How do International Tax Systems Influence Multinational Corporations' Income-shifting and Dividend Strategies?

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ABSTRACT : This study tests the effects of international tax systems on multinational corporations' income-shifting and dividend strategies. The empirical results of the study yield three main findings. First, there is no substantial difference in the level of income shifting between foreign affiliates subject to the territorial system (territorial affiliates) and those subject to the worldwide system (worldwide affiliates). The high tax incentives of U.S. multinationals for income shifting are considered a potential factor in this result. Second, compared to worldwide affiliates, territorial affiliates remit more earnings to their parents as dividends because their dividends are exempt from repatriation taxes. Specifically, territorial affiliates pay, on average, 29.1 percent more of their earnings as dividends compared to worldwide affiliates. Lastly, territorial affiliates pay more dividends as more income is shifted in, whereas worldwide affiliate pay less dividends. The last finding implies that territorial affiliates attempt to avoid home-country taxes by shifting income to lower-tax-rate affiliates and repatriating the income to their parents. By contrast, worldwide affiliates shift income to lower-tax-rate affiliates and hold the income overseas to defer home-country taxation. The results are generally supported by a series of supplementary tests.

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I. INTRODUCTION

A multinational corporation (MNC) is a group of firms that operates in more than one country. Because MNCs operate in various regions with different tax laws and treaties, they have more diverse options for tax planning compared to domestic corporations. Accordingly, multinational tax planning has attracted much attention from academics, practitioners, tax authorities and policymakers. This study examines the effects of international tax systems on the tax planning of MNCs.

International tax systems are broadly divided into two categories depending on how the foreign earnings of MNCs are taxed: territorial and worldwide systems. In countries adopting the worldwide system, the dividends received by parent companies from their foreign subsidiaries are taxed at the home-country tax rate. A credit is granted for any foreign taxes paid on the same income in overseas countries to prevent double taxation between countries.\(^1\) By contrast, parent companies established in countries adopting the territorial system exempt the full or a significant portion (e.g., 97 percent or 95 percent) of dividends received from foreign subsidiaries.\(^2\) The problem of double taxation does not arise in the territorial system.\(^3\)

Most countries once employed the worldwide system, but in the 2000s, a number of countries moved to territorial systems.\(^4\) After two G7 countries -

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1) The worldwide system taxes the aggregate amount of domestic and foreign source income at the domestic tax rate and then deducts the amount of foreign taxes. For this reason, the worldwide system is also referred to as a credit system (method).
2) The territorial taxation system is also referred to as an exemption system (method).
3) The present study classifies taxation systems (i.e., worldwide vs territorial) solely based on the treatment of dividends received from foreign affiliates. In reality, most countries adopt hybrid systems because they apply different taxation systems to dividends and other types of income. For example, in spite of its transition to the territorial system in 2009, Japan still applies the worldwide taxation system on income other than dividend income.