Testimony of
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Hearing on
How Other Countries Have Used Tax Reform
To Help Their Companies
Compete in the Global Market and Create Jobs

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Chairman Camp, Ranking Member Levin, and Members of the Committee

My name is Gary Thomas. I am a partner in the law firm of White & Case LLP, based in its Tokyo, Japan office. Although I began my career after law school in the United States, I have worked in Japan now for nearly 30 years as a tax practitioner. I appear before you today on my own behalf and not on behalf of my firm or any firm client.

It is a privilege to have been invited here today to testify on how Japan has used international tax reform to assist its companies to compete in the global market, to revitalize Japan's economy by encouraging the repatriation of foreign profits to Japan, and to enhance increased employment opportunities in Japan. I believe that the Japan experience can be instructive for the Committee as it considers fundamental international tax reform for the United States.

Prior to April 2009, Japan's international tax system bore a remarkable resemblance to that of the United States. Japan imposed its corporate taxes on a global basis, including taxing dividends from foreign subsidiaries, while avoiding double tax by means of a foreign tax credit system. Japan deferred taxation of profits of foreign subsidiaries until repatriation but restricted deferral for profits of controlled foreign corporations operating in low-tax countries unless an active business exception applied. It had transfer pricing rules based upon the arm's length principle, broadly similar to the US rules under Section 482 and the OECD Transfer Pricing Guidelines.

The similarity with the US international tax regime was not surprising, because for the past 50 years, the US tax system had been the model for Japan in structuring its international tax rules.

However, on April 1, 2009, Japan moved to a territorial tax regime by adopting a foreign dividend exemption system, pursuant to which 95% of the dividends received from qualified foreign subsidiaries will be exempt from Japanese national and local corporate taxes. At the same time, Japan abolished its indirect foreign tax credit system.

Why did this substantial change occur? There were a number of key reasons.

First, the Japanese Government concluded that it was vital to encourage the repatriation of profits of foreign subsidiaries in order to assist in revitalizing Japan's economy. There had been a significant increase in profits retained overseas by foreign subsidiaries of Japanese corporations in recent years, but Japan's tax regime resulted in the imposition of additional Japanese corporate taxes upon repatriation of those profits, thereby creating a clear disincentive to repatriate. It was felt that a failure to repatriate these profits to Japan raised the risk that R&D activities and jobs would be shifted overseas, while the repatriation of the profits would encourage investment in R&D and capital as well as job growth within Japan.

Second, policy-makers recognized that maintaining the competitiveness of Japan's multinational enterprises in the global marketplace would ultimately lead to additional investments and job creation within Japan and to the promotion of Japan's economy, and that eliminating bias in capital flows within corporate groups was critical for this purpose.

Third, the Government was deeply concerned about the increasing compliance burdens imposed by the indirect foreign tax credit system. The adoption of the foreign dividend exemption system together with the abolition of the indirect foreign tax credit would relieve Japanese companies of these burdens. In particular, small and medium Japanese companies increasingly are required by market demands to establish additional operations in other countries in Asia, so reducing these compliance burdens was viewed as particularly important.

It is noteworthy that, in adopting the foreign dividend exemption system, Japan explicitly rejected "capital export neutrality" as a key guiding principle in the new global business environment. Although this principle had been imported from the United States 50 years ago, the position of the foreign tax credit approach based upon capital export neutrality was characterized as "having declined" while the era of the United States as the dominant capital-exporting country in the world was ending.

In considering this new tax regime, Japan did not ignore the potential downside of adopting the foreign dividend exemption system. In particular, the Government was worried about the possible "hollowing out" of Japan's economy and the shifting of jobs overseas. But the Government accepted as unavoidable the reality that growth in foreign markets will be significant as compared to Japan, particularly taking into account relative population growth. As a result, Japan's policy-makers concluded that it is inevitable that Japanese companies will need to continue to establish manufacturing sites and other facilities in these growing markets. However, the Government concluded that the adoption of a foreign dividend exemption system itself would not unduly influence corporate decisions as to whether to establish or move operations overseas.

Nevertheless, the Japanese Government implemented, and continues to study, a number of design features in order to cope with the risk of the shifting of profits, assets and jobs overseas. It is important to note, however, that Japan opted to move ahead quickly to adopt its new international tax regime, while continuing to monitor and improve this system over time. As some of you may know, “kaizen” is a highly regarded business practice in Japan that focuses upon the continuous improvement of processes in manufacturing, engineering, operations, and management. The approach adopted for these recent tax reforms could be called a kind of “kaizen” in the tax field.

Consequently, for example, although Japan did not make changes to its transfer pricing rules in 2009, in 2010 it adopted into law a rigorous set of transfer pricing documentation requirements, for which a failure to comply shifts the burden of proof to the taxpayer. In 2011, the Government proposed amendments to Japan’s transfer pricing rules which would adopt the “most appropriate method” rule (in place of the earlier priority of methods) for selecting a transfer pricing method. This change is expected to make it easier for the Government to sustain transfer pricing assessments if necessary.

In addition, although not directly a Japan development, in July 2010 the OECD issued updated transfer pricing guidelines which include a new chapter concerning so-called “business restructurings” that could cover, for example, outbound transfers of intangible property. The Japanese tax authorities are currently studying these new guidelines very closely with the intention of applying them going forward.

Furthermore, in recent years, Japanese field examiners have sometimes applied so-called “donation” rules, which deny deductions for, or impute income to, corporate taxpayers, in order to deal with certain cross-border transactions which, in their view, may be difficult to address effectively with transfer pricing regulations. The criteria for applying these donation rules are quite vague, leading to considerable uncertainty for any taxpayer planning an outbound transfer of a business or intangible property. This enforcement development can have a chilling effect on potentially abusive transactions.

Another recent development has been the expansion of Japan’s tax treaty network and the conclusion of a number of tax information exchange agreements with non-treaty countries (including well known tax havens), with the intention of improving the ability of tax examiners to obtain foreign-based documentation in order to more effectively apply the transfer pricing rules.

Japan also has adopted changes to its controlled foreign corporation rules. In particular, in a departure from its historical entity approach to computing CFC profits subject to deferral, in 2010, Japan adopted measures to deny deferral for certain passive income of a CFC, even if the CFC otherwise is qualified for exemption under active business criteria.

A reduction in domestic corporate tax rates is another measure to reduce the incentive for income shifting under a territorial regime. In 2011, after carefully considering the trend among other OECD members as well as Japan’s neighboring countries in Asia to reduce corporate tax rates, the Government proposed a reduction in the overall corporate tax burden from approximately 40.7% to 35.6% (combining national and local rates). This proposal was headed for approval in the National Diet at the time of the March 11 earthquake but is now in political limbo along with the other 2011 tax reform proposals.

Nevertheless, it is anticipated by many that, at some point in the near future, the corporate tax burden will be reduced as originally planned.

The Government continues to evaluate potential measures to reduce the risk of outbound transfers of intangible property, while encouraging R&D and related job growth within Japan. For example, it is reported that potential relief for at least some types of royalty income is being closely reviewed.

Expense allocations are often raised as a concern for the introduction of a territorial tax system. As I noted earlier, Japan's foreign dividend exemption system grants an exemption for 95% of the dividends received, leaving the remaining 5% subject to taxation. This 5% is viewed as a proxy for the costs incurred to obtain and hold shares of foreign subsidiaries.

It is difficult to determine whether the changes have achieved or will achieve the objectives sought because the new regime went into effect only recently. However, preliminary data suggests that the repatriation of profits from overseas has increased considerably. For example, the Government has reported that dividend remittances increased 20% from 2009 to 2010.

In addition, reportedly, many Japanese companies have plans to increase their repatriation of profits, largely for investments in R&D and capital assets but also for repayment of debt to improve their capital positions. The recent disaster in Japan will likely make it even more imperative for many companies to repatriate profits from their foreign subsidiaries in order to fund the rebuilding of their Japan operations. However, they can now do so with considerable flexibility as their needs develop, without fear of an additional Japanese tax burden or possibly adverse indirect foreign tax credit implications.

Conclusion

With the adoption of its foreign dividend exemption system in 2009, Japan dramatically shifted direction in its international tax policy in order to encourage the repatriation of profits to further stimulate its economy, to enhance the competitiveness of Japanese multinational enterprises, and to reduce compliance burdens and costs for taxpayers.

I appreciate the opportunity to explain Japan's new tax system and hope that my remarks will be useful for the Committee in its deliberations concerning the future of the US international tax rules.

Finally, as a tax practitioner working in Asia, I have seen first hand how nimbly America's competitors can operate within their territorial tax systems, at the same time that US corporations struggle to deal with the very complicated and burdensome US worldwide tax regime. Your review of the US tax rules, while difficult and undoubtedly controversial, is therefore extremely important. Thank you.