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Japan’s Foreign Subsidiaries’ Dividends Exclusion

Toshio Miyatake
Adachi, Henderson, Miyatake & Fujita

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Toshio Miyatake[1]

1. Introduction

Like the United States and the United Kingdom, Japan has a system of worldwide taxation system. Accordingly, one of the key elements of the Japanese international taxation is that Japanese income taxation on the income of Japanese corporations' foreign subsidiaries is deferred until it is repatriated in the form of dividends to the Japanese parent corporations.

The only exception to such deferral is the Specified Foreign Subsidiaries regime, the so-called controlled foreign corporation (hereinafter called "CFC") regime, under which the Japanese parent corporations are currently taxed on the income of their foreign subsidiaries located in low-tax countries. In the other situations, Japanese parent corporations are taxed on the income of their foreign subsidiaries only when it is repatriated to the parent corporations in the form of dividends with the accompanying foreign tax credits.

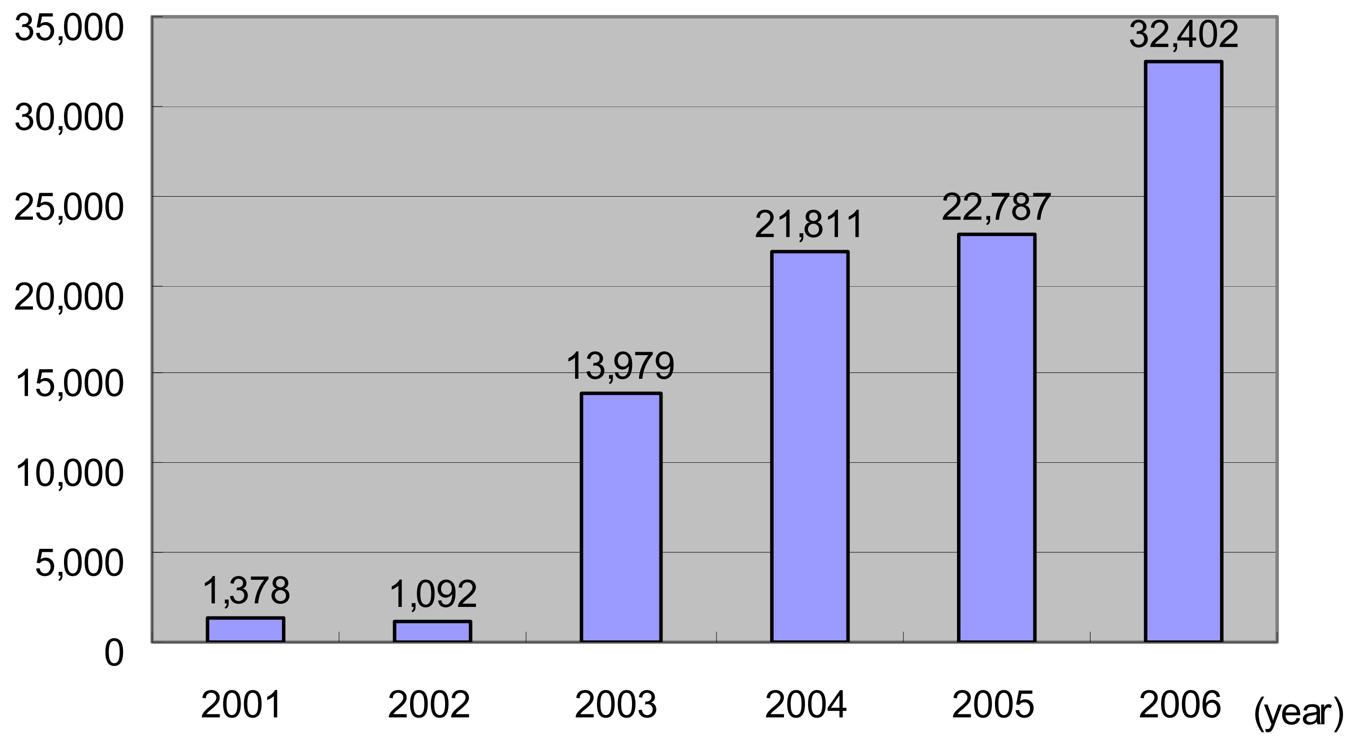
As the effective tax rate of the combined three Japanese corporate income taxes (the national Corporation Tax, local Inhabitant Tax, and Enterprise Tax) is approximately 40%, relatively higher than the corporate income tax rates in other countries of the world (perhaps except for the United States), Japanese corporations tended not to repatriate their foreign subsidiaries' profits to Japan.

According to statistics compiled by the Ministry of Economy, Trade and Industry, the retained profits of Japanese corporations' foreign subsidiaries continued to rise as shown in Figure 1 below.

[1] Attorney-at-law, Adachi, Henderson, Miyatake & Fujita.

Figure 1. Retained Profits of Overseas Local Corporations

(Unit: hundred billion yen)



Source: METI " Basic Research on Overseas Business Activities" (May, 2008)

It was a serious concern to the Japanese Government that Japanese multinational enterprises kept their profits outside Japan. The Basic Policy 2008 of the Reform of Economy and Public Finance adopted by the Cabinet on June 27, 2008, stated[2]:

> We will try to improve the circumstances to contribute to the flow into Japan of the profits acquired by Japanese enterprises in the overseas markets by utilizing their strength in order to prevent the profits from being kept overseas excessively and not to let the research and development and employment, etc. in Japan forming the source of our competitiveness flow out overseas.

Although it was only a temporary measure for one taxable year, the United States created a dividends received deduction for United States corporations receiving dividends from their foreign subsidiaries, as part of the American Jobs Creation Act of 2004. Also, in November, 2005, the President's Advisory Panel on Federal Tax Reform recommended exempting from US taxation, without time limitation, the dividends paid from active earnings of controlled foreign corporations and foreign branches of US corporations, but this proposal was not adopted.

On June 21, 2007, the UK HM Revenue & Customs issued a discussion draft offering a package of proposals to create a new regime for exempting foreign profits, aiming at a competitive tax system for business.

These moves were undoubtedly known to the Japanese community involved in Japanese tax policy.

The Tax System Council, an advisory body to the Prime Minister, stated in its report submitted to the Prime Minister on November 20, 2007, that the movements in recent years toward exclusion of foreign income or overseas subsidiaries' dividends in the United States and the United Kingdom should be monitored.[3]

The ruling party's outline of the 2008 tax system revision recommended comprehensively studying how the foreign tax credit system should be reformed from the viewpoints of reinforcement of international competitiveness, vitalization of the Japanese economy, proper elimination of double taxation, simplification of the system, etc., by taking into consideration the fact that as globalization progresses, overseas profits of Japanese enterprises have increased but largely have been kept abroad and have not been repatriated to Japan, and by watching the movements of other countries such as the United Kingdom and the United States.[4] It is noteworthy that the four reasons of (i)

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[2] The Cabinet, Basic Policy 2008 of the Reform of Economy and Public Finance (June 27, 2008) at 7.

[3] Tax System Council, Basic Thought Toward Fundamental Tax Reform (November 11, 2007) at 21.

[4] Liberal Democratic Party, Outline of the 2007 Tax System Revision (December 13, 2007) at 61.

reinforcement of international competitiveness, (ii) vitalization of the Japanese economy, (iii) proper elimination of double taxation and (iv) simplification of the foreign tax credit system are listed for the reconsideration. In this recommendation, the overseas accumulation of Japanese enterprises' foreign profits and the reconsideration of the (indirect) foreign tax credit are linked to each other.

On August 22, 2008, the International Tax Subcommittee organized by the Ministry of Economy, Trade and Industry published its interim report recommending the introduction of exclusion of overseas subsidiaries' dividends.[5] It was felt that this exclusion of foreign subsidiaries' dividends will improve the international competitiveness of Japanese enterprises.

On November 28, 2008, the Tax System Council submitted its report for tax system change in 2009 to the Prime Minister,[6] in which it stated the following in relation to international taxation:

> With globalization progressing and the business structures becoming more complicated and diversified, it is necessary that taxation of cross-border economic activities maintain a balance between Japan's adequate right of taxation and consideration for the economic activities and/or vitalization of the Japanese economy. From the perspective of invigoration of the Japanese economy, while improving the environment for the reflow into Japan of the profits which Japanese enterprises earn in the overseas markets, it is important that the enterprises can repatriate only the necessary amounts of money at the necessary times. With reference to the foreign tax credit system, in addition to the objective of maintaining neutrality in respect of the decisions by those enterprises concerning their dividend policies, and taking into consideration the viewpoint of simplifying the system while continuing adequate elimination of double taxation, it is reasonable to introduce, in lieu of the indirect foreign tax credit system, a system of income exclusion of the dividends received by parent companies from their foreign subsidiaries. Through the introduction of this system, the profits repatriated into this country are anticipated to be put to use for vitalization of the Japanese economy in the wide-ranging and various fields, such as capital investment, research and development, employment, etc.

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[5] The Ministry of Economy, Trade and Industry, Concerning the Fund Circulation of Overseas Profits of Our Country's Enterprises ~ Toward the Introduction of Income Exclusion Concerning Overseas Subsidiaries' Dividends ~ (August 22, 2008).

[6] Tax System Council, Report concerning the Revision of the Tax System of Heisei 21st Fiscal Year (November 28, 2008) at 7.

> Also, from the standpoint of taking steps to restrain tax avoidance acts, it is necessary to constantly review the foreign controlled corporation tax system, transfer pricing rules, etc. while closely paying attention to the actual status of business activities etc.

In the above report, the three basic legislative purposes of introducing the foreign subsidiaries' dividends exclusion are stated to be (i) to replace the indirect foreign tax credit for simplicity, (ii) to enable Japanese enterprise to repatriate foreign profits as they wish (removing a tax barrier against, or taking a neutral tax position for, Japanese enterprises' determination of repatriation of foreign profits), and (iii) to stimulate the Japanese economy for capital investment, research and development, and employment.

On January 23, 2009, the Cabinet sent the Diet a bill to amend the Japanese tax laws, among others, to exempt from Japanese corporation tax the dividends Japanese corporations will receive from their foreign subsidiaries and to abolish the indirect foreign tax credit.

On March 27, 2009, the bill to amend the tax laws passed the Diet, and on March 31, 2009, the adopted bill was published.[7] It contained new Article 23-2 of the Corporation Tax Law (hereinafter called "CTL") which exempts from the corporation tax Japanese corporations' receipts of dividends from their foreign subsidiaries. This provision became applicable to Japanese corporations with respect to their business years commencing on or after April 1, 2009. This statutory provision is supplemented by relevant provisions of the Corporation Tax Law Enforcement Order (hereinafter called "CTLEO") and the Corporation Tax Law Enforcement Regulations (hereinafter called "CTLER"). The local inhabitant tax and the enterprise tax will also be exempted.

This system is generally called the foreign subsidiaries' dividends exclusion.

2. Foreign Subsidiaries' Dividends Exclusion

One of the principal features of the Japanese foreign subsidiaries' dividends exclusion is its simplicity.

Accordingly, each of its requirements is explained below.

(1) Qualified Person

This system is applicable to a Japanese corporation that directly owns 25% or more of the issued shares of the dividend-paying foreign corporation for 6 months or more when the dividends are determined to be paid. This requirement exactly adopts the requirement for the indirect foreign tax credit that was replaced by this system.

If an applicable tax treaty provides for a different shareholding ratio for the indirect foreign tax credit, such ratio will apply. This approach is consistent with the fact

[7] Law Concerning the Revision of a Part of Income Tax Law, etc. (Law No. 13, 2009).

that the foreign subsidiaries' dividends exclusion is introduced to replace the indirect foreign tax credit.

The tax treaties with (i) the United States (10%),[8] (ii) Australia (10%), (iii) Brazil (10%) and (iv) France (15%) provide for such lower shareholding ratios.

More specifically, the Japanese corporation must hold 25% or more of the number or amount of (a) the issued shares or equity contributions or (b) the issued voting shares or equity contributions of a foreign corporation. Such foreign corporation is hereafter called the "Foreign Subsidiary."

The holding of such 25% or more must exist at least six months immediately prior to the time when the obligation to pay the dividends becomes final. The obligation to pay the dividends becomes final when the resolution to pay the dividends is adopted at the meeting of the board of directors or the general meeting of shareholders, as the case may be. If the foreign subsidiary has existed since its formation for less than six months when the obligation to pay the dividends becomes final, the six month requirement is considered to be fulfilled. Also, as long as 25% or more shares are held for the six month period, any additional shares acquired during that period will be qualified.

(2) Qualified Dividends

The definition of the dividends of the Foreign Subsidiaries that qualify for the exclusion is the distribution of profits or surpluses (limited to those related to shares or equity contributions),[9] which definition is used generally for other tax purposes also.

The definition of dividends of a Foreign Subsidiary under the laws of the country in which the Foreign Subsidiary has its registered head office may be different from that of a Japanese corporation under Japanese law. However, the qualified dividends must be equivalent to the definition of the dividends under CTL.

Deemed dividends also qualify.[10] Deemed dividends are distributions of cash or other assets arising out of (i) a merger (excluding a tax-free merger), (ii) a corporate division of division type (excluding a tax-free corporate division), (iii) a return of capital (limited to that incidental to a reduction of capital surplus), (iv) an acquisition of own shares or equity contribution, (v) a redemption of equity contributions, and (vi) a change in organizational structure (limited to cash or other assets other than those of the foreign

[8] Article 23, paragraph 1(b) of the US-Japan income tax treaty requires Japan to give a credit when dividends are paid by a US resident company to a Japanese resident company that owns not less than 10 percent of the voting shares issued by the company paying the dividends during the period of six months immediately before the day when the obligation to pay dividends is confirmed.

[9] CTL art. 23, para. 1.

[10] CTL art. 24, para. 1.

corporation the organizational structure of which is changed), to the extent that such distributed cash or assets exceed the capital amounts apportioned to them.[11]

Dividends from any kind of shares are qualified. Thus, dividends from the preferred shares of a Foreign Subsidiary are qualified, although they were not for the purpose of the indirect foreign tax credit.

In certain countries, dividends paid by a corporation are deductible by it in computing its taxable income. Even if dividends of a Foreign Subsidiary are deductible by it under the tax law of the country in which its registered head office is located, they are qualified.

(3) Qualified Amount

The qualified amount of dividends is calculated by deducting the deemed expenses for obtaining the dividends.[12] The deemed expenses are 5% of the dividends distributed.[13]

This 5% deduction appears to be adopted by taking the German, French and other systems of participation exemption as models. However, it does not appear in most cases that the expenses for the distribution of the dividend would be as high as 5% of the amounts of the dividends.

(4) Foreign Withholding Tax

The foreign withholding tax on dividends paid by the Foreign Subsidiary cannot be credited or deducted by the recipient Japanese parent corporation. This is a trade-off for the exclusion of the dividends income.

(5) Tax Consequence

The qualified dividends are excluded from the income of the Japanese parent corporation.

(6) Procedural Requirements

A Japanese corporation is required to enter the amount of the dividends and details of calculation of the dividends in a schedule to its final tax return. The amount of the dividends entered in the tax return sets the maximum amount for which the Japanese corporation can claim the exclusion whether it is in error or not unless the taxpayer proves that the error is due to a justifiable reason.[14]

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[11] Id.

[12] CTL art. 23-2, para. 1.

[13] CTLEO art. 22-3, para. 2.

[14] CTL art. 23-2, paras. 2 and 3.

The exclusion is granted only when a Japanese corporation makes the above entry in its tax return and keeps the following documents.[15]

(i) Documents proving that the dividend paying foreign corporation satisfies the requirements of the Foreign Subsidiary;
(ii) The balance sheet, profit and loss statement, shareholders capital change calculation document, and profit/loss disposition calculation document of the Foreign Subsidiary relating to the business year concerned; and
(iii) Documents proving the imposition and payment of the foreign withholding tax on the dividends.

3. **Legislative Purposes**

There are certain legislative purposes expressed for Japan's introduction of the foreign subsidiaries' dividends exclusion system.

(1) This system will offer a simplified mechanism for the avoidance of international double taxation instead of the indirect foreign tax credit system and reduce taxpayers' compliance burden.

Although Japan has a few legislative purposes for the introduction of its foreign subsidiaries' dividends exclusion system, this is the principal one stated.[16] The administration of the indirect foreign tax credit caused a compliance burden to taxpayers, and reducing such burden was felt to be necessary.

The US President's Advisory Panel on Federal Tax Reform and the Staff of the Joint Committee on Taxation stated in 2005 that the worldwide, deferral-based system of present law imposes on taxpayers a greater degree of complexity caused by foreign tax credit systems and the anti-deferral provisions and allocation of expenses, and distortion of economic decision-making, than is faced by taxpayers in the exemption system countries.[17] These views coincide with the conclusion of the Japanese Government.

The new exclusion system is positioned to replace the complicated indirect foreign tax credit for the purpose of avoiding international double taxation. The new exclusion system can replace the indirect foreign tax credit by adopting the same requirements of the former in the latter. Its shareholding requirements are tailored to replace the indirect foreign tax credit. This makes a sharp contrast to the United

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[15] CTL art. 23-2, para. 2; CTLER art. 8-5.

[16] *Supra* note 5 at 7.

[17] Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System: Report of the President's Advisory Panel on Federal Tax Reform (2005) 103-104; Options To Improve Tax Compliance and Reform Tax Expenditures Prepared by the Staff of the Joint Committee on Taxation (2005) 188-189.

Kingdom's participation exemption system which applies to distributions arising from any size of shareholding.

(2) This system will remove a tax barrier to the freedom of enterprises to repatriate their foreign subsidiaries' profits by adopting a neutral tax policy in this regard. This is the second legislative purpose.

It is stressed that the Japanese tax system should be neutral to the Japanese enterprises' dividend policies so that it should not present a tax barrier against their determination to repatriate foreign profits earned in overseas' markets at their will.[18]

(3) The dividends brought in tax-free will stimulate the Japanese economy and are expected to be used for capital investment, research and development, and employment etc. in Japan.

This premise is not necessarily correct. When the US dividends received deduction was introduced, there were active arguments over whether a similar premise is correct or not. The stated legislative purpose of the US dividends received deduction was to stimulate the US economy by repatriating foreign earnings that would otherwise have remained abroad.[19] The general opinions were negative above the effect of such policy. The US system even required a domestic reinvestment plan ("DRP") of investment in the United States (other than as payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation. However, there was a general agreement that the dividends received deduction was not effective in achieving its purpose.[20]

It will be the same with the Japanese foreign subsidiaries' dividends exclusion.

The Japanese Government wisely did not require the use of the funds repatriated to Japan for any particular purposes. This legislative purpose is merely suggested as a

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[18] *Supra* note 5 at 7.

[19] 150 *Cong. Rec*. S11019, S11038 (Oct. 4, 2004).

[20] There is ample literature that seeks to empirically establish this conclusion.

See, e.g., Joann M. Weiner, Bring Back the US Repatriation Tax Holiday, TAX NOTES INTERNATIONAL January 26, 2009, at 285-286:

> Since money is fungible and the investment did not need to exceed any previously planned investment – a firm that already planned to spend $5 billion a year on research and development could designate that entire amount as a use of repatriated fund and use the freed-up funds for other, possibly disallowed investments such as share repurchases – it is essentially impossible to determine whether funds were invested in permitted uses regardless of the number of rules and provisions designed to encourage such uses.

possible accompanying effect by stating that the profits repatriated to Japan are anticipated to be put to use for vitalization of the Japanese economy in the wide-ranging and various fields, such as capital investment, research and development, employment, etc., but did not go beyond that.[21] At least, the exclusion system can be utilized for such purposes without substantial additional tax costs if a Japanese corporation needs funds for such business activities in Japan and their foreign subsidiaries have retained earnings which can be used for such purposes.

The circulation of the funds within Japan will certainly contribute to stimulating the Japanese economy to a certain extent. If the accumulation of the aggregate funds brought in by Japanese corporations from their foreign subsidiaries is large, it will be bound to stimulate the Japanese economy to some extent.

However, the question is whether the foreign profits will actually be brought into Japan.

In the case of the US dividends received deduction, repatriation of foreign subsidiaries' dividends increased conspicuously. In the case of the United States, the period for the exemption was limited.

In the case of Japan, the period for the exclusion is indefinite. Japanese corporations will have more time to think about their dividend policy.

There are certain factors working against the possibility that Japanese corporations will affirmatively decide to repatriate their foreign subsidiaries' dividends.

In most cases, the funds retained within foreign subsidiaries may have been reinvested in other forms of assets and the subsidiaries may not have liquidity for distribution.

In addition, repatriating foreign subsidiaries' retained profits to Japan in cash may not be the first choice of Japanese parent corporations. Five percent of the funds brought into Japan in the form of foreign subsidiaries' dividends are still subject to ordinary corporate income taxation. Although it is intended to compensate for the deducted expenses in having the dividend paid to Japanese, any substantial expenses would be incurred for a foreign subsidiary to pay its dividends. It means that Japanese parent corporations must pay additional Japanese corporate income taxes on the brought-in funds at the rate of approximately 2%. Although that tax rate is small, it nevertheless is an additional tax cost for utilizing foreign subsidiaries' dividends.

There also must be assurance that there are opportunities within Japan that Japanese parent corporations can earn high returns on the investments in Japan with the funds brought into Japan from abroad.

Japan's high corporate income tax rate may be a barrier against bringing foreign subsidiaries' profits into Japan. Japanese parent corporations do not just keep idle the cash they bring in from their foreign subsidiaries. They will use such cash for their business in Japan. However, if the corporate income tax rate on the profits they will

[21] *Supra* note 5 at 7.

realize by utilizing the brought-in funds is high, it will work as a disincentive against bringing the foreign subsidiaries' profits into Japan. Therefore, the funds brought into Japan by utilizing this exclusion may leave Japan again.

Therefore, if the Japanese Government really wants Japanese corporations to bring their foreign subsidiaries' profits into Japan, the ultimate means may be to lower the tax rates of its corporate income taxes.

(4) This system will strengthen Japanese corporations' international competitiveness. This was stated as a reason at an early stage.[22]

This was apparently one of the first motives for the introduction of the foreign subsidiaries' dividends exclusion.

Many continental European countries such as Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Spain, and Sweden, as well as Australia and Canada, had already adopted the foreign subsidiaries' dividends exemption with respect to their tax treatment of foreign subsidiaries' dividends. Under such circumstances, it is inevitable that Japan will follow suit to preserve international competitiveness of Japanese enterprises.

(5) Other legislative purposes may be conceivable. For instance, the United Kingdom's reform proposal stressed the policy objective of supporting and enhancing the UK's competitive position as an attractive location for businesses to locate and invest.[23] However, Japan's exemption was not made out of consideration of this aspect.

4. **Influence on Other Tax Regimes**

(1) Indirect Foreign Tax Credit

In exchange for the creation of the foreign subsidiaries' dividends exclusion, the indirect foreign tax credit has been repealed. It is not necessarily logical to repeal the indirect foreign tax credit system in exchange for the introduction of the foreign subsidiaries' dividend exclusion. A possible explanation for the repeal is that the tax revenue loss to be caused by the introduction of the exclusion can be compensated for by the tax revenue increase that repealing the indirect foreign tax credit may bring about. The new exclusion system is tailored to replace the indirect foreign tax credit. This may be the unique feature of Japanese foreign subsidiaries' dividends exclusion.

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[22] *Supra* note 3 at 61.

[23] HM Revenue & Customs, Taxation of the Foreign Profits of Companies: Draft Provisions December (2008) 1-2.

(2) Specified Foreign Subsidiaries

Under the prior Specified Foreign Subsidiaries (Controlled Foreign Corporations) regime, a Specified Foreign Subsidiary's profits were excluded from the profits to be included in the income of the Japanese parent corporation if they were paid out as dividends at the end of the tax year in which the profits accrued.[24]

Since the earnings of a Specified Foreign Subsidiary will be excluded income of its Japanese parent corporation when distributed as dividends, it is necessary to include such earnings in the Japanese parent corporation's income even if they are distributed as dividends in order to prevent double non-taxation. This change has a harsh result for a Japanese corporation using a Specified Foreign Subsidiary because the current income taxation of the Specified Foreign Subsidiary at the level of the Japanese parent corporation cannot be avoided even if the Specified Foreign Subsidiary distributes its profits to the Japanese parent as dividends.

This is an unexpected adverse collateral consequence of the new regime for Japanese parent corporations. It is interesting to note that the introduction of the United Kingdom's participation exemption system is accompanied by a similar consequence.

On the other hand, another change that results is that the dividend income that a Specified Foreign Subsidiary receives from another Specified Foreign Subsidiary is excluded from the income of the recipient Specified Foreign Subsidiary in order to avoid double counting.

5. Remaining Issues

The Japanese system of foreign subsidiaries' dividends exclusion is amazingly simple, and there remain issues for the future.

(1) Portfolio Dividends

As the threshold for enjoying this exclusion is 25% or more of the issued shares, the exclusion system does not apply to Japanese parent corporations holding less than the 25% threshold, and there is no way to alleviate the double taxation on the corporate income taxes foreign affiliated corporations pay. This situation will be applicable to the portfolio dividends and the cases of foreign joint venture corporations in which Japanese corporations holds less than 25% of their shares.

Although the situation had been the same before this exclusion system was introduced and when the indirect foreign tax credit system had existed, it will be a remaining issue whether Japanese corporations holding less than the 25% threshold should be granted the same exclusion treatment.

Especially in comparison with the UK participation exemption system in which all distributions from any size of shareholding in foreign corporations are exempted from

[24] CTLEO (former) art. 39-16, para. 1, item (ii).

the UK income taxation, it will be worth considering exempting such foreign dividends from Japanese income taxation.

However, it does not appear that at present the Japanese Government is interested in enlarging the exclusion. The indirect foreign tax credit system having the same threshold had existed for 47 years since 1962 without changing that threshold.

Also, if one of the primary purposes of this dividends exclusion system is to promote the international competitiveness of Japanese enterprises, the 25% restriction on shareholding will not hinder that purpose.

(2) Foreign Branch

It is a valid position that income of foreign branches of Japanese corporations should be similarly exempted from Japanese income taxation. The US President Advisory Panel on Federal Tax Reform similarly recommended in 2005 to exempt foreign branch income.[25]

However, Japan has not done so. The reason appears to be that if the foreign branch income is to be exempted, the allocation of deductible expenses would create a difficult problem and would make the exclusion system more complicated.[26] Thus, foreign branch income is fully subject to Japanese income taxation.[27] This exclusion system is adopted on the basis of the Japanese Government's determination that indefinite deferral at the foreign subsidiaries' level is in fact equivalent to tax exclusion, rather than its conscious decision to adopt the territorial taxation system.

(3) Anti-abuse

The new exclusion system does not provide for any anti-abuse mechanism, except for including the distributed profit of the Specified Foreign Subsidiary in its Japanese parent corporation as stated above. It makes a sharp contrast to the UK system of participation exemption which is laden with anti-abuse provisions.

The new system may be subject to various abuses as the exclusion is very attractive to any corporate taxpayers. The Ministry of Finance may need to deal with abusive uses of this system in the future.

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[25] *Supra* note 16 at 187.

[26] A remark of Mr. Takuji Tanaka in Panel Discussion, Tides of International Taxation – Centering on Movements around Tax Treaties – The Records of Tax Study Convention (Japan Tax Association 2008) at 93, 177.

[27] Foreign branch income is subject to the national Corporation Tax and the local Inhabitant Tax, but not to the local Enterprise Tax.

6. **Certain Theoretical Problems**

(1) Territorial Tax System

Japan employs the worldwide tax system under which Japanese corporations generally are taxed on all income whether derived in Japan or abroad.

Japan also has a deferral system in which income earned by foreign subsidiaries generally is subject to Japanese tax when the income is distributed as a dividend to the Japanese parent. The only exception to the deferral system is the Specified Foreign Subsidiary regime – the so-called CFC rules.

The introduction of the foreign subsidiaries' dividends exclusion brings Japan closer to adopting the territorial tax system, but not quite. Income derived by a foreign branch of a Japanese corporation is subject to Japanese taxation as before. Income earned by a Specified Foreign Subsidiary of a Japanese corporation is fully subject to Japanese taxation on a current basis whether or not such income is distributed as a dividend to the Japanese parent corporation as a result of a simultaneous change in the Specified Foreign Subsidiary regime. Also, dividends paid by foreign subsidiaries in which Japanese corporations have less than 25% ownership are fully subject to Japanese taxation when repatriated.

Even after the introduction of the foreign subsidiaries' dividends exclusion, the Japanese tax system falls short of the territorial taxation system.

It is too early to say that Japan has gone to the territorial tax system. However, Japanese tax system concerning foreign subsidiaries' dividends exclusion has become similar to that of many industrialized countries.

(2) Capital Export Neutrality

The worldwide tax system promotes capital export neutrality, and the territorial tax system promotes capital import neutrality.

It is clear that Japan has steered toward capital import neutrality, as the United Kingdom heads in the same direction.

Japanese corporations will have more freedom in planning the repatriation of foreign profits earned by foreign subsidiaries, which will increase the international competitiveness of Japanese enterprises. This foreign subsidiaries' dividends exclusion system will have the effect of promoting foreign direct investments by Japanese corporations in the long run. This may be the result achieved by introduction of the foreign subsidiaries' dividends exclusion system.

7. **The Future**

The Japanese Government has determined that the indefinite deferral system is equal to the exclusion system from practical perspectives and has decided to adopt a more simple exclusion system for the avoidance of international double taxation. However, it has not adopted completely a territorial tax system.

As the global economy advances, Japan cannot avoid being influenced by other countries' taxation trends in order to keep an international competitive edge for its enterprises. The adoption of the foreign subsidiaries' dividends exclusion is only an example of such trend. This trend will be seen not only in the foreign subsidiaries' dividends exclusion but also in corporate income tax rates, the CFC regime, interest allocation rules, transfer pricing rules, and others in the future.

This trend is conspicuous in the field of direct foreign investment. A greater emphasis is placed on capital import neutrality than on capital export neutrality. It may be natural from the viewpoint of promoting international competitiveness of Japanese enterprises.