

Volume 14 (2017) | ISSN 1932-1821 (print) 1932-1996 (online)
DOI 10.5195/taxreview.2017.62 | <http://taxreview.law.pitt.edu>

JAPAN'S SHIFT TO TERRITORIALITY IN 2009 AND THE RECENT CORPORATE TAX REFORM: A JAPAN-UNITED STATES COMPARISON OF TAXING INCOME FROM MULTATIONALS

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*Toru Morotomi**

I. INTRODUCTION

Globalization and rapid increases in the movement of international capital has made taxing the income of multinationals a very important issue. Because the taxation of multinational corporations (MNCs) has become more difficult than before, governments have attempted to overcome such difficulties by reforming and correcting defects in tax laws and introducing new rules. However, the problems have worsened and the current need for fundamental changes to taxation rules for MNCs is being intensively discussed. The issue of taxing MNCs is of crucial importance because it has a decisive impact on the future of corporate tax systems.

To investigate this issue, a comparative study between the United States and Japan could be very useful; these countries are two of the three largest economic powers (the United States is the largest and Japan is the third largest) and, thus, can significantly influence the rest of the world. In addition, corporate tax rates in both countries have remained very high: the United States has the highest rate, at 39.0% (blended federal/state rate), among the Organization for Economic Cooperation and Development (OECD) countries for 2015, whereas Japan has the third highest rate at 32.1%

* Professor, Kyoto University Graduate School of Economics, Japan; Grotius Research Scholar for 2015–2016, University of Michigan Law School. The author thanks Professor Reuven S. Avi-Yonah for useful comments and advice on a draft version of this paper. The author also acknowledges valuable suggestions through interviews with Robert Pozen, Joseph Kennedy, Chuck Marr, Mark Keightley, Molly Sherlock, Bill Gale, Eric Toder, and Stephen Shay. This research is supported by the Abe Fellowship Program 2014 of the Social Science Research Council (SSRC) and the Japan Foundation Center for Global Partnership (CGP).

Editor's Note: The author has certified the accuracy of the foreign language sources included in this article.

(blended national/prefecture rate).¹ Therefore, both countries face greater difficulties in taxing MNCs than other countries. A high corporate tax rate attracts repeated critics from the industrial side who claim that such a rate negatively affects industrial competitiveness. Under growing pressure from tax competition, corporate tax reform that includes rate reductions is currently a high priority agenda item for both countries.

Interestingly, observations of both countries indicate their commonalities and differences when facing common difficulties and issues regarding how to tackle the problem of corporate taxation of MNCs. First, both countries introduced exemption systems for repatriated dividends from controlled foreign corporations (CFCs) of MNCs that intended to promote repatriation of CFC income. The United States introduced a one-time repatriation tax holiday in 2004, whereas Japan introduced a permanent repatriated dividend exemption system in 2009. Although the two countries' purposes in promoting repatriation have commonalities, they differ from each other in that the U.S. system was only a temporary policy instrument while Japan's system became a permanent part of the tax law. This difference is the reason that 2009 is evaluated as the turning point for Japan in moving from "worldwide taxation" to "territoriality."² In contrast, the United States still maintains its worldwide system.

Second, both countries' governments have proposed revenue-neutral tax reforms, including tax rate reductions. Their basic strategy is to implement a revenue-neutral corporate tax reform that makes possible a rate reduction by increasing revenue by extending the tax bases. However, both countries cannot adopt a corporate tax reform with only a rate reduction because they cannot easily lose tax revenues when faced with large fiscal deficits. The Abe

¹ Org. for Econ. Co-operation & Dev., *Tax Database: Table II.1. Corporate Income Tax Rate*, OECD.STAT, <http://stats.oecd.org/Index.aspx?QueryId=58204> (selected 2015 from the dropdown menu) (last visited May 31, 2017).

² For example, a comparative study of the taxation of MNCs in the United States, Japan, the United Kingdom, Germany, and Australia interpreted the corporate tax reforms of both Japan and the United Kingdom in 2009 as "moves to territoriality." ROSANNE ALTSHULER ET AL., TAX POLICY CTR., LESSONS THE UNITED STATES CAN LEARN FROM OTHER COUNTRIES' TERRITORIAL SYSTEMS FOR TAXING INCOME OF MULTINATIONAL CORPORATIONS (2015); see also PRICEWATERHOUSECOOPERS LLP, EVOLUTION OF TERRITORIAL TAX SYSTEMS IN THE OECD (2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf (discussing how OECD countries can be classified into "worldwide taxation" and "territoriality" taxation systems and specifically identifying Japan as one of twenty-seven countries associated with territoriality whereas the United States was classified as one of six countries associated with worldwide taxation). *Contra* Yoshihiro Masui, *Taxation of Foreign Subsidiaries: Japan's Tax Reform 2009/10*, 64 BULL. FOR INT'L TAXATION 242 (2010).

administration in Japan started a revenue-neutral corporate tax reform in 2015, whereas the same type of reform has yet to be realized in the United States despite the Obama administration making such a proposal.

A comparative study of the tax reforms of Japan and the United States, particularly given their commonalities and differences, could reveal useful insights into the tasks, possible solutions, and future challenges for corporate taxation. In this article, we proceed with a comparative analysis in the following three parts. In Part II of this article, we attempt to find commonalities and differences in Japanese and U.S. corporate tax reforms since the 1990s. In Part III, we attempt to explain the reasons behind such commonalities and the differences in corporate tax reforms between both countries. In Part IV, we attempt to draw useful policy lessons about the corporate tax reforms of both countries and present a future research agenda for the remaining issues. Part V contains brief concluding remarks.

II. TAX STRUCTURES OF JAPAN AND THE UNITED STATES: COMMONALITIES AND DIFFERENCES

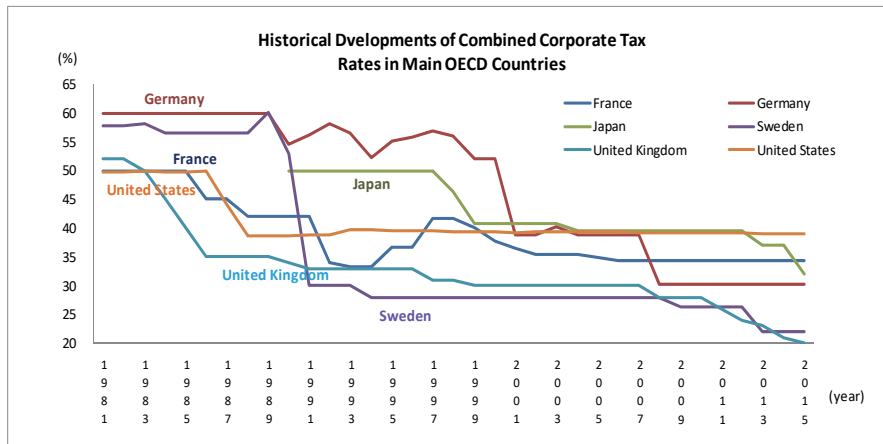
A. Globalization, Tax Competition, and Taxation of Multinationals

Globalization is a common important factor, and both Japan and the United States are compelled to take it into account when designing their corporate tax laws. Both countries have maintained the highest corporate tax rates of OECD countries. However, it is becoming increasingly difficult to keep these rates at their current levels because high corporate tax rates negatively affect industrial competitiveness and a nation's competing position in attracting industrial locations. In fact, multinationals tend to shift their financial resources to low-tax countries or tax havens to escape heavy tax burdens. We also observe the continuous movement toward inversions in the United States; that is, a U.S. corporation merges with another company in the same industry but that is located in a low-tax country and then transfer its U.S. headquarters from the United States to the low-tax country to escape U.S. corporate tax law. In this manner, both countries are under stronger pressure to reduce corporate tax rates. They need to redesign their corporate tax systems to address the following two challenges.

The first challenge is how to deal with tax competition. Figure 1 shows the historical development of corporate tax rates in the main OECD countries and shows why the period since the 1980s has been called the "age of tax competition." Even though Japan continued to be the country with the highest

corporate tax throughout the 2000s, it joined the competition in the 2010s by starting to reduce its corporate tax rate. In contrast, the United States has become the country with the highest corporate tax by keeping its tax rate at the same level almost constantly since the 1986 tax reform under the Reagan administration, which slashed the corporate tax rate drastically from 46% to 34%.

Figure 1



Source: OECD Tax Database (<http://stats.oecd.org/Index.aspx?QueryId=58204>; accessed Jan. 20, 2016).

However, the importance of corporate tax revenue in OECD countries has not decreased much despite the intense tax competition.³ One of the reasons for this phenomenon is the existing situation in which OECD countries attempt to keep their corporate tax revenues through extensions of

³ According to the OECD's Revenue Statistics the average ratio of OECD countries' total corporate tax revenue to total tax revenue increased from 7.4% in 1992 to 10.5% in 2007 despite stiff tax competition. Org. for Econ. Co-operation & Dev., *Revenue Statistics—OECD Countries: Comparative Tables*, OECD.STAT, <https://stats.oecd.org/Index.aspx?DataSetCode=REV> (selected "Total," "1210 On profits of corporates," and "Tax revenue as % of total taxation" from the three dropdown menus) (last visited May 31, 2017). However, the ratio declined to 8.3% in 2013 given the 2008 financial crisis. We also observe the same trend for the ratio of corporate tax revenue to GDP, which increased from 2.3% in 1992 to 3.6% in 2007, but then decreased to 2.8% during the crisis. This ratio also increased despite severe tax competition before the crisis.

corporate tax bases, such as abolishing and reducing tax expenditures.⁴ Again, we confirm that the basic strategy for corporate tax reform in OECD countries is revenue neutral with rate reduction and base broadening.

The second challenge is how to redesign taxation of MNCs. MNCs are increasingly trading goods, services, financial resources, and intangibles between their headquarters and subsidiaries. It is now well known that MNCs avoid significant tax burdens by manipulating trades with their subsidiaries in low-tax countries (“aggressive tax planning”).⁵ This issue is serious because such tax avoidance activities could of course result in significant revenue loss for both countries. How do both countries attempt to tackle these issues? Before going into detail on this point, an overview of both countries’ tax structures is useful.

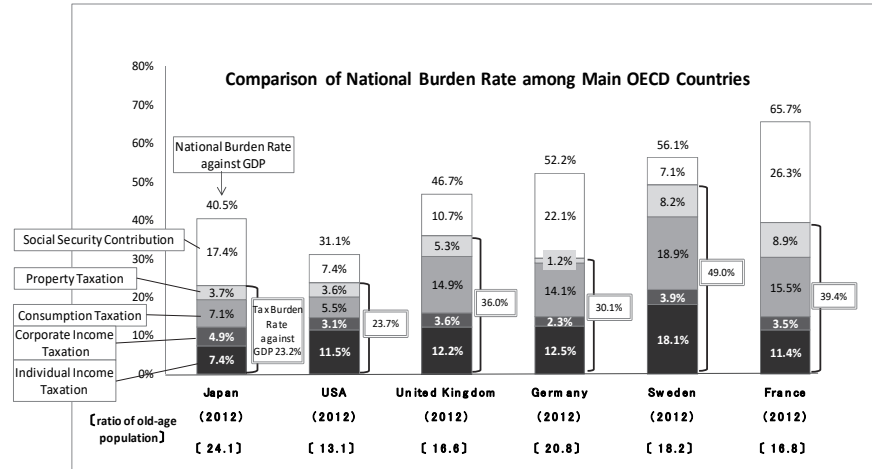
B. Comparison of Tax Structures of Japan and the United States

Figure 2 shows the national tax burden (defined as the ratio of tax burden plus social security contributions to GDP) in the main OECD countries. As figure 2 indicates, the tax structures of both countries are very similar and contrast significantly with the European tax structures. The commonalities in the Japanese and U.S. tax structures relative to the European structure are as follows: First, they are characterized by a lower ratio of tax burden to GDP. The ratios for Japan (23.2%) and the United States (23.7%) are almost the same, whereas the United Kingdom (36.0%), Germany (30.1%), Sweden (49.0%), and France (39.4%) all significantly exceed these ratios. The only difference to observe from figure 2 is the ratio of social security contribution burden to GDP. The ratio for Japan is relatively high (17.4%), whereas the U.S. ratio is the lowest (7.4%) among the countries in figure 2.

⁴ The concept of “tax expenditure” was originally developed by Stanley S. Surrey. Surrey himself stated that a tax expenditure budget is “essentially an enumeration of the present tax incentives or tax subsidies, contained in our present income tax system.” STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* 7 (1973). Surrey also defined tax expenditures as spending programs embedded in the Internal Revenue Code. *See also* PAUL R. MCDANIEL & STANLEY S. SURREY, *INTERNATIONAL ASPECTS OF TAX EXPENDITURES: A COMPARATIVE STUDY I* (1985).

⁵ *See* Edward D. Kleinbard, *Stateless Income*, 11 *FLA. TAX REV.* 699 (2011); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 *TAX L. REV.* 99 (2011).

Figure 2



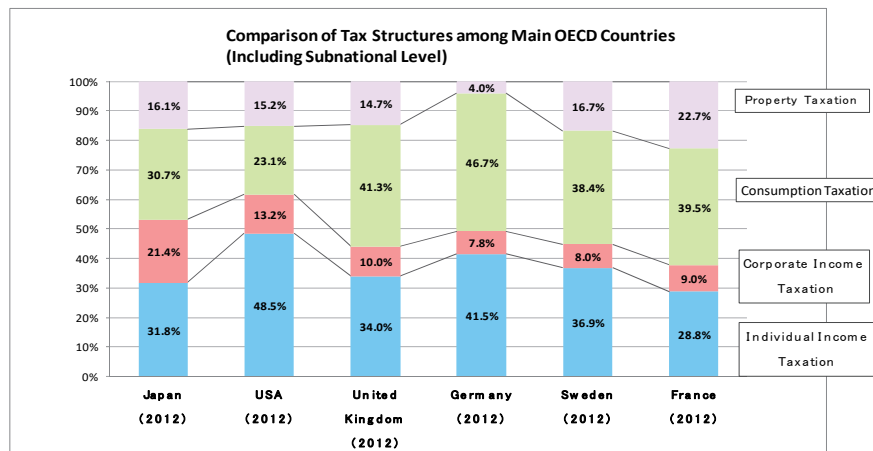
Source: Ministry of Finance (http://www.mof.go.jp/tax_policy/summary/condition/020.htm; accessed Jan. 20, 2016).

Second, both countries have very similar tax structures (tax revenue distribution ratio). As figure 3 shows, the tax revenues of Japan and the United States depend largely on direct taxes (individual income tax and corporate tax), whereas the Europeans depend heavily on revenue from consumption taxes, especially value added taxes (VAT). The high corporate tax rates in Japan and the United States partly contribute to this contrast. Similar tax structures between Japan and the United States are not a product of chance because Japan's postwar tax system was formed under the strong influence of the United States. In fact, Japan designed and formed its postwar tax system on the basis of the "Report on Japanese Taxation by the Shoup Mission." This report was written by tax experts of the Shoup Mission led by Carl Shoup, a public finance professor at Columbia University, who was delegated by General MacArthur as Supreme Commander for the Allied Powers (SCAP) to survey the Japanese tax system and propose a design for its fundamental reform.⁶ The Japanese government formed its tax system on

⁶ The first and the second reports were published in 1949 and 1950, respectively. For a recent comprehensive study on the Shoup Mission, see ELLIOT BROWNLEE ET AL., *THE POLITICAL ECONOMY OF TRANSNATIONAL TAX REFORM: THE SHOUP MISSION TO JAPAN IN HISTORICAL CONTEXT* (2013). Members of the Mission consisted of the most outstanding experts from the United States in those days:

the basis of the report, which mainly depended on direct tax revenues and has maintained its basic structure patterned after the U.S. tax system as a model until recently.

Figure 3



Source: Ministry of Finance (http://www.mof.go.jp/tax_policy/summary/condition/016.htm; accessed Jan. 20, 2016).

However, in 2015, Japan started to reform its corporate tax system, including reducing rates and extending the tax base. This corporate tax reform is virtually the same as the reforms implemented by numerous European countries. In addition, the Japanese “consumption tax” (VAT), which is being increased from 5% to 8%, was the second largest revenue raiser in the country’s tax system in 2015, but its revenue reached almost the same level as the income tax. This accomplishment was a historical turning point for the Japanese tax system because income tax was the largest revenue raiser during the entire postwar period. Additionally, a consumption tax rate

Dean Howard R. Bowen, College of Commerce and Business Administration, University of Illinois; Professor Jerome B. Cohen, Department of Economics, College of the City of New York; Mr. Rolland F. Hatfield, Director of Tax Research, Department of Taxation, St. Paul, Minnesota; Professor Carl S. Shoup, School of Business and Graduate Faculty of Political Science, Columbia University (Director of the Tax Mission); Professor Stanley S. Surrey, School of Jurisprudence, University of California, Berkeley; Professor William Vickrey, Graduate Faculty of Political Science, Columbia University; and Professor William C. Warren, School of Law, Columbia University (as appeared in the Report on Japanese Taxation by the Shoup Mission).

increase to 10% is scheduled for October 2019. Taken together, these actions could be interpreted as Japan starting to turn its tax structure from a direct tax-centered tax structure after the American model to a more indirect tax-centered tax structure after the European model. Hence, the differences in Japan's and the United States' tax structures might become larger than their commonalities in the near future.

III. "RATE REDUCTION AND BASE BROADENING" APPROACH AS A COMMON STRATEGY FOR JAPANESE AND U.S. CORPORATE TAX REFORM

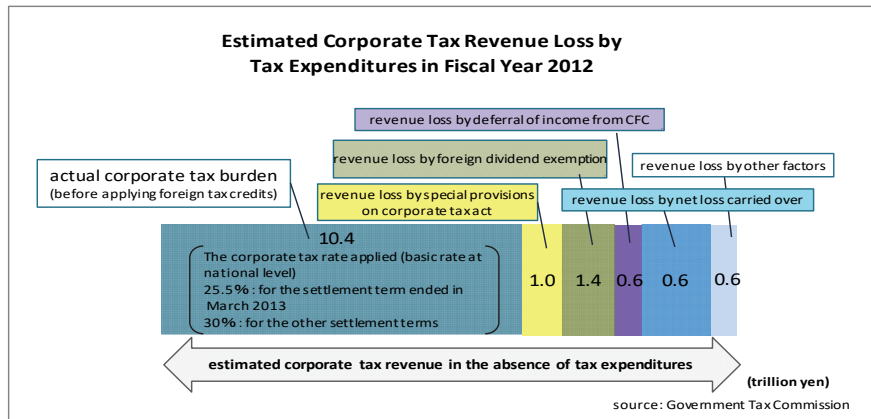
A. Recent Corporate Tax Reform in Japan

The Abe administration's corporate tax reform seeks to reduce the corporate tax rate to the 20% level within five years, starting in 2015, thus keeping in mind the tax rates of OECD and East Asian countries, such as China (25%), Korea (24.2%), Singapore (17%), and others. The Japanese effective corporate tax rate of both national and prefectural governments decreased stepwise from 34.62% to 32.11% in 2015, and then further to 29.97% in 2016 and 2017. The rate will be further reduced to 29.74% in 2018.⁷ Within this framework, the corporate tax rate at the national level will decline from 25.5% to 23.9% in 2015, which is expected to result in a revenue loss of 669 billion yen (\$5.57 billion). In contrast, the corporate tax rate at the prefectural level will be reduced from 7.2% to 4.8%, which is expected to result in a revenue loss of 787 billion yen (\$6.56 billion).

The revenue loss at the national level is almost compensated for by a revenue increase from lower tax expenditures. The tax base for the Japanese corporate tax is reduced by various tax expenditure items, as is the case of other countries. As figure 4 indicates, the 2012 estimated Japanese corporate tax revenue was 16.3 trillion yen (\$133.3 billion), in the absence of the tax expenditures shown in the figure. The difference between this estimated revenue and the actual revenue of 10.4 trillion yen (\$86.7 billion) represents a revenue loss of 6 trillion yen (\$50.0 billion).

⁷ Japan Ministry of Fin., Cabinet Decision on FY2016 Tax Reform (Main Points) (Dec. 24, 2015), http://www.mof.go.jp/english/tax_policy/tax_reform/fy2016/tax2016a.pdf.

Figure 4



To reduce the tax rate at the national level, the following base broadening measures were adopted:⁸ (1) revenue increase of 397 billion yen (\$3.31 billion) by limiting the net operating loss carryforward system,⁹ (2) revenue increase of 92 billion yen (\$766.7 million) by reducing the dividend income exclusion,¹⁰ and (3) revenue increase of 179 billion yen (\$1.49 billion) by reducing tax incentives.¹¹ All of these measures are

⁸ On the main points of tax base broadening in exchange for a tax rate cut, see Japan Ministry of Fin., Cabinet Decision on FY2015 Tax Reform (Main Points), at 2–3 (Jan. 14, 2015), http://www.mof.go.jp/english/tax_policy/tax_reform/fy2015/tax2015a.pdf.

⁹ A net operating loss carryforward system allows corporations to reduce corporate tax liabilities by carrying forward net operating losses and deducting them from their income for the subsequent nine years. As figure 4 indicates, this system occupies the largest part of the revenue loss among the 2012 tax expenditures. Through this amendment, the carryforward period was extended to 10 years, whereas the deduction limit was reduced from 80% of the taxable income of the fiscal year to 65% for 2015 and 2016, and further to 50% from 2017 onwards. Corporations with low profits are more strongly affected by this amendment because they will face a heavier tax burden under the condition that the room for net loss deductions should be reduced.

¹⁰ Dividend income exclusion allows corporations to exclude from their income any dividends received from other corporations to avoid double taxation of dividend income if they own more than a certain threshold of the total shares. Before the 2015 revision, the threshold was set at 25%. Conversely, 50% of dividend income should be included in a corporation's income if it owns less than 25%. Through this revision, the threshold will be increased to 33.3%. For all corporations owning less than 33.3% of total shares, the revision means an increase in the tax burden.

¹¹ Tax incentives are the various tax preferences based on special tax provisions that intend to promote research and development (R&D) activities, capital investment, and other activities to

expected to result in almost the same amount of revenue increase of 669 billion yen (\$5.57 billion) as the revenue loss of 669 billion yen (\$5.57 billion) incurred by the corporate tax reduction. This design can be interpreted as a typical revenue-neutral corporate tax reform along with the rate reduction and base broadening strategy.

In contrast, the revenue loss incurred by lowering the prefecture corporate tax rates will be offset by increasing the tax rates on the “external standard” part of the tax base, which consists of value added and capital. The prefecture corporate tax is not a pure corporate profit tax; instead, its tax base is a mix of (1) profits and (2) “external standard” (value added and capital). The tax was originally levied only on corporate profits, identical to the national corporate tax. However, prefectures have frequently complained of sharp revenue fluctuations attributable to business cycles and the revenue concentration in Tokyo. They prefer a revenue source that is more neutral to business cycles and that facilitates allocating revenue more equitably among the prefectures. For this purpose, the “external standard” tax base is more suitable than the profits tax base. In 2004, the prefecture corporate tax was reformed, and its tax base was divided into two parts: profits and “external standard.”

The prefecture corporate tax rates were set to raise 75% of total revenue from the profits tax base and 25% from the “external standard.” The 2015 tax reform decreased the tax rate on profits from 7.2% to 4.8%, whereas the tax rate on the “external standard” was doubled; the tax rate on value added was increased from 0.48% to 0.96% and the tax rate on capital was increased from 0.2% to 0.4%. These changes ensured that the revenue ratio between revenues from the profit tax base and the “external standard” tax base will be 50%/50%.

The revenue increase from the “external standard” will generate approximately 700 billion yen (\$5.83 billion), which almost equals the revenue loss from the profits tax base of 787 billion yen (\$6.56 billion). This revenue increase at the prefectural level is so large that it exceeds the revenue

accomplish policy purposes. We define tax incentives as part of the broader definition of tax expenditures. Among the 2012 total revenue loss of 1 trillion yen, tax incentives for R&D comprised 40% of the total, those for the support of small and medium-sized enterprises comprised 17%, and those to promote capital investment comprised 12%. The R&D tax credit system has been extended but was revised through the 2015 reform. Corporations have been allowed to deduct 8–10% of their total R&D expenditures from their corporate tax liabilities. From 2015 onwards, the tax credit limit will be reduced from 30% to 25% of the corporate tax liability. Finally, nineteen tax incentives were repealed or limited in scope in 2015.

increase from reducing tax expenditures at the national level. Hence, without a doubt, the revenue-neutral corporate tax reform in Japan is not possible without strengthened taxation of the “external standard” tax base.

This reform is significant for the economy in the following two ways. First, this reform would shift the tax burden from companies operating in the black to companies operating in the red. To date, Japan has been characterized by a high ratio of companies operating in the red that did not pay corporate taxes at either the national or the prefectural level before 2004.¹² However, introducing as well as strengthening the taxation of the “external standard” tax base dramatically changed this situation. Companies operating in the red will be compelled to reexamine whether they should continue their business even with low profits and low productivity conditions. A prefecture corporate tax reform would give those companies incentives to increase their profitability and productivity, whereas the reform could support companies operating in the black in strengthening their international competitiveness through a reduction in their tax burden.

Second, this reform will clarify the benefits from the characteristics of a prefecture corporate tax. The industrial side has sometimes criticized corporate taxes at both the national and the prefectural levels as representing double taxation of corporate profits. However, the prefecture corporate tax has gradually deviated from a pure corporate profits tax to a more “external standard”—oriented tax through the 2004 and 2015 reforms. Currently, corporate taxes at the national and prefectural levels may be said to have different tax characteristics; therefore, they do not necessarily overlap when applied to corporate profits.

The purpose of the prefecture corporate tax reform in 2004 was not only to stabilize revenue but also to transform the tax into a benefit tax. Generally, local governments provide public goods and services by developing infrastructure, education, and so on, irrespective of the business cycle. Corporations in the region should receive the same scale of benefits from local governments if they operate at the same scale, regardless of whether operating in the black or the red. The reason why value added and capital

¹² According to the Government Tax Commission materials, 4th General Assembly, Dec. 2, 2013, No. 4-3, at 16, http://www.cao.go.jp/zei-cho/gijiroku/zeicho/2013/_icsFiles/afldfile/2013/12/02/25zen4kai5_1.pdf, 72% of corporations in Japan operate in the red, compared with 54% in the United States, 50% in the United Kingdom, 34% in Germany, and 32% in Korea. As these statistics show, the ratio of Japanese corporations operating in the red is significantly higher.

were selected as the “external standard” tax base is simple: they are good indicators of the benefits that corporations receive. A gradual change in the weight of the composition of the tax base, decreasing weight of the profit base and increasing weight of the “external standard” base, transforms the nature of a prefecture corporate tax from taxation based on the ability to pay principle to taxation based on the benefit principle. This change partly means a return to the Shoup report’s original idea that a prefecture corporate tax should be implemented as a VAT. This VAT was supposed to be based on the “addition method,” which calculates value added as the summation of corporate profits, interests, rents, and wages. However, this method should be distinguished from the “subtraction method,” similar to adopting VAT as a general consumption tax.¹³

B. Delayed Corporate Tax Reform in the United States and Its Cause

In 2012, in a joint report by the White House and the Department of the Treasury, the Obama Administration proposed a corporate tax reform consisting of rate reduction and base broadening.¹⁴ The administration’s proposal included a tax rate reduction from 35% to 28%, with the loss in revenue compensated for by a revenue increase through a reduction in tax expenditures. The report stressed that the United States could promote economic growth by implementing such a revenue-neutral corporate tax reform. This concept is supported by economists on the ground because it would improve economic efficiency.¹⁵ Nevertheless, why is it difficult to

¹³ See 2 REPORT ON JAPANESE TAXATION BY THE SHOUP MISSION, ch. 13 (1949), <http://www.rsl.waikei.jp/shoup/shoup13.html>. The Japanese government introduced a value-added prefecture corporate tax in 1950 on the basis of the proposal in the report. However, this trial failed because of practical problems regarding the value-added calculation method, protests against the taxation of corporations running in the red, and a relatively heavy tax burden particularly on small and medium-sized corporations. The tax was repealed and converted into a pure corporate profits tax in 1954, which continued to work until 2004.

¹⁴ See THE WHITE HOUSE & U.S. DEP’T OF TREASURY, THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM (2012); see also MARK P. KEIGHTLEY & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R42726, THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM (2014) (comprehensive survey of the issues facing the U.S. corporate tax system that reviews possible solutions and the future of corporate tax reform).

¹⁵ See Alan D. Viard, *Two Cheers for Corporate Tax Base Broadening*, 62 NAT’L TAX J. 399 (2009). The author insists that a revenue-neutral tax reform would result in the benefit of improving allocative efficiency by equalizing the effective marginal tax rate among industrial sectors. Another simulation analysis compares the following three policy options: (1) a corporate rate cut of 5% financed

implement revenue-neutral corporate tax reform in the United States? We offer at least three reasons: First, adequate revenue cannot be created by merely reducing tax expenditures. Second, a corporate tax reform with a rate reduction and base broadening would affect noncorporate businesses (i.e., “pass-throughs” such as S corporations and partnerships) to a large extent. Third, even if revenue-neutral tax reform could be implemented, distributional issues caused by the tax reform would politically prevent it from being implemented.

Regarding the first point, a calculation made by Scott Hodge of the Tax Foundation is useful as a reference point.¹⁶ The revenue loss on U.S. corporate tax expenditures is estimated at \$118 billion and is projected to grow to \$239 billion by 2024.¹⁷ Over the next ten years, the total budgetary cost of all corporate tax expenditures is \$1.8 trillion, an average of approximately \$180 billion per year.

The ten-year cost of reducing the corporate tax rate to 25% is approximately \$1.26 trillion, or \$126 billion per year. According to this calculation, the cost of a rate cut clearly requires eliminating all of the corporate tax expenditures except for deferrals, which results in a revenue increase of \$1.1 trillion over the next ten years. A repeal of deferral cannot be expected to be a source of a revenue increase because the amount of revenue could be expected to vary significantly depending on the differences

with increased debt, (2) a corporate rate cut of 5% financed with reductions in hypothetical inframarginal base-broadening tax expenditures, and (3) a corporate rate cut of 5% financed with a partial repeal of MACRS (Modified Accelerated Cost Recovery System) depreciation. On the basis of the simulation, the authors insist that a revenue-neutral tax reform would result in the desired economic effects. According to their simulation result, option two is preferable to the other options from the perspective of promoting economic growth. GDP growth under option two is higher than under option one by 0.1–0.2 percentage points. Long-term productive capacity is significantly higher when the producer’s capital stock is between 0.7% and 1.2% higher in the long run. Policy option two is also superior to option three because GDP and the producer’s capital stock are higher by 0.2% and 1.5%, respectively. See Nicholas Bull et al., *Corporate Tax Reform: A Macroeconomic Perspective*, 64 NAT’L TAX J. 923 (2011).

¹⁶ See SCOTT A. HODGE, TAX FOUND., THE CHALLENGES OF CORPORATE-ONLY REVENUE NEUTRAL TAX REFORM (2015), <http://taxfoundation.org/article/challenges-corporate-only-revenue-neutral-tax-reform>.

¹⁷ Under the concept of corporate tax expenditures, deferral, MACRS, R&D credits, § 199 manufacturing deductions, and all of the other corporate tax expenditures are included.

between the U.S. corporate tax rate and other countries' corporate tax rates.¹⁸ Therefore, a tax reform scenario to finance rate reduction costs by repealing only tax expenditures is unrealistic.

Regarding the second point previously mentioned, a revenue-neutral tax reform with base broadening would unintentionally affect pass-throughs by reducing their tax expenditure benefits. In fact, they are allowed to enjoy most of the tax expenditure benefits just as corporations, even though they do not pay any corporate taxes. If a revenue-neutral tax reform is implemented, they lose such benefits without compensating for the benefits from the rate cut.¹⁹

Third, a revenue-neutral tax reform would inevitably result in distributional issues. Reducing tax expenditures would result in disadvantages for corporations enjoying their benefits. In contrast, the benefits from a rate cut would be larger for corporations that have received minimal benefits from tax expenditures. Martin Sullivan showed this result through his calculations.²⁰ His basic assumption is to reduce the corporate tax rate to 28%, financed by reducing an equal portion of all tax expenditures. Figure 5 shows the net economic effects of this revenue-neutral tax reform for each industrial sector on the basis of his calculations. Clearly, a revenue-neutral tax reform would divide the industrial sectors into winners and losers: the winners are financial businesses, accommodations, retailers, and others,

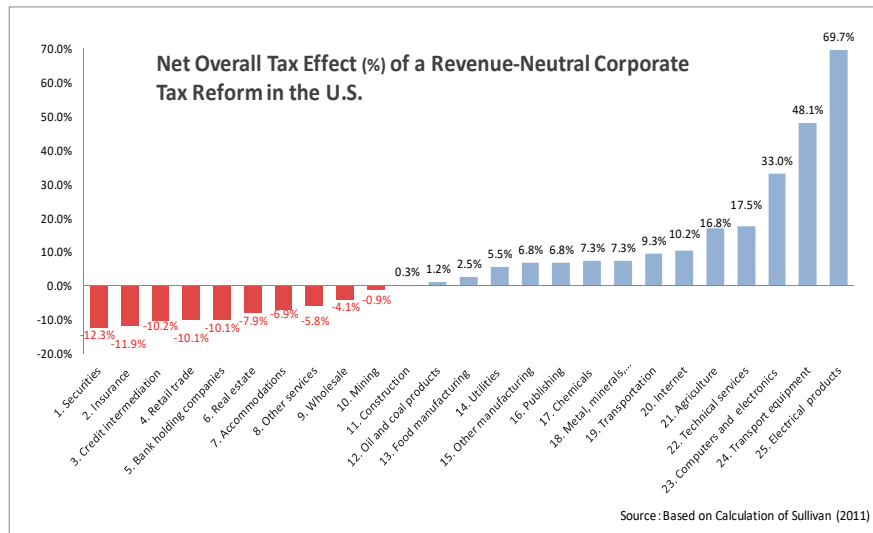
¹⁸ According to Eric Toder of the Urban Institute, the deferral cost depends on the difference between the U.S. and foreign rates and not the U.S. rate alone. For example, assume that the United States reduced its rate from 35% to 25%. Repealing deferral would then raise no revenue from the taxation of foreign income already subject to a 25% (or even higher) foreign income tax because the domestic tax liabilities are perfectly offset by the foreign tax credits. Moreover, repealing deferral would make the United States the only country that taxed multinationals' worldwide income on a current basis, putting U.S.-based firms at a major competitive disadvantage with firms based in other countries. For this reason, repealing deferral could not be a starting point for discussion. See Eric Toder, *Corporate Income Tax Reform: Dreaming On*, MILKEN INST. REV., Jan. 2014, at 16, 22–23.

¹⁹ However, some suggest that pass-throughs should be taxed as corporations. Different treatments in the taxation of various types of pass-throughs are summarized in MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R43104, BRIEF OVERVIEW OF BUSINESS TYPES AND THEIR TAX TREATMENT (2013). Introducing corporate tax for very large pass-throughs can raise significant revenue. See MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42451, TAXING LARGE PASS-THROUGHS AS CORPORATIONS: HOW MANY FIRMS WOULD BE AFFECTED? (2012).

²⁰ See Martin A. Sullivan, *Winners and Losers in Corporate Tax Reform*, 130 TAX NOTES 731 (2011).

whereas the losers are electrical products, transport equipment, computers, and electronics, and others.

Figure 5



Because such economic effects of tax reform are understood, the lobbyists for the losers would naturally oppose the reform and attempt to stop it by influencing the legislative process. Even though each tax expenditure benefit is relatively small, losing them would be a vital issue for the interested parties. Therefore, they may strongly protest against the reform.

As Eric Toder points out, the only way to enact reform is to take on many special tax preferences at once to pay for a large enough reduction in rates to garner broader support. This situation occurred during the corporate tax reform of 1986 during the Reagan administration, when reform advocates were able to win over an influential group of corporations that found the prospect of a large rate cut more attractive than the loss they would suffer in terms of narrowly targeted benefits. The problem with repeating the 1986 experience today is that there simply is not enough revenue to be gained by

attacking vulnerable tax expenditures to pay for the rate cut as proposed by the Obama administration.²¹

As surveyed to date, financing all of the costs of a rate cut by simply reducing tax expenditures seems very difficult. A revenue-neutral tax reform is difficult to implement for this major reason. For the Japanese case, relatively large room for creating adequate revenue by slashing the existing tax expenditures made the reform possible. This situation is different from that of the U.S. case. Until recently, Japan has experienced no major revenue-neutral corporate tax reform with base broadening, as in the 1986 U.S. tax reform. The number and scale of Japanese tax expenditures have grown during the postwar period, which is why relatively more room exists for reducing tax expenditures. However, this phenomenon alone could not have created enough revenue to pay for a rate cut. As previously stated, strengthened taxation to the “external standard” tax base was a crucial factor for raising enough revenue for the reform.

In the case of the United States, taxation of companies operating in the red could be strengthened by converting part of the existing corporate tax base from profits to value added (addition method). Basic tax principles justifying corporate taxes are frequently referred to as (1) the “ability-to-pay principle,” which corresponds to a corporate tax function as a backstop to individual income tax and (2) the “benefit principle,” which corresponds to its function as a price for public goods and services. The former asks for taxation of corporate profits, whereas the latter asks for taxation of corporate value added.

Because the benefits of public goods and services are equally attributable to companies operating in the black and in the red, a corporate tax on value added is more appropriate for allocating their costs to all companies on the basis of the benefits they receive. Partial conversion of the existing corporate tax base to a value-added base would have the effect of shifting the tax burden from companies operating in the black to those operating in the red. The costs of tax cuts for the corporate profit tax base would be financed by new taxation on corporate value added, a change that might be politically infeasible in the United States. However, the change would result in a preferable industrial policy effect that gives companies

²¹ See Toder, *supra* note 18, at 16–27.

operating in the red an incentive to increase their productivity and profitability.

For the reasons previously surveyed, a revenue-neutral corporate tax reform in the United States seems difficult to implement. Currently, the focus of the corporate tax reform debate is more concentrated on its international tax aspects. A shift in the corporate tax reform strategy has occurred, from a rate reduction with a base broadening approach to a rate reduction with strengthened taxation of MNCs. How to tax MNCs is an acute issue for the United States because the Internal Revenue Code fails to appropriately tax the earnings of controlled foreign corporations (CFCs). Hence, large loopholes are created. Currently, approximately two trillion dollars are being accumulated in the hands of CFCs, and taxing this wealth could raise substantial revenue for the U.S. Treasury.

C. U.S. Corporate Tax and Taxation of MNCs

1. Major International Taxation Issues for U.S. Corporate Taxes

Why is it difficult to appropriately tax the foreign earnings of MNCs under the current Internal Revenue Code (Code)? To understand this issue, we need to review the basic tax rules of the Code. The first rule is the principle of worldwide taxation, which frequently refers to the residence principle in economics that is capital export neutral. Under worldwide taxation, a corporate tax rate of 35% is always applied to corporate earnings regardless of where U.S. corporations may invest.²² Hence, the U.S. tax does not affect their investment decisions because the tax causes no tax differences based on investment locations. Yet, in reality, their earnings abroad are not always taxed currently under the Code.

We need to understand the concept of a deferral. Deferral affects the taxation of MNCs' foreign earnings. Under deferral, the United States does not immediately tax certain of the foreign earnings of MNCs from active businesses and allows them to defer paying taxes until they repatriate them to the United States in the form of dividends.²³

²² I.R.C. § 11; Treas. Reg. § 1.11-1(a) (as amended in 1976).

²³ *Cf.* I.R.C. §§ 951–964, 1291–1298.

The combination of worldwide taxation and deferral leads to the following issues. First, the combination provides U.S. MNCs with incentive to keep their earnings abroad because they are taxed at a 35% rate on repatriation. Holding their earnings abroad is attractive because MNCs often bear much lower taxes in source countries. If they continue to indefinitely hold these earnings abroad, they not only enjoy the time value of money but also virtually escape from paying U.S. corporate taxes.²⁴ Therefore, deferral gives U.S. MNCs an incentive to shift their profits abroad and, hence, erodes the U.S. tax base. Of course, this erosion results in substantial revenue loss.²⁵

Second, the U.S. corporate tax is noted as driving U.S. MNCs into a corner in their competition with their rivals in low-tax countries. The latter are taxed at much lower rates on the dividends repatriated to their home countries. However, among OECD countries, U.S. MNCs face the highest tax rate of 35%, thus weakening their competitive edge in source countries' markets. Therefore, U.S. MNCs are attempting to shift their income through "aggressive tax planning" to low- or no-tax countries. They are undertaking a significant endeavor to avoid U.S. taxation, and are in fact succeeding. Thus, substantial revenue losses have occurred, as well as a loss of investment opportunities and employment. Moreover, excessive tax avoidance by MNCs leads to distortions of their investments and transfers of financial resource allocations.

²⁴ U.S. Generally Accepted Accounting Principles (GAAP) generally require that MNCs recognize a deferred tax liability on unremitted foreign earnings in the current period, regardless of whether or not the foreign earnings are actually repatriated back to the United States. Therefore, for firms required to file a financial statement with the SEC, the income tax expense attributable to deferred taxes on unremitted foreign earnings is to be recorded. However, an exception to this general rule is also defined, which specifies that a firm may overcome a presumption that foreign earnings will be repatriated if sufficient evidence indicates that the subsidiary has invested or will invest the undistributed earnings indefinitely. Accounting Principles Bd., Op. 23, ¶ 12 (1972), <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820901676&blobheader=application%2Fpdf>. Consequently, if a firm plans to indefinitely retain unremitted earnings offshore, the firm may defer recording U.S. income tax expenses attributable to these foreign earnings until the earnings are repatriated back to the United States or are no longer considered indefinitely reinvested. See Rodney P. Mock & Andreas Simon, *Permanently Reinvested Earnings: Priceless*, 121 TAX NOTES 835 (2008).

²⁵ According to estimates by Kimberly Clausing, the revenue loss incurred from MNCs shifting their income offshore amounted to \$90 billion in 2008, or approximately 30% of total U.S. corporate tax revenue. See Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, 130 TAX NOTES 1580 (2011).

In the United States, two different reform proposals are shown and discussed.²⁶ The first proposal insists that the United States should immediately tax the foreign earnings of MNCs by ending deferral.²⁷ The second proposal recommends that the United States abandon worldwide taxation and shift to territorial taxation. This shift would be realized by exempting repatriated dividends from CFCs, indicating a shift to source principle under which capital import neutrality is maintained.²⁸

In addition, Mihir Desai and James Hines insist that optimum resource allocation would be attained in a globalized world if a tax system that is neutral to capital asset ownership could be realized. Such a tax system satisfies the tax principle of “capital ownership neutrality” (CON).²⁹ According to their argument, a tax system that satisfies both CON and “national ownership neutrality” (NON) legitimizes territorial taxation. They stress that territoriality would promote foreign investments of U.S. multinationals by exempting repatriated dividends. These dividends could then promote investments back to the United States by CFCs of U.S. multinationals.

²⁶ The Joint Committee on Taxation analyzed the policy designs and economic impacts of adopting two alternative reform proposals, the “territorial system” and the “full inclusion system.” See STAFF OF JOINT COMM. ON TAXATION, JCX-55-08, ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSIS OF ALTERNATIVE U.S. TAX POLICIES FOR FOREIGN DIRECT INVESTMENT (Comm. Print 2008). As a comprehensive survey of various alternative reform options regarding taxation of U.S. MNCs, including worldwide taxation and territoriality, see also JANE G. GRAVELLE, CONG. RESEARCH SERV., R42624, MOVING TO TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES (2012); JANE G. GRAVELLE, CONG. RESEARCH SERV., R34115, REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES (2015).

²⁷ From this perspective, a series of articles by Fleming, Peroni, and Shay points out the various defects of U.S. corporate taxes and discusses directions for reform. J. Clifton Fleming et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001); J. Clifton Fleming et al., *Worse than Exemption*, 59 EMORY L.J. 299 (2009); Robert J. Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

²⁸ Territorial taxation was implemented in twenty-eight of thirty-four OECD countries, including Japan, as of 2012. See PRICEWATERHOUSECOOPERS LLP, *supra* note 2. This territorial taxation exempts 95–100% of repatriated dividends from CFCs. The number of countries that moved from worldwide taxation to territoriality was exactly doubled—an increase from fourteen countries in 2000 to twenty-eight countries in 2012. The United States is now one of six OECD countries, along with Chile, Ireland, Israel, Korea, and Mexico, using worldwide taxation.

²⁹ See Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003); see also Mihir A. Desai & James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937 (2004).

In particular, views that ask for a move to a territorial system have been activated since Japan and the United Kingdom moved to territoriality in 2009. However, a simple move to territoriality means no solution because MNCs' incentives to reduce their tax burden by shifting their income offshore cannot be removed as long as rate differences exist between the United States and low-tax countries. Rather, a simple shift to territoriality without antiavoidance measures would incentivize MNCs to concentrate their income in low-tax countries, thereby repatriating them back to the United States without any further taxation. This situation further induces tougher tax competition among low-tax countries to attract capital. For the United States, this competition leads to substantial revenue losses. If the United States is to move to territoriality with a corporate tax rate cut, methods for financing the revenue loss incurred by such a shift must be seriously considered.

2. Camp Tax Reform Plan and Obama Administration Reform Proposal

Against the previously described debate, Congress has seriously considered multiple reform plans that improve the defects of U.S. MNCs' taxation and seek to move to territoriality. One of the most important reform plans is the "Camp Plan," which is based on three discussion drafts published by former House Ways and Means Committee Chair Dave Camp (R-Mich.).³⁰ In October 2011, he published a first discussion draft proposal to shift the United States to territoriality. In January 2013, Camp released a second discussion draft on the taxation of financial products. In March 2013, he released a third discussion draft on the taxation of small businesses and pass-through entities. On the basis of these three discussion drafts and further scrutiny, Camp finally released the "Tax Reform Act of 2014."³¹ His plan

³⁰ The three discussion drafts are available at: https://waysandmeans.house.gov/UploadedFiles/Discussion_Draft.pdf (Oct. 26, 2011) (first discussion draft), https://waysandmeans.house.gov/UploadedFiles/Leg_text_fin.pdf (Jan. 23, 2013) (second discussion draft), and https://waysandmeans.house.gov/UploadedFiles/FINAL_Sm_Bus_Passthrough_Legislative_Text_03.12.13.pdf (Mar. 12, 2013) (third discussion draft).

³¹ H.R. 1, 113th Cong. (2014); see JIM NUNNS ET AL., TAX POLICY CTR., DESCRIPTION AND ANALYSIS OF THE CAMP TAX REFORM PLAN (2014), <http://www.taxpolicycenter.org/UploadedPDF/413176-Camp-Plan-Description-and-Analysis.pdf> (containing the major elements and contributions of the Camp Plan embodied in the Tax Reform Act of 2014).

contributed to moving the discussion about territorial taxation from broad descriptions of design features to legislative language for specific provisions.

The main features of the Act included: (1) reducing the corporate tax burden through a rate cut to 25% and a repeal of the corporate alternative minimum tax, (2) shifting the U.S. tax system from worldwide taxation to territoriality by exempting 95% of dividend income from CFCs, (3) considering the accumulated earnings of foreign subsidiaries after 1986 and before 2015 that had not been previously subject to current U.S. taxation as Subpart F income and subject to a tax at 3.5–8.75%, (4) taxing CFCs' future earnings at the rate of 12.5–15%, and (5) proposing three options as antiavoidance measures necessary for moving to territoriality.³²

In February 2015, the Obama administration announced its corporate tax reform proposal in the fiscal year 2016 U.S. federal budget, which consists of the following three elements:³³ First, the tax rate is reduced from 35% to 28% (25% is applied to domestic manufacturers). Second, a one-time transition tax at the rate of 14% is imposed on accumulated CFC earnings. Once MNCs paid this tax on past CFC earnings, then they could repatriate them without paying any further U.S. tax. Third, a minimum tax is imposed on future CFC earnings. After paying the minimum tax, no further U.S. tax would be imposed on repatriated CFC earnings if they are located in source countries with more than a 19% withholding tax. If the source countries impose less than a 19% withholding tax on CFC earnings, the U.S. government would tax the earnings at a rate equal to the rate difference between the United States and source countries.

This proposal is a product of compromise. Certainly, exemption of repatriated dividends is not proposed because of the inclusion of a 15% one-time tax on past earnings as well as a 19% tax on future CFC earnings. In contrast, this proposal shows an important departure from the principle of

³² See NUNNS ET AL., *supra* note 31, at 13–17. For critical scrutiny of the problems with these three antiavoidance measures, see Stephen E. Shay et al., *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 TAX NOTES 173 (2013).

³³ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2016 (2015); Council of Economic Advisors, *Annual Report of the Council of Economic Advisors*, in ECONOMIC REPORT OF THE PRESIDENT TRANSMITTED TO THE CONGRESS FEBRUARY 2015 TOGETHER WITH THE ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISORS, at 203–39 (2015).

worldwide taxation because once CFCs' earnings are taxed, they do not have to pay subsequent taxes at repatriation. This approach largely differs from the existing rule that uniformly imposes a 35% tax rate on all repatriated dividends from CFCs. Therefore, the administration's proposal means a repeal of the "repatriation tax" corresponding to the tax differences between the United States and source countries, an important change to the existing tax rule.³⁴ However, considering that the present combination of worldwide taxation and deferral virtually allows firms to indefinitely postpone paying taxes on CFC earnings, this proposal strengthens taxation of MNCs relative to the current situation. Judged from this perspective, the proposal could be viewed as neither worldwide nor territorial but a hybrid made of both.

Interestingly, the administration's proposal underlined two merits of the 19% minimum tax on future CFC earnings.³⁵ First, this minimum tax would drastically reduce the merit of tax avoidance by setting up "shell corporations" in tax havens with low or zero tax rates. Second, the minimum tax would have the effect of promoting source countries to implement rigorous source taxation. MNCs' total tax burden would not increase up to a 19% source taxation rate because of foreign tax credits. Therefore, MNCs would not leave source countries because of tougher source taxation. Certainly, to implement rigorous source taxation without the pressure of tax competition, we need an appropriate backup through residence taxation.³⁶

Reuven Avi-Yoanah evaluated the Camp Plan and the Obama administration's proposal as being so similar that their difference lies only in tax differences; therefore, reaching a consensus between Democrats and Republicans on the basis of both reform plans was possible.³⁷

³⁴ Stephen E. Shay et al., *Designing a 21st Century Corporate Tax—An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base*, 17 FLA. TAX REV. 669 (2015). The authors of this article criticized this point of the proposal, and alternatively proposed that a 19% minimum tax on CFC earnings should be only a temporary measure instead of a final tax, as the administration proposed. According to the authors' proposal, a repatriation tax should be imposed on top of the minimum tax upon the repatriation of dividends.

³⁵ Council of Economic Advisors, *supra* note 33, at 233.

³⁶ Regarding the concept of "residence taxes supporting source taxes," see Reuven S. Avi-Yonah, *Obama's International Tax Plan: A Major Step Forward*, 123 TAX NOTES 735 (2009). See also REUVEN S. AVI-YONAH, *ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW* 43–44 (2015).

³⁷ See Reuven S. Avi-Yonah, *All or Nothing? The Obama Budget Proposals and BEPS* (Univ. of Mich. Pub. Law Research Paper No. 442, 2015), <http://dx.doi.org/10.2139/ssrn.2565727>. However, a

IV. ECONOMIC EFFECTS OF MOVING TO TERRITORIALITY: A COMPARISON OF JAPAN AND THE UNITED STATES

A. Is Moving Toward Territoriality a Solution?

The focus of the U.S. debate on MNC taxation seems to have gradually shifted from worldwide taxation to territorial taxation. However, is moving to territoriality really a solution? The reasons for preferring territoriality are as follows: (1) it would strengthen MNCs' competitive edge by reducing their tax burden on the basis of the repeal of a repatriation tax and (2) it would promote domestic investment and employment through repatriation from CFCs back to the United States. The second argument is more important than the first as a ground for public policy because the first states that corporate tax reform could contribute only to the private interest of MNCs. The second argument could justify the reform on the ground that it will result in general benefits to the American people through an increase in investment and employment. Whether moving toward territoriality could be justified depends on whether it results in general benefits to the public, which can be scrutinized on the basis of the experiences of both Japan and the United States.

The debate in the United States around territoriality often refers to the fact that Japan, along with the United Kingdom, partly moved to territoriality in 2009. Both countries introduced a dividend exemption from CFCs: Japan exempts 95% of these dividends, whereas the United Kingdom exempts 100% of these dividends. Because five years have passed since Japan's move

situation existed that made a compromise between both sides difficult. Whereas the Camp Plan sought revenue-neutral reform with a rate cut and anti-base erosion measures, the administration's proposal would increase net revenues. In fact, the administration proposed to finance investment costs for transportation infrastructure, such as highways and public transportation systems, through the Highway Trust Fund with a one-time 14% tax on past CFC earnings. Republicans would not agree with earmarking tax revenue through a one-time taxation of MNCs for investing in domestic infrastructure. A PricewaterhouseCoopers' report estimated that a 19% tax on future CFC earnings would create revenue of approximately \$205.9 billion over ten years. In contrast, a one-time 14% tax on accumulated CFC earnings would raise revenue of approximately \$268.1 billion over ten years. This amount is approximately equal to the \$297 billion needed for an investment in transportation infrastructure. PRICEWATERHOUSECOOPERS LLP, PRESIDENT OBAMA'S FY 2016 BUDGET CALLS FOR BUSINESS TAX REFORM: PROPOSES NEW INTERNATIONAL AND INDIVIDUAL TAX INCREASES, TAX INSIGHTS (2015), <https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-president-obamas-fy-2016-budget-calls-business-tax-reform.pdf>.

to territoriality, obtaining knowledge on the basis of past experiences is possible, particularly on the economic effects of the dividend exemption. The United States also experienced a temporary move to territoriality through a tax holiday introduced in 2004 for repatriated dividends. These experiences in both countries could play an important role as policy experiments that we can use to verify the appropriateness of the second argument above. They provide us with rich information on how a move to territoriality works and whether it could attain its promised policy goals.

B. Economic Effects of the American Jobs Creation Act of 2004

The American Jobs Creation Act (AJCA) allowed U.S. corporations to deduct 85% of dividend income from their corporate tax base if they repatriated these dividends from CFCs.³⁸ Therefore, for corporations facing a 35% tax rate, the effective tax rate applied to repatriated income declined to 5.25% under the AJCA, but just for one year. Firms were asked to prepare a domestic reinvestment plan (DRP) and submit it to the IRS with their financial statements to obtain the exemption.³⁹

Permitted types of investments included hiring new employees or training existing staff, increasing employees' salaries or benefits (excluding executives), research and development (if conducted within the United States), investments in infrastructure, intangible property, other capital investments, and others.⁴⁰ Types of investments that are not permitted include executive compensation, intercompany transactions, shareholder distributions, stock redemptions, portfolio investments, and others.⁴¹ The AJCA attempted to promote domestic investment and employment by specifying the use of repatriated dividends for these purposes.

Immediately after the enactment of the AJCA, repatriated dividends from CFCs increased dramatically. According to data from the Bureau of

³⁸ I.R.C. § 965. For a survey study on the economic effects of dividend exemption, see DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40178, TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS (2011).

³⁹ I.R.C. § 965(b)(4).

⁴⁰ *Id.* § 965(b)(4)(B).

⁴¹ Notice 2005-10, 2005-1 C.B. 474.

Economic Analysis,⁴² repatriated dividend income increased from \$81.6 billion in 2004 to \$298.7 billion in 2005—more than triple in scale.⁴³ Judged from this perspective, the AJCA seemed to be extremely successful. However, the real issue lies in the amount of investments and volume of employment created by the AJCA.

Roy Clemons and Michael Kinney investigated firms' behavior by looking at 364 firms that repatriated dividends under the AJCA.⁴⁴ They showed that these firms significantly increased stock repurchases that were prohibited under the AJCA. These actions were possible because the AJCA provided no regulatory measures to enforce its proscriptions. For instance, firms were not asked to create a separate fund to demonstrate that qualified dividends were used along with their DRPs. Therefore, the lack of regulatory constraints in implementing the AJCA likely permitted firms to spend repatriated funds on disallowed uses. Clemens and Kinney concluded that the AJCA provided a windfall gain to firms by allowing them to repatriate substantial amounts of CFC earnings to the United States with a very low tax burden.

Jennifer Blouin and Linda Krull also lead us to the same conclusion.⁴⁵ They identified 357 firms that repatriated CFC earnings under the AJDA and found, through their quantitative analysis, that firms allocated the repatriated funds to share repurchases. On the basis of their regression analysis,

⁴² Bureau of Econ. Analysis, U.S. Dep't of Commerce, *International Data: Table 4.2. U.S. International Transactions in Primary Income on Direct Investment* (Mar. 21, 2017), https://www.bea.gov/iTable/bp_download_modern.cfm?pid=1.

⁴³ According to an IRS survey, 843 of 9,700 corporations with CFCs took advantage of this deduction and repatriated a total of \$362 billion. However, of that amount, \$312 billion qualified for the deduction, creating a total deduction of \$265 billion. Most corporations—86%—reported the deduction for the 2004 tax year, 6.8% reported it for the 2005 tax year, and the remaining 6.8% reported it for the 2006 tax year. See Melissa Redmiles, *The One-Time Received Dividend Deduction*, STAT. INCOME BULL., Spring 2008, at 102.

⁴⁴ Roy Clemons & Michael Kinney, *An Analysis of the Tax Holiday for Repatriation Under the Jobs Act*, 120 TAX NOTES 759 (2008).

⁴⁵ Jennifer L. Blouin & Linda K. Krull, *Bringing It Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004*, 47 J. ACCT. RES. 1027 (2009). Sample firms in this investigation increased their share repurchases during 2005 by \$60 billion more than nonrepatriating firms. *Id.* at 1029. This amount accounted for 20.9% of the total amount of repatriations reported by the sample firms under the AJCA. *Id.*

Dhammikka Dharmapala, Fritz Foley, and Kristin Forbes also identified that repatriation did not increase domestic investments, employment, or R&D. Instead, increases in repatriation were associated with increases in shareholder payouts, which were also disallowed under the AJCA.⁴⁶

Surprisingly, Thomas Brennan's empirical research showed that permanently reinvested offshore earnings have increased since 2004.⁴⁷ CFC earnings repatriated under the AJCA were more than offset by increased levels of overseas investments. As a major reason for this, Brennan pointed to MNCs' expectations of the possibility of a "second tax holiday" in the future.

Finally, the Majority Staff of the Permanent Subcommittee on Investigations of the United States Senate's Committee on Homeland Security and Governmental Affairs integrated the knowledge and information on scientific research results, including the previously noted studies, and carried out its own investigation that targeted twenty corporations, including the top fifteen repatriating corporations under the AJCA, and then made the following conclusions: (1) U.S. jobs were lost rather than created, (2) research and development expenditures did not accelerate, (3) stock repurchases increased after repatriations, (4) executive compensation increased after repatriations, (5) only a narrow sector of multinationals benefited, (6) most repatriated funds flowed from tax havens, (7) offshore funds increased after 2004 repatriations, and (8) more than \$2 trillion in cash assets are now held by U.S. corporations.⁴⁸

On the basis of these findings, the Majority Staff of the Subcommittee reached the conclusion that the 2004 tax holiday failed and did not attain its designated goals, and even resulted in a \$3.3 billion revenue loss during the ten years after 2004.⁴⁹ As a result, the Majority Staff of the Subcommittee

⁴⁶ See Dhammika Dharmapala et al., *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act*, 66 J. FINANCE 753 (2011).

⁴⁷ Thomas J. Brennan, *What Happens After a Holiday? Long-Term Effects of the Repatriation Provision of the AJCA*, 5 NW. J. L. & SOC. POL'Y 1 (2010).

⁴⁸ See MAJORITY STAFF REPORT, PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, 112TH CONG., REPATRIATING OFFSHORE FUNDS: 2004 TAX WINDFALL FOR SELECT MULTINATIONALS (Comm. Print 2011).

⁴⁹ The "\$3.3 billion revenue loss" numerical value is based on the estimation of the Joint Committee on Taxation. This estimate revealed that the AJCA increased revenue by \$2.8 billion for 2005, but the

recommended against enacting a second corporate repatriation tax break given the associated harms.

Regarding the economic effects of the 2004 tax holiday, the best data and its objective evaluations are well summarized in this report; dividend exemption certainly gave MNCs strong incentives to repatriate their CFC earnings back to the United States, but the effect was not long lasting. Moreover, the exemption failed to increase domestic investments and employment. Even though some investigations positively evaluated the effects of the AJCA,⁵⁰ it is fair to state that the 2004 tax holiday as a policy experiment did not attain the policy goals that advocates of territoriality were expecting.

C. Japan's Move to Territoriality in 2009 and Its Economic Effects: A Japan-U.S. Comparison

1. Outline of the Japanese Dividend Exemption System

Whereas the United States introduced a one-time exemption system for repatriated dividends and then returned again to a worldwide system, Japan introduced a permanent dividend exemption system in 2009.⁵¹ This system allows corporations to exclude 95% of their dividend income from corporate taxable income if they repatriate this income back to Japan. For CFCs,

result was a revenue loss of \$3.3 billion over the ten years after 2004. STAFF OF JOINT COMM. ON TAXATION, JCX 69-04, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 4520, "AMERICAN JOBS CREATION ACT OF 2004," FISCAL YEARS 2005–2014 (2004). However, this estimate has both its critics, see Robert J. Shapiro & Aparna Mathur, *The Revenue Implications of Temporary Tax Relief for Repatriated Foreign Earnings: An Analysis of the Joint Tax Committee's Revenue Estimates* (2011), http://www.sonecon.com/docs/studies/JCT_Revenue_Estimate_for_HIA_and_Its_Reprise-Shapiro-Mathur_081911.pdf, and its defenders, see Edward D. Kleinbard & Patrick Driessen, *A Revenue Estimate Case Study: The Repatriation Holiday Revisited*, 120 TAX NOTES 1191 (2008).

⁵⁰ E.g., Allen Sinai, *Macroeconomic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment*, Study performed by Decision Economics (Decision Econ., Inc. Studies Series No. 66, 2008), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.476.5824&rep=rep1&type=pdf>.

⁵¹ See Masui, *supra* note 2; see also ALTSHULER ET AL., *supra* note 2, at 24–27; Robin D. Beran et al., *Session 2: Lessons in Reform—Discussion of Recent Tax Reform in Other Countries*, 88 TAXES 33 (2010); Jim Carr et al., *New Foreign Dividend Exemption Systems in Japan and U.K.: Tax Considerations for Distributions from U.S. Subsidiaries*, 38 TAX MGM'T INT'L J. 319 (2009).

Japanese corporations must own at least 25% of their total shares and hold them for more than six months.⁵²

This policy change in Japan was first initiated by the Subcommittee on International Taxation established by the Ministry for Economy, Trade, and Industry (METI). The Subcommittee released its report in 2008 recommending Japan's move to territoriality.⁵³ The report was issued against a background of the globalization of Japanese corporations. The ratio of offshore production to total production increased to approximately 30% in 2007, and profits earned through CFCs increased to four times those of 2001.⁵⁴ The report pointed out that Japanese MNCs with CFCs retained their earnings of approximately three trillion yen (\$25 billion) every year without repatriating them to Japan.⁵⁵ Additionally, in 2006, approximately seventeen trillion yen (\$141 billion) was accumulated in Japanese CFCs.⁵⁶

According to the report, one of the main obstacles to dividend repatriation was the Japanese repatriation tax, which at the time had the highest corporate tax rate among OECD countries.⁵⁷ By escaping this

⁵² Japan Ministry of Fin., FY2009 Tax Reform (Main Points) (Dec. 19, 2008), http://www.mof.go.jp/english/tax_policy/tax_reform/fy2009/tax2009a.pdf.

⁵³ 国際租税小委員会(2008), 「我が国企業の海外利益の資金還流について～外国子会社からの配当についての益金不算入制度の導入に向けて-中間論点整理」平成20年8月, 経済産業省貿易経済協力局貿易振興課 [SUBCOMM. ON INT'L TAXATION, MINISTRY FOR ECON., TRADE, & INDUS., REPATRIATION OF FOREIGN PROFITS BY JAPANESE ENTERPRISES: TOWARD AN INTRODUCTION OF EXEMPTION OF DIVIDENDS FROM OVERSEAS SUBSIDIARIES] (2008).

⁵⁴ 「近年、我が国企業の海外生産比率が向上し3割にまで達するとともに、海外子会社の利益は2001年と比較して4倍超にまで大幅に増加している。」[SUBCOMM. ON INT'L TAXATION, *supra* note 53, at 1 (the back data of this statement are on the appendix slide 1-1)].

⁵⁵ 「我が国企業は、これらの海外利益の多くを国内に資金還流させずに海外に留保する傾向がみられ、海外での内部留保額が急増している。毎年2～3兆円強が海外子会社に留保され、・・・」[SUBCOMM. ON INT'L TAXATION, *supra* note 53, at 1 (the back data of this statement are on the appendix slide 1-2)].

⁵⁶ 「2006年度には約17兆円強の利益が内部留保されている。」[SUBCOMM. ON INT'L TAXATION, *supra* note 53, at 1 (the back data of this statement are on the appendix slide 1-2)].

⁵⁷ 「現在の国際租税制度の下では、海外子会社利益を日本に資金還流すると国際的に高い水準にある日本の税率が適用される。」[SUBCOMM. ON INT'L TAXATION, *supra* note 53, at 1]. The Japanese blended national/prefectural corporate tax rate in 2009 was 39.51%, which was the highest among the OECD countries. Org. for Econ. Co-operation & Dev., *supra* note 1 (selected 2009 from the dropdown menu).

repatriation tax, Japanese firms retained their CFC earnings abroad, which then resulted in stagnated domestic investment, R&D, and employment. On the grounds that a dividend exemption system would contribute to removing this obstacle, the report concluded that Japan should allow Japanese firms to exclude 95% of repatriated dividends from their taxable income. However, the report did not mention the policy goals, such as an increase in investment, R&D, or employment. Therefore, it did not specify the uses of repatriated dividends, unlike the AJCA in 2004, and preferred to permit freedom of corporate behavior.

The report also underlined another merit of the dividend exemption system, namely, that it would lighten corporations' paperwork for claiming foreign tax credits. To take advantage of the foreign tax credit system, corporations had to identify the amounts of the source country taxes they paid and prove that they were qualified to claim the credits. All of this paperwork imposed a heavy burden on corporations. If the foreign tax credit system was repealed with Japan's move to territoriality, corporations would be released from such burdens.

2. Economic Effects of Japan's Dividend Exemption System: From the Perspective of a Japan-U.S. Comparison

Did Japan's move to territoriality in 2009 contribute to increasing repatriated dividends from CFCs? On this point, Tajika, Hotei, and Shibata⁵⁸ and Hasegawa and Kiyota⁵⁹ conducted quantitative analyses.

Tajika, Hotei, and Shibata analyzed the economic effect of the move to territoriality in 2009, which was the first year after the policy change, with the following findings: First, those firms that increased dividend payments increased them after the introduction of a dividend exemption system.⁶⁰ Second, firms with high funding requirements for investments increased their

⁵⁸ See Eiji Tajika et al., *The Effects of Dividend-Exemption Method on Repatriation of Income from Abroad: The Case of 2009 Japanese Tax Reform*, 188 *ECON. ANALYSIS* 70 (2014) (in Japanese).

⁵⁹ See Makoto Hasegawa & Kozo Kiyota, *The Effect of Moving to a Territorial Tax System on Profit Repatriation: Evidence from Japan* (GRIPS Discussion Paper No. 15-09, 2015), <http://ssrn.com/abstract=2618058>.

⁶⁰ See Tajika et al., *supra* note 58, at 85.

dividend payments, whereas the dividend exemption system had no impact on the behavior of firms with low funding requirements.⁶¹

They concluded that the repeal of the Japanese repatriation tax, which had curbed dividend repatriation, in particular promoted firms with high funding requirements to repatriate their CFC earnings, and increased their funds in hand. Tajika, Hotei, and Shibata insisted that the fact that firms with low funding requirements did not increase repatriations indicates that the funds repatriated were used efficiently.

Hasegawa and Kiyota also found that the dividend exemption system succeeded in increasing repatriation between 2009 and 2011. Interestingly, firms 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.⁶²

In contrast, they found that the change in dividend payments was not positively associated with the grossed-up tax rate differentials between Japan and foreign countries after the tax reform.⁶³ This result shows that no evidence exists to indicate that the 2009 tax reform increased tax avoidance by Japanese MNCs. The authors interpreted this result as Japanese firms possibly not being as active in avoiding taxes as U.S. firms (possibly partly because of their high compliance consciousness with tax laws) or that the reform of the Japanese CFC regime in 2010 might have some effects on this result.⁶⁴ On the basis of these findings, we might conclude that the Japanese move to territoriality in 2009 succeeded in increasing repatriation at least during 2009–2011. This result is the same as that for the U.S. 2004 tax holiday. However, the difference between the countries is that the U.S. policy was temporary, whereas the Japanese one is permanent. Did this difference have different impacts on both countries' manner of repatriation? Unfortunately, because both Tajika, Hotei, and Shibata and Hasegawa and Kiyota limited the scope of their analysis to only 2009 and 2009–2011, respectively, we cannot obtain information on long-lasting policy effects after 2011. Therefore, we check whether both countries' policies could have

⁶¹ *See id.* at 86–89.

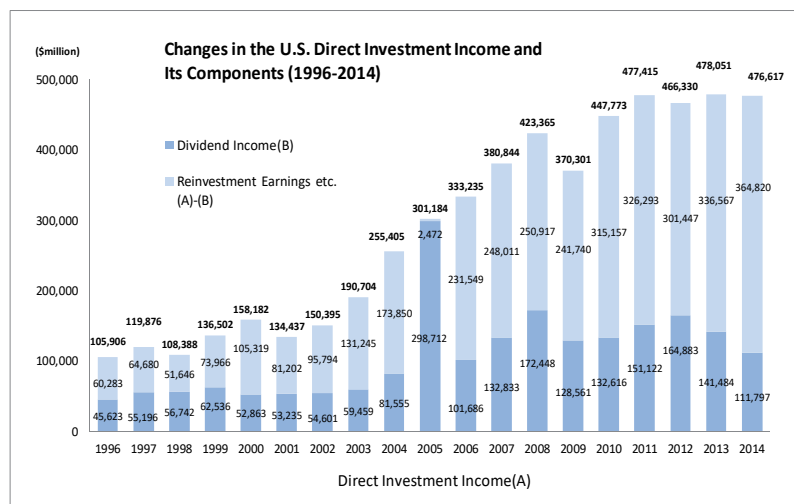
⁶² *Id.* at 3.

⁶³ *Id.*

⁶⁴ Hasegawa & Kiyota, *supra* note 59, at 15–16.

long-lasting economic effects by using time series data on the direct investment income of both countries. The U.S. data are based on the international balance of payments statistics from the Bureau of Economic Analysis. The Japanese data are based on the international balance of payments statistics from the Bank of Japan. Figure 6 shows changes in U.S. direct investment income for 1996–2014. This income was either reinvested as “reinvested earnings etc.” or repatriated to the United States. Figure 6 enables us to easily understand that repatriated dividend income to the United States drastically increased in 2005, which was the year after the enactment of the AJCA and the year in which approximately 90% of all repatriating firms under the AJCA applied for the exemption.

Figure 6



Source U.S. Bureau of Economic Analysis, International Transactions Data, Table 4.2. U.S. International Transactions in Primary Income on Direct Investment (<http://www.bea.gov/Table/Table.cfm?reqid=62&step=1#reqid=62&step=6&isuri=1&6210=1&6200=57>; Access: January 20, 2016)

As Table 1 indicates, the ratio of dividend income to direct investment income ((B)/(A)) reached a record high of 99.2% in 2005, and then declined to 30.5% in the subsequent year. The ratio then remained almost constant between 20% and 30% after 2006, which is nearly the same level as in the years before 2004. This pattern indicates that the effect on repatriation was realized only for 2005 and subsequently disappeared without long-lasting effects. This pattern is compatible with the research findings on the economic effects of the AJCA, as surveyed above.

Table 1**Changes in the U.S. Direct Investment Income and Its Components (1996-2014)**

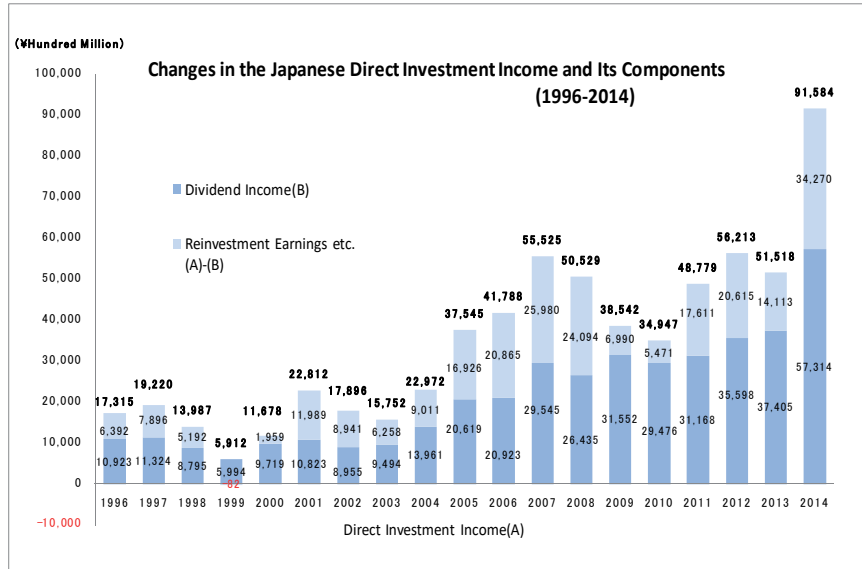
(Million Dollars)

Calendar Year	Direct Investment Income(A)	Dividend Income(B)	Reinvestment Earnings etc. (A) \ (B)	Ratio : (B) / (A)
1996	105,906	45,623	60,283	43.1%
1997	119,876	55,196	64,680	46.0%
1998	108,388	56,742	51,646	52.4%
1999	136,502	62,536	73,966	45.8%
2000	158,182	52,863	105,319	33.4%
2001	134,437	53,235	81,202	39.6%
2002	150,395	54,601	95,794	36.3%
2003	190,704	59,459	131,245	31.2%
2004	255,405	81,555	173,850	31.9%
2005	301,184	298,712	2,472	99.2%
2006	333,235	101,686	231,549	30.5%
2007	380,844	132,833	248,011	34.9%
2008	423,365	172,448	250,917	40.7%
2009	370,301	128,561	241,740	34.7%
2010	447,773	132,616	315,157	29.6%
2011	477,415	151,122	326,293	31.7%
2012	466,330	164,883	301,447	35.4%
2013	478,051	141,484	336,567	29.6%
2014	476,617	111,797	364,820	23.5%

Source: U.S. Bureau of Economic Analysis, International Transactions Data, Table 4.2. U.S. International Transactions in Primary Income on Direct Investment (<http://www.bea.gov/tTable/tTable.cfm?reqid=62&step=1#reqid=62&step=6&isuri=1&6210=1&6200=57>; Access: January 20, 2016)

In contrast, figure 7 shows the changes in Japan's direct investment income for 1996–2014 and indicates that dividend income increased in 2009—the first year of the Japanese participation exemption—but not as drastically as in the case of the United States. This phenomenon occurred because direct investment income declined as a result of the 2008 financial crisis, which made it difficult to identify the real effect caused by the Japanese policy change. We then turn to table 2, which shows the ratio of dividend income to direct investment income, and easily find that the ratio significantly increased to higher than 80% in 2009 and 2010. This increase can be identified as the effects of the dividend exemption system. However, the ratio decreased after 2011 to 60–70%.

Figure 7



Source: Bank of Japan, Balance of Payments Data
 (http://www.stat-search.boj.or.jp/ssi/cgi-bin/famecgi2?cgi=\$nme_a000_en&lstSelection=10; Access: January 20, 2016).

Table 2

Changes in the Japanese Direct Investment Income and Its Components (1996-2014)

(Hundred Million Yen)

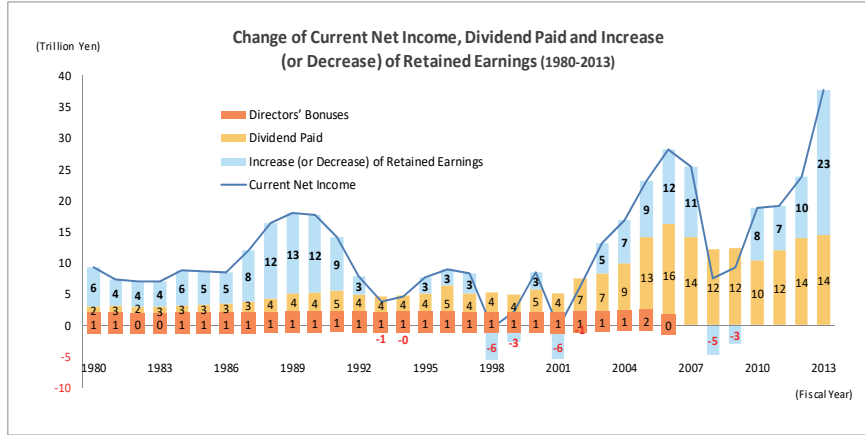
Calendar Year	Direct Investment Income(A)	Dividend Income(B)	Reinvestment Earnings etc. (A)-(B)	Ratio : (B)/(A)
1996	17,315	10,923	6,392	63.1%
1997	19,220	11,324	7,896	58.9%
1998	13,987	8,795	5,192	62.9%
1999	5,912	5,994	-82	101.4%
2000	11,678	9,719	1,959	83.2%
2001	22,812	10,823	11,989	47.4%
2002	17,896	8,955	8,941	50.0%
2003	15,752	9,494	6,258	60.3%
2004	22,972	13,961	9,011	60.8%
2005	37,545	20,619	16,926	54.9%
2006	41,788	20,923	20,865	50.1%
2007	55,525	29,545	25,980	53.2%
2008	50,529	26,435	24,094	52.3%
2009	38,542	31,552	6,990	81.9%
2010	34,947	29,476	5,471	84.3%
2011	48,779	31,168	17,611	63.9%
2012	56,213	35,598	20,615	63.3%
2013	51,518	37,405	14,113	72.6%
2014	91,584	57,314	34,270	62.6%

Source: Bank of Japan, Balance of Payments Data
 (http://www.stat-search.boj.or.jp/ssi/cgi-bin/famecgi2?cgi=\$nme_a000_en&lstSelection=10; Access: January 20, 2016).

On the basis of the previously described data, we conclude that both Japan and the United States succeeded in significantly increasing repatriation through dividend exemption systems, at least during the period immediately after their introduction. However, the effects in the United States were not long lasting because of the system's temporary nature. Additionally, for Japan, high-level repatriation such as that which occurred in 2009 and 2010 did not last long. Nevertheless, it is also important to note that the average ratio (B)/(A) in table 2 for 2001–2008 was 65.6%, which exceeds by more than ten percentage points the average ratio of 53.6% during 2011–2014. This result might indicate that the Japanese policy change resulted in long-lasting effects. However, whether we can draw this conclusion depends on more rigorous statistical analysis.

The next point that we must check is whether the Japanese dividend exemption system contributed to increasing domestic investments. Figure 8 shows the change in current net income and its use during 1980–2013. Traditionally, a low dividend payout ratio characterized Japanese corporations' behavior and, in fact, as figure 8 indicates, they paid out little dividends to their shareholders up to the 1980s. However, the dividend payout has come to occupy a more important recent position for Japanese firms, not only in absolute terms but also in relative terms. Firms were forced to record negative retained earnings in 2008 and 2009 because Japanese corporations attempted to maintain their dividend payout levels despite dramatic declines in current income attributable to the financial crisis. However, after the crisis, retained earnings increased rapidly during the recovery process, with the dividend payout level maintaining constant. The issue is whether the increasing retained earnings were used for investments. Unfortunately, one of the most significant problems of Japanese corporations today is that they cannot find promising investment opportunities and, therefore, continue to pile up retained earnings without using them for productive purposes. As figure 9 shows, the retained earnings stock has grown consistently since 1980.

Figure 8



Source: Ministry of Finance Japan, Policy Research Institute, Annual Survey of Financial Statements Statistics of Corporations by Industry. (https://www.mof.go.jp/pri/publication/zaikin_geppo/hyou07.htm; Access: January 20, 2016).

notes: Retained Earnings = [before 2006] Retained Earnings = Current Net Income — Directors' Bonuses — Dividend Paid / [after 2007] Retained Earnings = Current Net Income — Dividend Paid

Figure 9



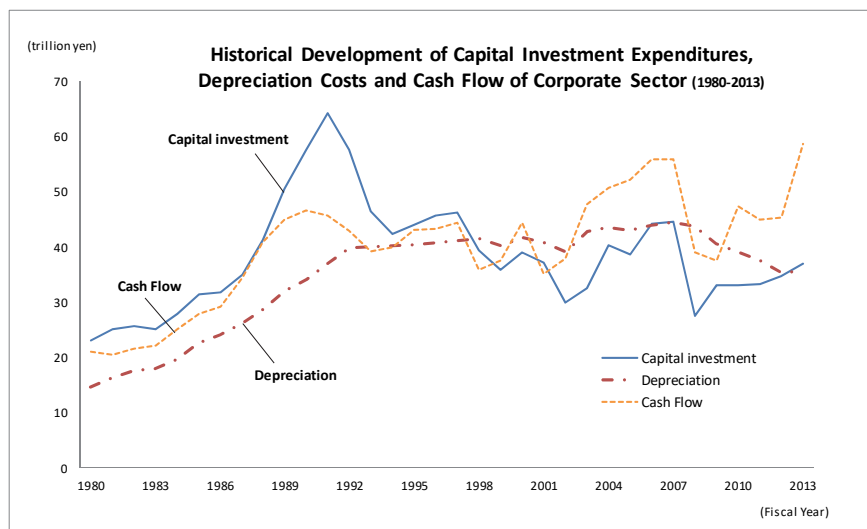
Source: Ministry of Finance Japan, Policy Research Institute, Annual Survey of Financial Statements Statistics of Corporations by Industry. (https://www.mof.go.jp/pri/publication/zaikin_geppo/hyou07.htm; Access: January 20, 2016).

notes: Retained Earnings = [before 1994] Retained Earnings = Current Net Income — Directors' Bonuses — Dividend Paid / [after 1995] Retained Earnings = Current Net Income — Dividend Paid

Figure 10 shows the historical development of capital investment expenditures by Japanese corporations. After the 2008 financial crisis, capital

investment significantly declined and then recovered, but never reached the same high level as in the 1990s and 2000s. Indeed, the Japanese dividend exemption system in 2009 increased MNCs' funds in hand, which nevertheless only led to an increase in retained earnings instead of investments. The investment level in figure 10 was almost always below the cash flow and depreciation levels, and most investments were supposedly made only for equipment replacements. Under these circumstances, increased repatriations would not necessarily contribute to an increase in domestic investments.

Figure 10



Source: Ministry of Finance Japan, Policy Research Institute, Annual Survey of Financial Statements Statistics of Corporations by Industry. (https://www.mof.go.jp/pri/publication/zaikin_geppo/hyou07.htm; Access: January 20, 2016).

On the basis of the previous Japan-U.S. comparison, we draw the following conclusion. A shift from worldwide taxation to territoriality could be justified on two grounds. First, it would strengthen MNCs' competitive edge by reducing their tax burden. Second, it would increase domestic investment and employment. Indeed, the dividend exemption system in both countries had the effect of increasing repatriations at least immediately after the reform. Particularly for Japan, moving to territoriality might have caused a long-lasting effect given its permanent feature. However, we found no evidence in support of the second justification that territoriality contributed to the domestic economies of both countries. This finding leads to our conclusion that a dividend exemption system certainly contributes to the

private interest of MNCs but also cannot be justified on the basis of its contribution to the domestic economy.

Even if a country moves to territoriality on the basis of the first justification, the introduction and strengthening of antiavoidance measures against the expected tax avoidance is inevitable. Otherwise, such a move would give MNCs windfall profits and incur huge revenue losses to governments without any corresponding positive feedback on the domestic economies. We learned this crucial lesson from the U.S. experience with the 2004 tax holiday. On this point, it should be noted that Japan reformed the existing Japanese CFC regime in 2010 to prevent the tax avoidance caused by its move to territoriality from occurring. In the next section, we observe additional details on this point.

D. Reform of the Japanese CFC Regime and Anti-Base Erosion

1. What Is the “Principled Dividend Exemption”?

Reuven Avi-Yonah has referred to the “benefit principle” and the “single tax principle” as two basic principles of international taxation.⁶⁵ The single tax principle states that cross-border income should be taxed only once and that double taxation and double nontaxation should be avoided. Under the international tax regime, the priority to tax active income is given to source countries on the basis of the benefit principle, whereas the priority to tax passive income is given to residence countries. However, if source countries do not tax active income or tax it at only a very low rate, the single tax principle requests residence countries to tax active income supplementarily. Otherwise, double nontaxation is induced. How to eliminate double nontaxation is one of the most acute issues to be tackled by the OECD BEPS project; therefore, the single tax principle should be recognized as one of the most fundamental tax principles under the present international tax regime.⁶⁶

⁶⁵ See AVI-YONAH, *supra* note 36, at 3–7.

⁶⁶ See Reuven S. Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 N.Y.L. SCH. L. REV. 305 (2015).

Under the single tax principle, regardless of the international tax system that a country runs—worldwide or territorial—the manner in which it taxes cross-border income should obey the tax rules as requested by the single tax principle. After a move to territoriality, appropriate antiavoidance rules should be adopted to avoid double non-taxation. A territorial tax system with appropriate antiavoidance rules is called the “principled dividend exemption” by Clifton Fleming, Robert Peroni and Stephan Shay.⁶⁷ They discussed the conditions that U.S. corporate taxes should meet if the United States decides to move to territoriality. According to Fleming, Peroni, and Shay, the most important requirement for designing a principled dividend exemption is the “subject-to-tax requirement.”⁶⁸ Under this requirement, exemption-claiming cross-border income should be taxed properly in the source countries. Conversely, if that income is not taxed properly at source, the United States should not exempt it from tax. This concept is also compatible with the previously stated single tax principle.

According to Fleming, Peroni, and Shay, a properly designed exemption system should have the following three design features: First, under the subject-to-tax requirement, a benchmark tax rate should be introduced because we need a standard for judging the appropriate taxation level.⁶⁹ Certainly, determining a benchmark tax rate on the basis of a single, well-justified ground is difficult, as Fleming, Peroni, and Shay also admit. However, once a benchmark is set, a country with a corporate tax rate less than the benchmark tax rate is regarded as a country with improper taxation. The retained earnings of CFCs that locate in a country with improper taxation should be recognized as “disqualified income” and should not be subject to exemption.⁷⁰ In contrast, the retained earnings of the CFCs located in the country with a higher corporate tax rate than the benchmark rate should be recognized as “qualified income,” which should be subject to exemption

⁶⁷ J. Clifton Fleming Jr. et al., *Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty*, 13 FLA. TAX REV. 397, 413 (2012). They apparently prefer an improvement in worldwide taxation by repealing the deferral privilege but also consider a properly designed exemption or territorial system for the case in which Congress creates a U.S. territorial system or an exemption system. *See generally id.*

⁶⁸ *Id.* at 413–15.

⁶⁹ *Id.* at 415–19.

⁷⁰ *See id.* at 424–25.

when repatriated to the United States. To properly operate such a system, we still need a CFC regime even after moving to territoriality, and need to tax disqualified income by incorporating CFC income into corporate taxable income.

Second, how should we address passive income received by CFCs? Fleming, Peroni, and Shay concluded that passive income received by CFCs should not be subject to exemption.⁷¹ Subjecting such income to exemption would give MNCs strong incentive to concentrate their passive income in CFCs located in low-tax countries, and then repatriate that income to the United States without further U.S. taxation, thus creating a huge loophole. Therefore, only active business income should be subject to exemption, and passive CFC income should be designated as CFC income, which is subject to U.S. taxes.

Finally, how should we address income such as royalty, interest, and services payments that U.S. headquarters receive from their CFCs? Fleming, Peroni, and Shay concluded that none of these types of income should be subject to exemption.⁷² These types of income are passive and bear no foreign income tax because they are frequently exempted from foreign tax by an applicable income tax treaty. Because the treaty gives the priority to tax passive income to residence countries, usually no international double taxation occurs; therefore, no reason exists to provide double taxation relief.⁷³

2. Reform of the Japanese CFC Regime and Introduction of the Passive Income Rule

As discussed in the previous section, we should maintain a “principled exemption system” with a rigorous CFC regime even after a move to territoriality to prevent tax avoidance by MNCs. In this context, how do we evaluate the reform of the Japanese CFC regime in 2010 that followed

⁷¹ *Id.* at 426–28.

⁷² *Id.* at 431–39.

⁷³ *See id.* at 431.

Japan's move to territoriality? To discuss this point, we must first have a basic understanding of the Japanese CFC regime.⁷⁴

Japan first introduced its CFC regime in 1978 to regulate tax avoidance by MNCs through CFCs located in low-tax countries or tax havens. This regime is applied to foreign corporations that meet the following conditions.⁷⁵

1. The foreign company must be controlled by Japanese resident individuals or Japanese companies, directly or indirectly, through holding 50% or more of its shares.
2. The foreign company must be located in a country or region with a corporate tax rate of less than 20%.⁷⁶

Shareholders who own 10% or more of the foreign corporation's shares, provided the foreign corporation meets both of the above conditions, are

⁷⁴ See Masui, *supra* note 2, at 244–47 (explaining the details of the Japanese CFC regime and of its reform in 2010). However, please note that the existing CFC regime will face a major change in April 2018. According to the 2017 tax reform proposal of the ruling party (LDP and Komeito), the Japanese CFC regime, which is based so far mainly on “entity approach,” will be shifted to a mixture of the “transaction approach” and the “entity approach,” in consideration of the OECD's BEPS recommendations. Under the new scheme, the CFC's active income will be excluded from taxable income and just passive income will be taxed, even though the effective foreign tax rate is lower than 20%. This point represents a shift to the “transaction approach.” On the other hand, the CFC regime will not apply, irrespective of types of incomes, if the effective foreign tax rate is 20% or more. This point represents an “entity approach” aspect of the new scheme. Finally, all the income of “paper companies” that earn only passive income will be taxable, if the effective foreign tax rate is less than 30%. See Japan Ministry of Fin., Cabinet Decision on FY2017 Tax Reform (Main Points), at 5 (Dec. 22, 2016), http://www.mof.go.jp/english/tax_policy/tax_reform/fy2017/tax2017a.pdf.

⁷⁵ See TAX BUREAU, JAPAN MINISTRY OF FIN., COMPREHENSIVE HANDBOOK OF JAPANESE TAXES 2010, at 122 (2010), available at http://www.mof.go.jp/english/tax_policy/publication/taxes2010e/taxes2010e.pdf.

⁷⁶ This rate corresponds to the “benchmark tax rate” described in Fleming et al., *supra* note 67, at 415. The rate was “20% or less” until 2014. However, because the United Kingdom reduced its corporate tax rate to 20% in 2015, the Japanese benchmark tax rate was also reduced to “less than 20%” in 2015 to prevent the earnings of U.K.-located Japanese CFCs from being taxed as “disqualified income.” See 2015 年税制改正大綱 (2015年1月14日閣議決定) の「第5章 国際課税」における「4 外国子会社合算税制等の見直し」を参照。「内国法人等の特定外国子会社等に係る所得の課税の特例 (いわゆる外国子会社合算税制) 等について、次の見直しを行う。(1) 特定外国子会社等に該当することとされる著しく低い租税負担割合の基準 (いわゆるトリガー税率) を20%未満 (現行: 20%以下) に変更する。」[2015 Tax Reform Proposal (cabinet decision on Jan. 14, 2015), Chapter 5 “International Taxation,” Section 4 “Revision of CFC regime.” “On special tax rules applied to CFCs’ income (so-called CFC rule) the following revision will be made: (1) The effective tax rate used as a measure for determining whether a foreign subsidiary is a specified foreign subsidiary under the CFC rule (so called “trigger tax rate”) will be changed from ‘20% or less’ to ‘less than 20%’”].

subject to the CFC regime. Retained earnings of a CFC are attributed to these shareholders' taxable income on the basis of a pro rata share of the taxable income of the CFC. Unlike the U.S. Subpart F regime, which adopts a "transaction approach," the Japanese CFC regime adopts an "entity approach" that does not classify CFC income into multiple income categories. All of the taxable income of a CFC, regardless of whether it is active or passive, is subject to the regime.

In contrast, the Japanese CFC regime provides that four conditions must be met for exclusion from its application:

1. Active business test: The main business of the company is not the holding of shares or debt securities; the licensing of intellectual property rights, know-how, or copyrights; or the leasing of vessels or aircraft;
2. Substance test: The company has a fixed place of business in the foreign country in which its head office is located;
3. Local management and control test: The company manages, controls, and operates its business in the country in which the head office is located; and
4. Unrelated party transaction test or local business test: Under the unrelated party transaction test, the main business of the company is that of wholesale, banking, trust company, securities, insurance, shipping, or air freight, and more than 50% of its business is conducted with unrelated parties. If the main business is not of a type listed for the unrelated party transaction test, then the company must conduct its business mainly in the country in which its headquarters is located, per the local business test.⁷⁷

If a CFC meets all four of these conditions, it is exempted from the regime and is judged to have substance as an independent corporation and adequate reasons to locate and operate in the country or region.

The dividend exemption system in 2009 was easily expected to provide MNCs with strong incentive to avoid Japanese taxation by concentrating

⁷⁷ See TAX BUREAU, *supra* note 75, at 122–23 (http://www.mof.go.jp/english/tax_policy/publication/taxes2010e/taxes2010e.pdf).

their offshore income in CFCs located in low-tax countries and then repatriating them to Japan. However, the Japanese CFC regime of those days was not free from defects and was unable to prevent such tax avoidance.⁷⁸ Whether the Japanese CFC regime was applicable depended on whether the CFC satisfied all four conditions for exclusion (described above)—a type of “all or nothing approach.” If they did not meet any one of these conditions, all of the CFC’s income would become taxable income. In contrast, if the CFC met all four conditions, the Japanese government could not tax the CFC’s income at all, even if the passive income related to tax avoidance. In the event that the CFC regime was not applicable, MNCs could easily repatriate their CFC income to Japan without incurring any Japanese taxation because the government had no other way to tax it.

To deal with this issue, a new income category was created to capture passive income in 2010, even when CFCs satisfy all of the active business exemption tests.⁷⁹ Under this scheme, the passive income received by the CFC located in a country with less than a 20% corporate tax rate is included in its taxable income. Under the Japanese CFC regime based on the entity approach, no distinction has been made between active and passive income. However, Japan’s move to territoriality in 2009 created the need to establish a new income category of passive income for antiavoidance purposes.⁸⁰ Importantly, note that this passive income rule overrides the active business exemption rule.

⁷⁸ Regarding the features and issues of the Japanese CFC regime and the significances and perspectives of its 2010 reform, see 伴忠彦(2009), 「外国子会社合算税制における合算方式と適用除外基準の再考」『税務大学校論叢』第63号, 189–356頁 [Tadahiko Ban, *Reconsideration of the Income Attribution Approach and Exceptions Under the CFC Rules in Japan*, 63 J. NAT’L TAX C. 189 (2009), available at <https://www.nta.go.jp/ntc/kenkyu/ronsou/63/02/pdf/63-2.pdf>]. See also 保井久理子(2011), 「外国子会社合算税制における新しい概念について-資産性所得を中心として」『税務大学校論叢』第71号, 335–424頁 [Kuriko Yasui, *New Concept of Controlled Foreign Company Rules: Focus on Income from Assets*, 71 J. NAT’L TAX C. 335 (2011), available at <https://www.nta.go.jp/ntc/kenkyu/ronsou/71/03/03.pdf>].

⁷⁹ Passive income includes dividends, interest, capital gains, royalties, and income from the leasing of ships and aircraft. See TAX BUREAU, *supra* note 75, at 123.

⁸⁰ Because current U.S. Subpart F rules include passive income (i.e., dividends, interest, capital gains, and royalties), base company income (i.e., income arising from transactions between companies within the same group), and § 956 income (generally, loans of subsidiary companies to shareholders), it does not need to create a new income category for passive income. Therefore, the United States simply assumes that it would continue maintaining and applying Subpart F to prevent tax avoidance caused by the move to territoriality.

This policy design is almost in accordance with the “principled exemption system” of Fleming, Peroni, and Shay. First, Japan’s move to territoriality is limited to the exemption of repatriated dividends from CFCs’ active business income. Royalty, interest, service payments, capital gains, and other types of passive income are not targets for the exemption system. Second, because passive income received by CFCs is included in the taxable income of the Japanese shareholders, the loopholes are closed. Third, the benchmark tax rate is set at “less than 20%.” If a CFC locates in countries with less than a 20% corporate tax rate, its earnings are designated as “disqualified” for exemption.

It is useful to mention here two points concerning this reform. First, Japan did not impose a transition tax when it moved from worldwide taxation to territorial taxation. Both the Camp Plan and the Obama administration’s proposal included one-time transition taxes on the accumulated CFC earnings after the policy change. In contrast, Japan retroactively exempted all CFC earnings that were accumulated before Japan’s move to territoriality. Thus, the Japanese Treasury lost a rare opportunity to obtain substantial revenue. Second, Japan did not introduce a tax on future earnings of the CFCs that both the Camp Plan and the Obama administration proposed. They include a proposal of taxing CFCs’ earnings annually, at 12.5–15% in case of the Camp Plan and at 19% in case of the Obama administration’s proposal. Although both rates are lower than the existing U.S. corporate tax rate of 35%, they are higher than the repatriation tax rate of 5% in the Camp Plan, which was applied to the repatriated earnings from the CFCs. These proposed taxes on the retained earnings of CFCs would function as a “penalty” against retaining their earnings abroad. Japan also could have introduced this type of tax on the shift to territoriality in 2009 for revenue raising purposes as well as to provide incentives for repatriation. However, we cannot find any traces of such policy discussions in Japan.

V. CONCLUSION

At present, Japan is in a fiscal crisis with outstanding public debt of approximately 1,035 trillion yen (\$8.36 trillion) as of the end of 2015. The public debt to GDP ratio has already hit 205% at both the national and the subnational levels, which is the worst situation among developed countries. Japan’s public debt is growing in both absolute and relative terms given the country’s continuous budget deficit. Therefore, Japan cannot implement a tax reform that undermines its fiscal situation.

Japan's corporate tax reform with a rate cut and base broadening is designed to be revenue neutral because the country seeks to strengthen its industrial competitiveness and to secure its fiscal sustainability. Because Japan had room to broaden its base, it was able to do so even without any experience with a rate cut or base broadening, such as the 1986 corporate tax reform under the Reagan administration. Moreover, shifting the tax base of the prefecture corporate tax from profits to an "external standard" (value added and capital) contributed to realizing revenue-neutral tax reform.

Strengthening the taxation of corporations in the red naturally caused them to protest against the reform. However, the "external standard" taxation is applied only to large corporations with capital stock of 100 million yen (\$833,000) or more. Accordingly, almost all small and medium-sized corporations remain untaxed under the "external standard," which softened their political resistance to the reform. The reform was also seriously criticized because the extension of the value-added tax base was a strengthened taxation of wages. Even if this criticism was misguided, the government decided to lighten the tax burden of corporations that attempted to raise wages by allowing them to exclude the increased portion of their wage payment from the value-added tax base.

Regarding the U.S. debate on worldwide or territorial taxation, this paper conducted a comparative analysis from the perspective of the economic effects of a transition to territoriality by regarding both the U.S. 2004 tax holiday and Japan's move to territoriality in 2009 as a kind of policy experiment. This comparison made it clear that both policy changes succeeded in significantly increasing dividend repatriation. However, this effect was limited only to 2005 and did not last for a long time in the U.S. case, whereas the Japanese policy change might have a relatively long-lasting effect on repatriation. This difference presumably came from the situation in which the U.S. policy change was only temporary, whereas the Japanese one was permanent. However, to obtain a more definite conclusion, we need a more rigorous statistical analysis.

Regarding the effects on investments and employment, we found no evidence that shows that both countries' policy change gave rise to any positive results. Therefore, we concluded that the move to territoriality could not be justified on the ground that it could contribute positively to the domestic economy.

Finally, a simple transition to territoriality would create a large loophole in the corporate international tax system and could, therefore, incentivize tax

avoidance by MNCs. Therefore, a move to territoriality should be a move to a “principled exemption system” under the single tax principle. For this purpose, a CFC regime should play a central role in preventing tax avoidance even after a move to territoriality. On this point, Japan closed the loophole by reforming its CFC regime immediately after its move to territoriality, under which passive income received by CFCs was taxed. As Hasegawa and Kiyota indicated, we do not see any evidence that Japanese MNCs increased their tax avoidance behavior after 2009. Based on this, the reform of the Japanese CFC regime in 2010 presumably succeeded and is now functioning well.