Repatriating 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.

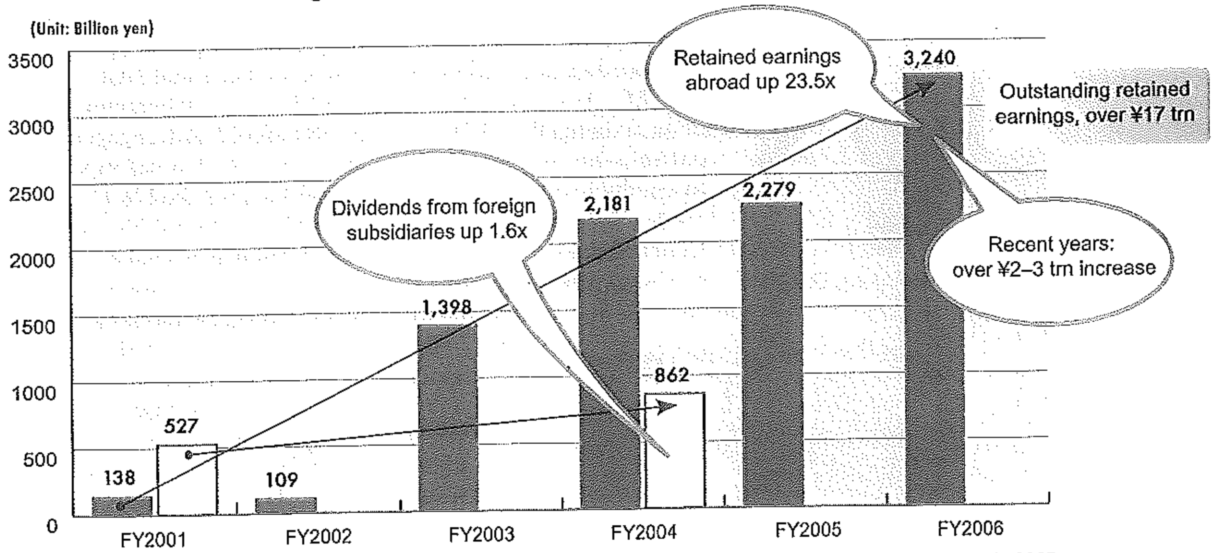
Adopted in the United States and Japan, the foreign tax credit system (worldwide system) is based on the principle of "capital export neutrality." Wherever a domestic corporation main-

Figure 1: Basic Study of Overseas Business Activities

Present status

- Japanese companies have tended to keep most earnings of overseas subsidiaries abroad, leading to a sharp rise in retained earnings abroad in recent years.
- Meanwhile, dividends received from overseas subsidiaries have risen only slightly.

Retained Earnings of, and Dividends Received from Overseas Subsidiaries



Note: When similar amendments were made in the U.S., dividends from overseas subsidiaries rose from ¥5.8 trn in 2004 to ¥28 trn in 2005.
Source: Ministry of Economy, Trade and Industry

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.

- Permanent new rules should be incorporated into Japanese tax law to exclude from taxable income any dividend income from overseas subsidiaries.
- The new rules should be incorporated not just into the corporation tax but into other tax categories as well, including local corporate income taxes such as the corporation residence tax, the corporation enterprise tax and the local corporation special tax.
- The type of income subject to the new rules would be foreign dividend income, not branch earnings. Since this issue involves computational difficulties and is currently being discussed at the Organization for Economic Cooperation and Development, it will become a long-term issue for the future.
- With regard to investment income (interest, leasing fees), the foreign tax credit system has become a global standard. Investment income differs qualitatively from dividend income, the repatriation of which is subject to some control in terms of timing.
- Subject companies are in principle overseas subsidiaries in which the parent holds an equity interest of 25% or more.
- Adoption of a system which excludes overseas dividend income from taxable income risks encouraging tax avoidance, which runs counter to the original intent. Thus, in order to avoid excessive regulation of business firms while safeguarding taxpayer foreseeability, minimal preventive measures should be adopted only when appropriate and necessary.

As a result of these considerations, a system for excluding dividend income from overseas subsidiaries from taxable income became effective for domestic corporations beginning their fiscal year from and after April 1, 2009. Specifically, when computing their income for each fiscal year, domestic corporations need no longer include in taxable income the amount of dividends which they receive from overseas subsidiaries. At the same time, the indirect foreign tax credit was scrapped, pending expiration of transitional measures.

A "foreign subsidiary" is defined as a foreign corporation in which a domestic corporation has directly held at least 25% of the outstanding shares for at least six months prior to the date on which the obligation to pay dividends arises. In some cases, an existing tax treaty may provide that a domestic corporation may deduct from its own corporate income tax any foreign corporate income tax imposed on the income of its foreign affiliates, but the provision may in fact specify a shareholding ratio other than 25%. In such cases, whether the foreign affiliate is a subsidiary for the purposes of the new system will be determined by the ratio specified in the tax treaty. In the case of Japan and the United States, for example, it is 10% or more.

In conjunction with the new system, also, two relevant amendments were made in the Special Provisions for Taxation on Income of Specified Foreign Subsidiary Companies of Domestic Corporations. (These Provisions had provided for a unitary tax system governing foreign subsidiaries as an anti-tax-haven measure.) Under the first amendment, the dividends paid by a Specified Foreign Subsidiary subject to inclusion in the taxable income of its Japanese parent company are no longer subject to a tax credit. Under the second, the amount of dividends received by a Specified Foreign Subsidiary subject to inclusion 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 reinvigorating Japan's economy.

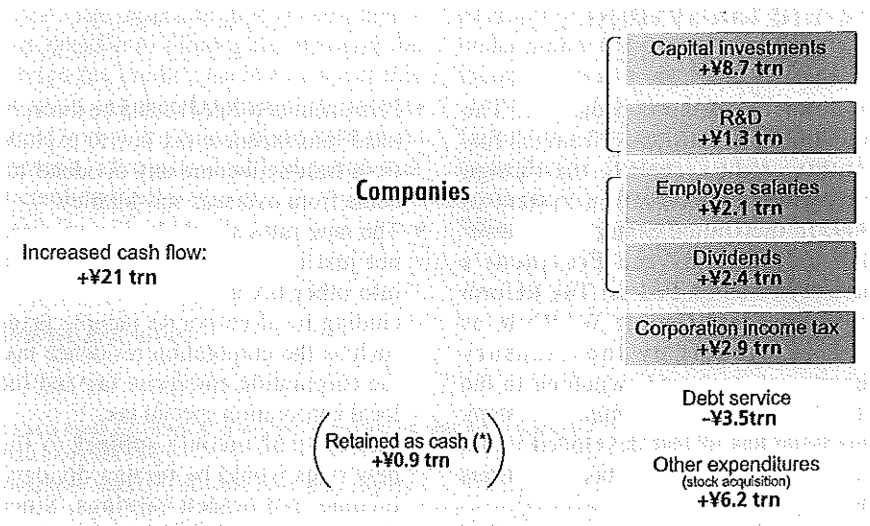
The final question concerns just how business firms will use the increased cash flows resulting from the repatriation of earnings retained overseas. Estimates based on the financial statements of Tokyo Stock Exchange First Section listed companies from 2004 through 2006 show that, of 21 trillion yen in increased cash flows, 8.7 trillion was used for capital expenditures, 1.3 trillion for investment in research and development, 2.1 trillion for employee salaries, and 2.9 trillion for dividends, the great bulk being allocated for investments destined to invigorate the economy. In the survey referred to above, moreover, a great number of companies responded that, since taxes on foreign dividends have been scrapped, they are allocating the income repatriated from overseas to capital investments and research and development. However, whether or not the repatriated funds will translate into capital investments leading to stronger competitiveness will no doubt be determined by the individual circumstances of each company.

As seen above, 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. 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. The tax system will also be simplified, which will greatly reduce the cost of tax compliance for businesses. These changes will also respond to the charge that not enough has been done to eliminate double taxation, given the diversification of business forms now adopted by companies, such as the regional headquarters system. In other words, it represents a move toward a truly effective system for eliminating double taxation, which will help invigorate the Japanese economy. This is the meaning of the new amendments.

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

Recent use of increased cash flow by listed companies (04–06)



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

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