Repatrinating Profits

Japan’s economy is set for a boost as the government drops taxes on the dividends of overseas subsidiaries, writes Morinobu Shigeki.

Earnings of the overseas subsidiaries of Japanese companies have been rising fast, led by those located in Asia. At the same time, the retained earnings of overseas subsidiaries have also been mounting fast since 2003 (see figure 1). The Japanese tax system may be cited as a main reason for this trend on the part of business firms. Since the effective income tax rate on Japanese companies is high by international standards, Japanese business firms faced additional tax on any repatriated funds, and given the ceiling on tax credits for deduction of overseas taxes, companies have not been able to completely avoid double taxation. These tax rules have hindered Japanese business firms in repatriating earnings. Recently in particular, the forms adopted by business firms have diversified as companies have set up regional headquarters (RHQ) and bought up foreign companies. As a result, as many observers pointed out, the foreign tax credit no longer functioned adequately in eliminating double taxation.

The earnings of Japanese companies overseas are for the most part retained overseas rather than being repatriated to Japan. The Japanese government therefore decided to thoroughly overhaul the foreign tax credit system to correct this situation and thereby strengthen international competitiveness, invigorate management, eliminate double-taxation and streamline the tax system.

Foreign Tax Credit and Foreign Income Exemption

There are two methods for avoiding double taxation of income earned overseas by business firms. The first is the foreign tax credit system, under which the government taxes the entire worldwide income of domestic corporations while providing a deduction for the amount of foreign income taxes paid. The second is the foreign source income exemption system (territorial system) under which the government only taxes income derived from domestic sources.

Adopted in the United States and Japan, the foreign tax credit system (worldwide system) is based on the principle of “capital export neutrality.” Wherever a domestic corporation main-
tains business offices, the share of the tax burden on its worldwide income is the same as it is for domestic corporations which only maintain domestic business offices. The foreign source income exemption system, meanwhile, is adopted in France, Germany, Canada and elsewhere. It is based on the principle of "capital import neutrality," under which the tax burden on domestic source income is the same regardless of the domicile of the corporation. The United Kingdom switched from the foreign tax credit system to the foreign source income exemption system in 2009. In the United States too, the reforms drafted by the President's Advisory Panel on Federal Tax Reform under President George W. Bush, as well as a report by the Treasury Department, proposed switching to the foreign source income exemption system. This issue has in fact developed into a major discussion among tax authorities and tax professionals.

There are two reasons underlying this development. The first reason involves concerns over the international competitiveness of business firms. When a company is headquartered in a country which adopts the foreign source income exemption system and does business in a different country where the tax rates are lower, the company need only pay the tax of the country in which it does business. In contrast, a company based in a country which adopts the foreign tax credit system would bear the additional burden represented by the higher effective tax rate of its home country, putting it at a competitive disadvantage.

A second problem relates to the complexity of tax systems. Under a foreign tax credit system, a variety of rules are necessary, beginning with those governing the types of credit, and these rules tend to make the tax system convoluted.

With this in mind, Japan in turn began to consider adoption of the foreign source income exemption system with a view to encouraging a greater repatriation of funds from abroad.

Overview of the System

In conducting this study, the following basic approach was adopted.

The recent amendments are not meant to achieve interim policy goals but represent a long-term change in the tax system with a view to giving Japanese companies more freedom and streamlining the tax system.
in the taxable income of its Japanese parent will be subject to a tax credit.

Expected Economic Impact

The question is whether introduction of the system for excluding foreign dividends from taxable income will actually encourage business firms to repatriate earnings.

The Ministry of Economy, Trade and Industry carried out a survey in November of 2007 in regard to this question, and of fifty-five companies which responded, twenty-seven said it would be a big incentive to increase dividends from overseas subsidiaries. The reason was that dividend income from overseas subsidiaries would only be subject to taxation in the relevant foreign country, so it would be easier to pay dividends to the Japanese parent without concern about Japanese national tax rates. In addition, the then existing limitation of tax credits to subsidiaries of subsidiaries would be abolished. Businesses responded that such factors would be major incentives to repatriate funds to the parent company in the form of dividends.

On the other hand, one concern has been that adoption of the system to exclude foreign dividends from taxable income would mean a greater shift of head office functions and manufacturing bases offshore, leading to a hollowing out of domestic industry. In response to this concern, many companies commented that the decision of whether to move head office functions and manufacturing bases is not influenced by the tax system but rather is made strictly with reference to the location and needs of the target customers, while for parts manufacturing companies, it is made with reference to the strategy of the downstream manufacturer. The Nihon keizai shimbun newspaper in fact reported on August 27, 2009 that major Japanese companies, led by Mitsui & Company, have begun to repatriate overseas earnings to Japan.

In this way, there is much hope that the recent changes in the international taxation system will encourage Japanese business firms to repatriate profit to Japan from overseas subsidiaries and that these funds will be mobilized in resource policy goals but represent a long-term change in the tax system with a view to giving Japanese companies more freedom and streamlining the tax system. Under the former tax system, companies might use excess credits from one source country of foreign income to offset Japanese taxes imposed on income from another source country ("cross crediting") without regard to the intent of the tax regulations. The abolition of such practices under the new system will help rationalize the tax system.

Figure 2: Use of increased Cash Flow by Japanese Companies

Japanese companies have allocated increased cash flows not only to dividends but also to capital investments and employee salaries.

<table>
<thead>
<tr>
<th>Capital investments</th>
<th>+¥8.7 trn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt service</td>
<td>−¥3.8 trn</td>
</tr>
<tr>
<td>Employees salaries</td>
<td>+¥2.1 trn</td>
</tr>
<tr>
<td>Dividends</td>
<td>+¥2.4 trn</td>
</tr>
<tr>
<td>Corporation income tax</td>
<td>−¥2.9 trn</td>
</tr>
<tr>
<td>Other expenditures (cash equivalent)</td>
<td>+¥6.2 trn</td>
</tr>
</tbody>
</table>

Increased cash flow: +¥21 trn

Retained as cash (*) +¥0.9 trn

Source: Nikkei NEEDS, based on cash flow and financial statements of 1,474 TSE 1st Sect. listed companies.

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