

Territorial Tax System Reform and Financial Behaviors of Multinational Firms

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Summary

We investigate whether the move from the worldwide tax system to the territorial tax system in Japan in 2009 affects the financial behavior of overseas affiliates of Japanese multinational companies. The reform substantially reduces the tax costs of profit repatriation in the form of dividends for Japanese overseas affiliates. We use this reform as a quasi-natural experiment to investigate whether and how the tax system affects multinationals' cash holding and financing policies. Findings from our study sheds some light on possible outcomes of similar tax reforms in countries such as the United States.

Based on a sample of Japanese overseas affiliates located in both Europe and Asia, we do not find a robust link between the tax costs of dividend repatriation and the cash-asset ratio for Japanese overseas affiliates before the territorial tax system reform. Moreover, we do not find that Japanese overseas affiliates reduced their cash-holdings since the territorial tax reform, no matter whether they are located in countries with high tax costs of repatriation or in countries with low tax costs of repatriation. We further conduct Difference-in-Differences analysis to compare Japanese overseas affiliates with similar US overseas affiliates located in the same host countries. The comparison between the Japanese and US overseas affiliates are reasonable as the tax system on foreign profits were similar in the two countries before Japan moved to the territorial tax system. We do not find significant difference in the cash-holding patterns and capital structures between Japanese and similar US overseas affiliates. While the territorial tax system reform did not change multinationals' financial behavior during our sample period, the reform can enhance the competitiveness of Japanese firms in foreign countries by reducing their tax burden of repatriation.