

# Japan tax bulletin

Quarterly newsletter on important tax and business developments in Japan  
**July 2009**

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### International taxation under 2009 Tax Reform

The 2009 Tax Reform was disclosed on March 31, 2009. The main part of the 2009 Tax Reform in relation to international tax is an introduction of non-taxable dividend from foreign subsidiaries. Foreign tax credit system and CFC rules were also amended accordingly. The 2009 Tax Reform will significantly affect multinational companies with foreign subsidiaries abroad and provide an opportunity to discuss the restructuring of the foreign subsidiaries from the point of dividend back-flow to such companies.



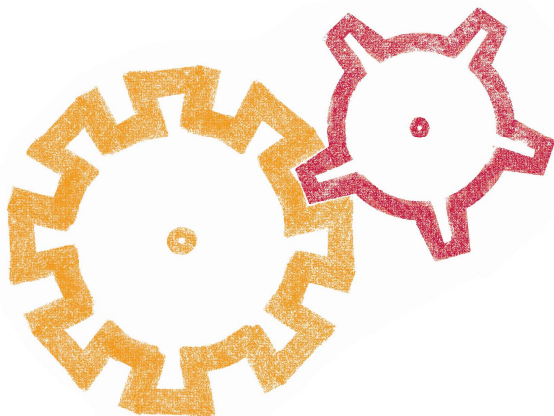
# Exemption of foreign dividends

## 1) Non-taxable dividend from foreign subsidiaries

Under the 2009 tax reforms, a dividend received by a Japanese company from a foreign subsidiary in which the Japanese company has held at least 25% of the outstanding shares for a continuous period of six months or more ending on the date on which the dividend is declared can be excluded with deduction of expense amount (5%) from the Japanese company's taxable income. (Corporation Tax Law 23-2(1), Corporation Tax Law Enforcement Order 22-3 (1), (2))

In applying the new rule, the non-taxable dividend amount (i.e. 95% of the entire amount) and the details of calculation need to be described on the return. The company is responsible to preserve the related documents. (CTL 23-2(2))

If a tax treaty stipulates a specific ratio of shareholding of a foreign subsidiary (i.e. if the ratio is different from general ratio of shareholding 25% above), a determination must be made as to whether the foreign dividend exemption can be applied under the rules of the applicable tax treaty. (CTLEO 22-3(4)) For example, it is reduced to 10% under the Japan-US and Japan-Australia Tax Treaty.



## 2) Non-deductible foreign tax on dividend paid by foreign subsidiaries

Withholding tax on dividends from foreign subsidiaries is a non-deductible expense for tax purposes when the foreign dividend exemption is applied. (CTL 39-2)

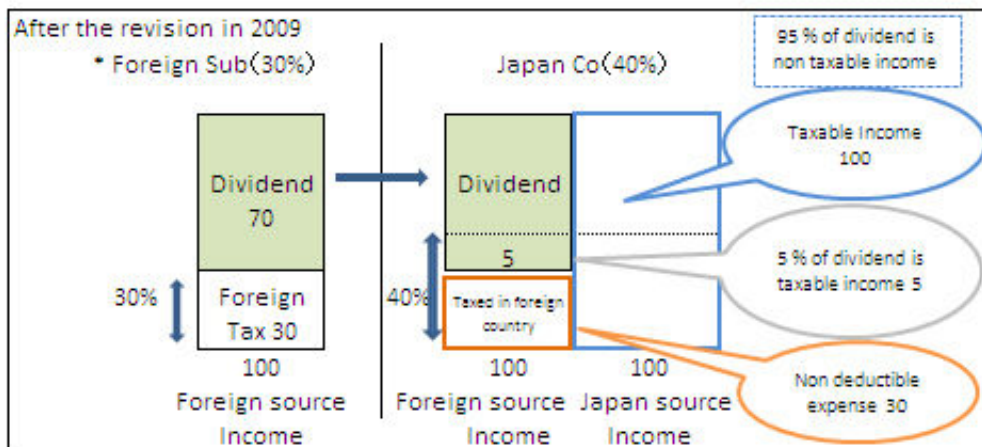
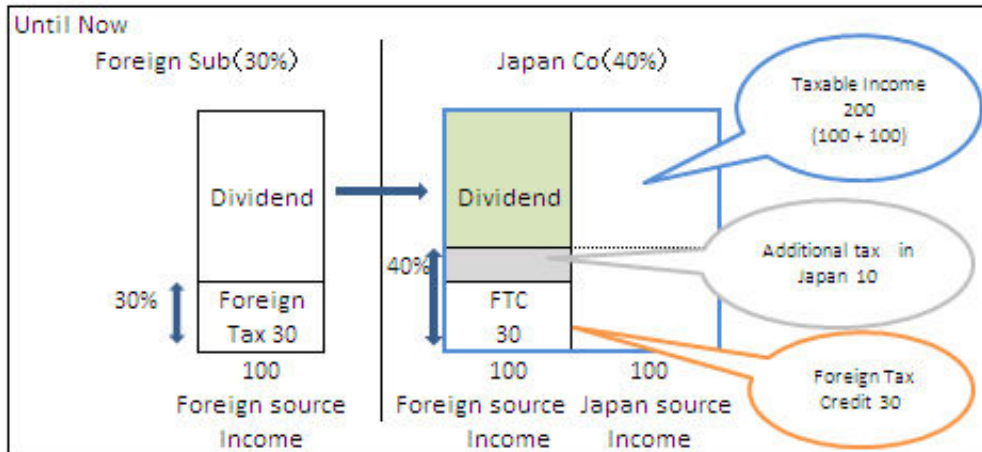
## 3) Timing of commencement

The foreign dividend exemption will apply to eligible dividends received during fiscal years starting April 1 2009 or later. Withholding tax on dividends from foreign subsidiaries will be treated as a non-deductible expense for tax purposes for fiscal years starting April 1 2009 or later.

## 4) Comments

Murata Manufacturing Company Ltd., a Japanese multinational headquartered in Kyoto, released an increase of net profit for the fiscal year March 2009 on January 31, 2009. According to the press release, the increase is a result of the reversal of deferred tax liability recognized in the past years due to the introduction of non-taxable dividend from foreign subsidiaries. Companies which have recognized deferred tax liability for future taxation on dividends from foreign subsidiaries may be able to reverse the liability and recognize an additional net profit for accounting purposes.

Non-taxable dividends from foreign subsidiaries may give multinationals an incentive to locate foreign operations in lower tax rate jurisdictions to take the advantage of the new system. Because of this, the NTA may need to strengthen CFC rules and Transfer Pricing rules applying to Japanese multinationals.



Source: METI

\* Foreign subsidiary:

Over 25% shares owned for more than 6 months continuously since the dividend payment date.

## International taxation under 2009 Tax Reform

# Foreign Tax Credit

Because of the introduction of the exemption of foreign dividends, the indirect foreign tax credit system was abolished under the 2009 Tax Reform. Foreign withholding tax on dividends excluded from the Japanese company's taxable income is no longer eligible for direct foreign tax credits (CTLEO 142-3(7)(3)). Such withholding tax is not allowed as a deductible expense for corporate tax purposes as mentioned above.

For a company with a branch in a foreign jurisdiction, the profit earned by the branch is subject to Japanese taxation. A foreign tax credit is available for taxes paid in the foreign country. Depending on the corporate tax rate and withholding tax rate in the foreign country, it may be worth considering conducting business through a subsidiary rather than a branch.

# Tax Haven rules

## 1) Dividend paid by CFC

Previously, when a CFC made a distribution of dividends out of undistributed earnings previously subject to CFC rules, the recipient Japanese company could take a deduction for the distribution when computing taxable undistributed income for CFC rule purposes. This was a measure to avoid double taxation.

Under the new dividend exemption rules, a deduction for distributions of undistributed income of a CFC previously subject to CFC rules are no longer allowed as the distributions are exempt under the foreign dividend exemption. (Special Taxation Measures Law 66-6 (1), (2))

If a Japanese company receives a dividend from a CFC to which the foreign dividend exemption is not applicable (due to less than 25% shareholding, etc.), the dividend is excluded from the taxable income to the extent of the previously taxed earnings. (STML 66-8(1)) If a Japanese company receives a dividend from a CFC to which the foreign dividend exemption is applicable, expense deduction (5% of the dividend) does not have to be considered to the extent of the previously taxed earnings so that this can result in a 100% tax exemption. (New STML 66-8(2)) In order to avoid double taxation on the undistributed income of the CFC and 5% of the dividend paid from the taxed undistributed income, the dividend is fully exempted from the taxable income in Japan.

## 2) Dividend received by CFC

Previously, distributions which a CFC receives from other foreign subsidiaries constitute taxable undistributed income for CFC rule purposes.

Under the new rule, distributions which a CFC receives from other foreign subsidiaries do not constitute taxable undistributed income for CFC rule purposes.

A dividend paid by other foreign subsidiary of CFC to a CFC that has held 25% or more of the shareholding of the foreign subsidiary for a continuous period of six months or more ending on the date on which the dividend is declared, is deductible from the undistributed income of the CFC.

(Special Taxation Measures Law Enforcement Order 39-15 (1)(4))

If such dividend is included in the undistributed income of the CFC, the dividend would be subject to Japanese taxation as a result. In order to maintain a balance with the case where the Japanese parent receives the dividend directly from the subsidiary of the CFC, the dividend received by the CFC is deductible from the undistributed income of the CFC.



# Investment Limited Partnerships:

## Changes affecting PE determination

Under the previous rules for investment limited partnerships (*toushi jigyou yugen sekinin kumiai*), a non-resident partner is deemed to have a permanent establishment (PE) in Japan if the general partner of the partnership is located in Japan and carrying out the operation of the partnership, with the result that certain income of the non-resident partner will be subject to taxation in Japan. Under the 2009 reforms, for PE determinations made on or after April 1, 2009, a non-resident partner satisfying the following conditions will be treated as an individual or corporation who does not have a PE in Japan (STML 41-21(1)):

1. The partner is a limited partner of the partnership;
2. The partner does not carry out the operation of the partnership;
3. The partner has less than a 25% interest in the partnership assets;
4. The partner does not have a special relationship with a general partner of the partnership; and
5. The partner has no PE in Japan with respect to another business.

As a result, the non-resident partner who is applicable to this new rule will not have to file a tax return in Japan in most cases except for the case where it is a real property holding company or it falls "25/5" rule below.

Please note that an investment limited partnership (*toushi jigyou yugen sekinin kumiai*) is a vehicle organized under Japanese law. Further, most of the fund vehicles are foreign vehicles. Unless the new rule is applicable to foreign vehicles similar to *toushi jigyou yugen sekinin kumiai*, there will be no benefits to foreign investors.

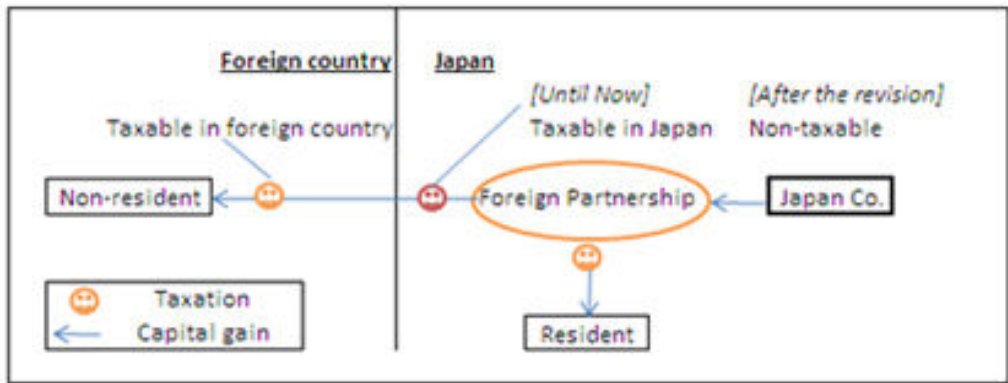
## Capital Gains Exemption

Under the previous '25/5' rule, a non-resident investor is subject to Japan tax on capital gains from the sale of shares in a Japanese company if the investor (a) owned 25% or more of the company's shares during the year of sale or the preceding two years; and (b) sells 5% or more of the company's shares during any one fiscal year. Since reforms introduced in 2005, the holdings of a non-resident investor making an investment through a partnership are aggregated with holdings of the other partners when determining if the non-resident investor meets these thresholds.

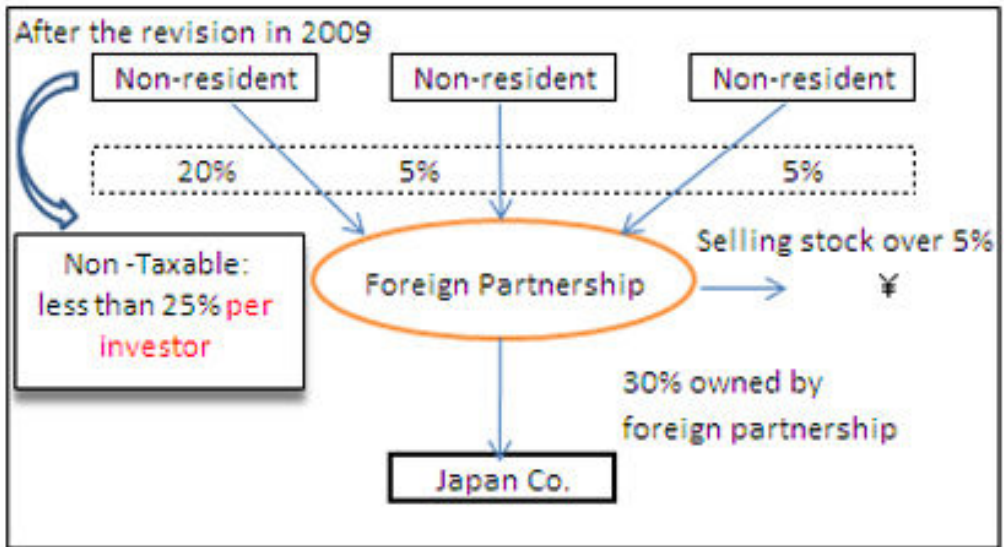
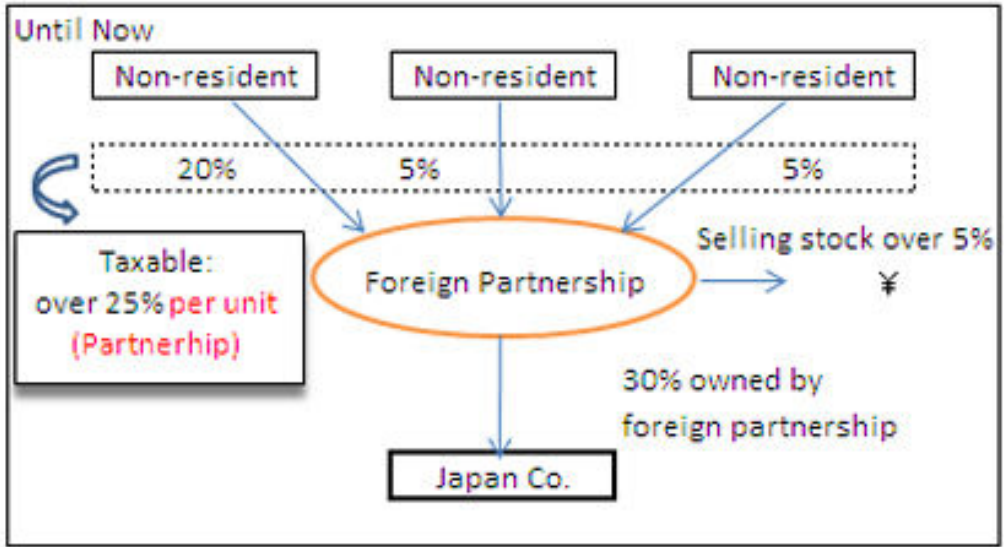
Under the reforms, with respect to sales of shares made on or after April 1<sup>st</sup>, 2009 by investment limited partnerships (or foreign equivalent) who satisfies the conditions 1-5 (noted above), the holdings of a non-resident investor making an investment through a partnership will not be aggregated with the holdings of the investor's partners for purposes of determining the 25/5 thresholds if the non-resident investor satisfies the following conditions (STML 39-33-2(1)):

6. The non-resident partner is a limited partner for the period of the partnership agreement in previous three years;
7. The non-resident partner does not carry out the operation of the partnership for the period of the partnership agreement in previous three years; and
8. Each non-resident partner of the partnership owns less than 25% of the shares in question at anytime in previous three years.

Sales of shares held for less than a year or sales of shares in certain distressed financial institutions will not be covered. (STML 39-33-2-(2), 26-31(3))



Source: METI



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