Japan Disproves Fears of Territorial Taxation

By Tax Foundation Staff

This is the second case study in a series on territorial tax systems in other countries. The intent of the study is to see what lessons the U.S. can learn from other countries' experiences and to evaluate the validity of some of the fears critics express when discussing what would result if the U.S. were to move to a territorial system.

“Through the introduction of this system, the profits repatriated into this country are anticipated to be put to use for vitalization of the Japanese economy in the wide-ranging and various fields, such as capital investment, research and development, employment, etc.”—Japan Tax System Council, 2008

Prior to 2009, “Japan’s international tax system bore a remarkable resemblance to that of the United States.” It taxed on a worldwide basis, provided foreign tax credits, allowed deferral of tax on active income until repatriation, and claimed the highest corporate tax rate in the developed world. In introducing the 2009 budget, however, the Japanese Minister of Economy, Trade, and Industry (METI) announced that his country would pivot to a policy of territorial taxation as part of a “new growth strategy” designed to stimulate innovation in Japan through strengthening the competitiveness of Japanese firms in foreign markets and encouraging repatriation of overseas earnings.

In the run-up to 2009, Japan’s leaders became very concerned with the accumulation of foreign earnings held overseas, which increased from ¥138 billion ($1.1 billion) in 2001 to ¥3.2 trillion ($28 billion) by 2006. Officials believed that this pool of earnings represented foregone investment in Japan, and that the barrier to repatriation increased the risk that R&D operations would be moved abroad. Before the policy

4 See Miyatake, supra note 1, at 3.
change, a survey by METI found that 21 of 46 companies intended that they would spend repatriated earnings on upgrading domestic production and R&D facilities.5

A second concern was the competitiveness of Japanese firms in the world marketplace. With an aging and shrinking population, officials recognized that sustained economic health would originate in growth of Japanese firms abroad. A simpler, territorial system, it was thought, would allow firms to grow abroad and “ultimately lead to additional investments and job creation within Japan.”6 To further promote the competitiveness of its companies and attract investment, Japan also announced plans to lower its corporate tax rate by five percentage points, bringing its combined rate just below the U.S. combined rate. According to one Japanese tax professional, “the government concluded that the adoption of a foreign dividend exemption system itself would not unduly influence corporate decisions as to whether to establish or move operations overseas.”7

Japan produced an international tax system with a 95-percent exemption for foreign-source dividends, which also permits deductions of all “necessary and reasonable expenses” associated with foreign income on home country taxes.8 To guard against erosion of the corporate tax base through income shifting, Japan enacted a series of strict transfer pricing and reporting regulations.9 It now imposes rules based on effective tax rates of controlled foreign corporations; if any subsidiary pays an effective tax rate to foreign tax authorities of less than 20 percent and cannot prove that it is actively engaged in business, the dividend exemption does not apply.10 The system also imposes “thin capitalization rules” to limit the ability of corporations to take on excessive debt on behalf of foreign affiliates, because the interest would otherwise be deductible for tax-exempt foreign earnings.11

The government reported that dividend remittances increased 20 percent from 2009 to 2010, indicating that the policy may have induced the intended effect.12 Japanese repatriation again made the news

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5 See JCT, Economic Efficiency, supra note 3, at 49.
6 See Thomas Statement, supra note 2, at 2.
7 Id.
9 See Thomas Statement, supra note 2, at 3.
11 See JCT, Background, supra note 8, at 28.
12 See Thomas Statement, supra note 2, at 4.
in 2011, as Japanese firms announced they would repatriate foreign earnings to help finance the post-tsunami recovery.\textsuperscript{13} It is also worth mentioning that the \textit{Wall Street Journal} reports that “Japanese companies are in the midst of the biggest boom in overseas investment the country has ever seen.”\textsuperscript{14} They have been aggressively acquiring foreign companies and engaging the global markets just as the policy intended.

The consequences for U.S. policy are perhaps best captured in the recent musings of Mieko Nakabayashi, a member of the Japanese House of Representatives. She observes:

> With most of the world—Japan included—cutting corporate tax rates and employing territorial tax systems to remain competitive, the U.S. must surely know that its hesitancy to do these things is handing the advantage to its international competitors. They will suffer from that hesitancy while we and others outside the U.S. will benefit.\textsuperscript{15}

\textbf{Data}

Since the policy change in 2009, Japan’s unemployment rate has trended downward, similar to the OECD average (Figure 1, above). Relative to ten years ago, Japan’s unemployment rate has been reduced, contrary to the U.S. or OECD averages. In addition, economy-wide wages have picked back up after a sustained drop off from 2006 to 2009 (Figure 2).\textsuperscript{16} These phenomena are not entirely attributable to the territorial system, particularly because of Japan’s concurrent struggle with the strength of the yen, the global recession, the beginning of recovery, and the 2011 tsunami, but the tax policy transition itself has certainly not dealt an obvious blow to the Japanese labor force.


\textsuperscript{14} Kana Inagaki, \textit{Cash-Rich Japanese Firms Go on Global Buying Spree}, WALL STREET JOURNAL, May 29, 2012, \url{http://online.wsj.com/article/SB10001424052702303505504577403743150818820.html}. In decades past, Japanese investment was focused in the U.S. and Europe, but has recently picked up in Brazil, India, South Africa, and other developing markets.

\textsuperscript{15} Walter J. Galvin, \textit{This is No Time for the U.S. to Hesitate on Corporate Tax Reform}, INVESTORS BUSINESS DAILY, Apr. 25, 2012, \url{http://news.investors.com/article/609144/201204251738/us-has-highest-corporate-rate-in-world.htm}.

Regarding corporate tax receipts, the Japanese government reports that it increased collections in 2010 and projects that receipts will remain stable for fiscal years 2011-2012 (Figure 3, below).\textsuperscript{17} The OECD also reports that receipts ticked up as a share of GDP in 2010, and Japan’s score remains higher than the OECD GDP-weighted average (Figure 4, below).\textsuperscript{18} Though corporate tax receipts are sensitive to a host of factors, particularly growth in the economy, it appears that the territorial system has not caused immediate erosion of the tax base.

What do these data tell us? In the first three years of the new territorial taxation policy in Japan, not one of the popular fears has become a reality. While outbound FDI is up from 2009,\textsuperscript{19} this is by the design of Japanese policymakers; foreign investment represents new growth opportunities for the domestic Japanese economy as its companies engage the world marketplace. The unemployment rate is down, wages are up, and corporate tax revenues have remained stable. This is antithetical to what opponents of a U.S. territorial system might expect.

\begin{figure}[h]
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\includegraphics[width=\textwidth]{figure3.png}
\caption{Corporate Tax Revenue (100 million ¥)}
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\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure4.png}
\caption{Corporate Tax Revenue as Share of GDP}
\end{figure}

\textsuperscript{17} Ministry of International Affairs and Communications, \textit{Chapter 5 Public Finance, Table 5-4A}, \url{http://www.stat.go.jp/english/data/nenkan/1431-05.htm}.

\textsuperscript{18} OECD, \textit{OECD StatExtracts, Revenue Statistics – Comparative Tables}, \url{http://stats.oecd.org/Index.aspx?DataSetCode=REV}.

\textsuperscript{19} Though Japan’s FDI inflows as a share of GDP have ticked up since 2009, they have not yet caught up with the OECD total. See OECD, \textit{Foreign Direct Investment Statistics}, \url{http://www.oecd.org/daf/internationalinvestment/investmentstatisticsandanalysis/foreigndirectinvestmentfdistatistics-oecddataanalysisandforecasts.htm} (updated July 27, 2012).