will decide to keep their cash overseas or bring the physical cash back to the United States. Harry's work suggests that many U.S. MNCs effectively tax planned to avoid the repatriation tax, suggesting that removing this impediment might immediately result in large repatriations of cash. In other words, only foreign cash that was "trapped" abroad should be repatriated. Moreover, there may be withholding taxes, intercompany loans, or other impediments to bringing the physical cash back. Tax accountants have access to rich data sources and institutional knowledge to understand, anticipate, and explain these one-time decisions about the movement of stockpiles of foreign cash.

The second stream of potential future research pertains to the unwinding of past tax avoidance. How costly will changing those planning decisions be and do the tax benefits exceed the costs? Harry's work estimated that these implicit taxes were quite high. However, it is unclear, with many new, complex tax provisions, exactly who will benefit the most from the tax law changes? Therefore, some companies may be expected to unwind some international tax planning, while others will not. The nascent line of accounting research on ownership structures, for instance, will likely expand as U.S. MNCs deal with the changing landscape of international tax planning surrounding base erosion and profit shifting and the TCJA.

Finally, what does tax planning in U.S. MNCs look like going forward? We anticipate that the drastic reduction in the corporate tax rate from 35 to 21 percent will alter incentives for profit shifting. For instance, the rate reduction will reduce the tax benefit to be gained by stripping earnings out of the United States via deductible payments, but may also incentivize MNCs to restructure their internal capital markets so royalty and interest payments flow into the United States from jurisdictions with higher corporate tax rates. This type of restructuring, in turn, would be expected to impact the location of debt and/or IP, all topics in which accounting research has historically made significant inroads. Grubert (2012) provides a solid framework within which to begin analyzing MNCs' responses to changing income-shifting incentives.

There are a number of other notable international provisions of the TCJA. Just as Harry would have done, we need to dig into the details of these provisions to try to understand and identify the changing incentives and resulting behavioral changes we might expect to see with respect to U.S. MNCs. These include the "Global Intangible Low-Taxed Income" (GILTI) tax, a provision that imposes immediate U.S. tax on the above-normal foreign returns of U.S. MNCs; the "Base Erosion Anti-Abuse Tax" (BEAT), a minimum tax triggered by related-party deductible payments; and the "Foreign-Derived Intangible Income" (FDII) provision, which is the domestic

counterpart to the GILTI, stating that the component of income (above a presumed normal return on U.S. tangible assets) derived from exports is taxed at 13.125 percent rather than the standard 21 percent rate. Both the GILTI and the FDII regimes would seem to provide incentives to repatriate IP back to the United States. In addition, each of these taxes creates new financial reporting consequences for MNCs. As the TCJA was passed so quickly, the Treasury Department has not yet had the opportunity to issue guidance that alleviates the uncertainty in the computation of GILTI and BEAT. In an unprecedented move, the Securities and Exchange Commission allowed U.S. MNCs to accrue provisional estimates of these taxes in its publicly available financial statements. There is a wealth of work to be done on understanding how MNCs deal with both the tax and financial reporting uncertainty and how capital markets will respond to any adjustments to financial accounting estimates.

Accounting researchers are nicely positioned to begin analyzing the effects (both intentional and unintentional) of the TCJA on MNC activity. As an academy, we are also adept at finding new data sources and methodologies that are useful for understanding the inner workings of MNCs, including FactSet, Orbis, and textual analysis. Accountants' familiarity with firm-level data can contribute greatly to understanding microlevel consequences of the TCJA in empirical work. Furthermore, accountants are gaining access to more proprietary sources, such as the BEA surveys and IRS data, including the Form 5471s that Harry used in much of his research.

One final area where accountants can contribute to Harry's research agenda is by doing more to compare public and private firms. Harry's work looked at large samples of U.S. MNCs, but he did not focus on the difference between public and private firms when examining how U.S. MNCs might respond to changing tax incentives. Similar to Blouin, Krull, and Robinson (2012) or Beatty and Harris (2001), accountants can investigate whether having public financial reporting alters MNCs' tax activities. With access to more and better data sources and knowledge of capital market incentives and agency costs, accountants can offer insight into how financial reporting incentives interact with tax incentives to explain variation in firms' responses to the TCJA.

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