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The Effect of Moving to a Territorial Tax System on Profit Repatriation: Evidence from Japan*

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Abstract

In an increasingly globalized world, the design of international tax systems in terms of the taxation of foreign corporate income has attracted much attention from policy makers and economists alike. In the past, Japan's worldwide tax system taxed foreign source income upon repatriation. However, to stimulate dividend repatriations from Japanese-owned foreign affiliates, the Japanese government introduced a foreign dividend exemption system in 2009 that exempted dividends remitted by Japanese-owned foreign affiliates to their parent firms from home-country taxation. This paper examines the effect of this dividend exemption system on profit repatriation by Japanese multinationals. We find that the response of Japanese-owned affiliates to the dividend exemption was heterogeneous. More particularly, foreign affiliates with a large stock of retained earnings were generally more responsive to the reform and significantly increased dividend payments to their parent firms in response to the enactment of the dividend exemption system. Dividend payments by these affiliates also became more sensitive to withholding tax rates on dividends levied by host countries under the new exemption system.

Keywords: International taxation; Worldwide tax system; Territorial tax system; Profit repatriation; Dividend exemption

JEL classification: H25; F23

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