PUBLICATION

Japan Exempts Foreign Subsidiary Dividends from Corporate Taxation

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A new Japanese tax exemption for dividends paid by foreign subsidiaries became effective for fiscal years beginning on or after April 1, 2009. That provision, which is part of various 2009 tax reform initiatives considered by the Japanese government, is designed to encourage repatriation of profits earned by foreign subsidiaries of Japanese domestic corporations. In calculating its Japanese corporate taxable income, a Japanese corporation may now exclude from such calculation 95% of the dividends received from its foreign subsidiaries.

For purposes of this exemption, a foreign subsidiary means a foreign corporation, other than those in a tax haven country, where at least 25% of the outstanding stock is owned by a Japanese domestic corporation for at least six months before the dividend declaration date. Foreign withholding taxes on these dividends are nondeductible expenses, and the direct foreign tax credit does not apply for exempt dividends.

The new exemption is intended to stimulate the Japanese economy by encouraging companies to repatriate earnings and invest the funds domestically in equipment, infrastructure, and research and development. Because the Japanese corporate tax rate is fairly high, some Japanese corporations may previously have preferred to retain earnings in their overseas subsidiaries rather than to repatriate the earnings at a high tax rate. This foreign dividend exemption may work to neutralize that preference. When the United States enacted similar legislation in 2005, Congress limited the repatriation period to 12 months. The Japanese exemption provision does not include a similar limitation.

It is too early to determine whether the foreign dividend exemption will significantly affect Japanese companies' inclination to repatriate earnings. Because of volatility in the world financial system, some Japanese companies may desire to leave a cushion of liquidity in certain overseas markets.