

# Japan tax bulletin

Newsletter on tax and business developments in Japan

May 2010

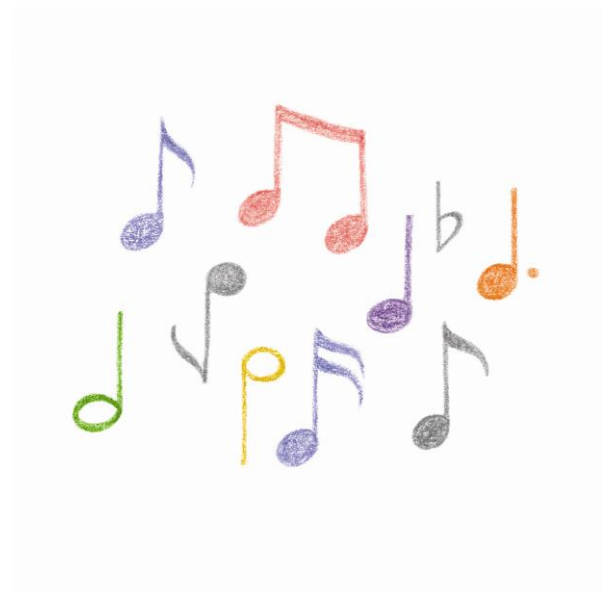
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## In this issue

### 2010 Tax Reform

The 2010 tax reforms were adopted by the Japanese Diet on March 31th, 2010. The reforms are substantially unchanged from the proposals introduced in December of 2009. The following is a summary of the most significant changes.

1. Group taxation system
  - Tax deferral for certain intra-group asset transfers
  - Loss denial on intra-group share redemptions
  - Relaxation of certain group tax consolidation rules
2. Tax haven rules
3. Transfer pricing audits



# Group taxation system

Changes introduced to the group taxation system affect companies belonging to a wholly owned group. Transactions between Japanese subsidiaries wholly owned by the same foreign parent are subject to the group taxation rules. Transactions between a Japanese subsidiary and its foreign parent are out of scope. Certain changes only apply if companies have elected to file consolidated returns.

## 1. Deferred taxation of gains or losses made on intra-group asset transfers

Effective for transactions that take place on or after October 1st, 2010, taxation will be deferred on gains or losses resulting from transfers of certain assets between companies belonging to the same wholly-owned group. If the assets are later transferred outside the group, the gain or loss will be recognized by the company that originally made the transfer.

## 2. Donations

Intragroup donations<sup>1</sup> will no longer be taxable income for recipients and will no longer be deductible for donors. Prior to the reform, this was already so for groups filing consolidated returns. For groups not filing consolidated returns, donations were deductible up to a limited amount. Effective for transactions taking place on or after October 1st, 2010.

## 3. Dividends in kind

Taxation will be deferred on gains or losses from dividends in kind distributed between companies within the same wholly owned group. Withholding taxes will no longer be imposed. Effective for transactions taking place on or after October 1st, 2010.

## 4. Dividends

The reforms make intragroup dividends fully exempt from inclusion in recipient's taxable income. This treatment is the same as the treatment for taxpayers filing consolidated returns. Previously dividends were not included in income only after the exclusion of attributable interest expense. The new treatment is effective for dividends recognized in fiscal year starting on or after April 1<sup>st</sup>, 2010.

## 5. Share repurchases

If a company (subsidiary) repurchases shares from another company (parent) within the same wholly owned group, the parent will not be allowed to recognize a gain or loss if the repurchase price includes a deemed dividend. Prior to the reform it was possible for a company to receive a tax exempt dividend and at the same time deduct a capital loss. Effective for repurchases taking place on or after October 1st, 2010.

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<sup>1</sup> 'Donation' in the context of Japanese tax law refers to any benefit conferred on another party without receiving arm's length consideration.

## 6. Small and medium sized companies

Certain tax benefits<sup>2</sup> are given to companies with capital below JPY 100M. The reforms require that when determining whether such benefits are available to a subsidiary within a wholly-owned group, the capital amount of the subsidiary's parent must also be considered. If the parent has paid-in capital at or above JPY 500M, the benefits will not be available. Effective for fiscal years starting on or after April 1<sup>st</sup>, 2010.



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<sup>2</sup> Such benefits include (a) reduced corporate tax rate of 18% applied to taxable income not exceeding 8M yen; (b) application of statutory percentages for bad debt reserve; (c) partial deductions for otherwise non-deductible entertainment expenses; (d) availability of loss carry backs.

# Tax Haven Rules

Japan's tax haven rules designate a specified foreign subsidiary (or "SFS") to be any foreign corporation located in a jurisdiction where corporate income tax is 25% or less that is more than 50% owned, directly or indirectly, by Japanese residents.

If a Japanese resident individual or corporation owns 5% of the stock of such a subsidiary, or is a member of a group of affiliates that collectively owns 5%, the taxpayer is required to include its prorated share of the taxable retained earnings of the SFS in its income for Japan tax purposes.

Because the tax haven rules are not intended to apply to subsidiaries with legitimate business activities, income of an SFS that meets each of the following conditions is exempt from the income aggregation requirement:

## a. Business purpose requirement

The main business of the SFS must be other than holding debt or equity securities, licensing intellectual property rights, or leasing ships or aircraft.

## b. Substance requirement

The SFS must have a fixed business facility in the jurisdiction where its head office is located, and the facility must be necessary for the subsidiary to conduct its main business.

## c. Local management and control requirement

The SFS must itself manage and control its main business in the jurisdiction where its head office is located.

## d. Unrelated persons requirement, or local business requirement

If the main business of the SFS is wholesale trade, banking, insurance, or a similar business, more than 50% of the business must be conducted with unrelated persons. If the main business of the subsidiary is retail, manufacturing, services, real estate, leasing of property, construction, agriculture, forestry, or a similar business, the subsidiary must conduct its main business within the jurisdiction where its head office is located.



The 2010 reforms introduced changes to the holding threshold, the minimum effective tax rate, the business purpose requirement, and the requirement to deal with unrelated persons. Additionally, the reform made certain types of passive income subject to the aggregation regardless of whether the SFS meets the exception conditions. These changes, summarized below, are effective for fiscal years that start on or after April 1st, 2010.

#### 7. Increased minimum holding threshold

If a Japanese company does not hold at least 10% (directly or indirectly) of the SFS, the anti-avoidance rules do not apply. Prior to the reforms this holding threshold was 5%.

#### 8. Decreased threshold tax rate

The reforms reduce the minimum effective income tax rate that will result in being classified as an SFS from 25% to 20%. This will benefit foreign subsidiaries located in China, Vietnam, and certain other Asian countries with effective tax rates above 20%, but at or below the former minimum effective tax rate of 25%.

#### 9. Changes to application of SFS exception tests

One issue to date has been that a company that receives a majority of its income from dividends may not satisfy the business purpose test even though it conducts a substantive business. The reforms clarify that if the SFS meets the definition of a regional headquarters company (“RHQ”), its shareholdings in a controlled company (“CC”) not be considered for purposes of determining whether it meets the requirements of the business purpose test. Similarly, the reforms state that when applying the unrelated persons test, transactions between an RHQ and its CCs will not be considered as transactions with related persons.<sup>3</sup>

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<sup>3</sup> An SFS qualifies as an RHQ if (i) 100% of its shares are held (directly or indirectly) by a Japanese company; and (ii) it holds at least 2 CCs and carries on certain regional activities to manage the CCs’ business; and (iii) it has a fixed place of business and employees in the country

Japanese parent of an RHQ are also required to disclose certain information about the RHQ on the Japanese parent’s tax return.

#### 10. Passive income

The reforms introduce rules whereby the parent of an SFS is required to aggregate the following types of passive income earned by the SFS even where the exception conditions described above are met:

- a. Dividends from shares where the SFS holds less than 10%, and capital gains from sale of shares through exchange trades or OTC transactions where SFS holds less than 10%.<sup>4</sup>
- b. Bond interest and capital gains on exchange traded or OTC bond sales.<sup>5</sup>
- c. Royalties from industrial property rights or copyrights (excluding royalties from rights in property or works that were invented or developed by the SFS).
- d. Income from leasing of vessels or aircraft.

The amount of taxable passive income may not exceed the taxable income of the SFS.

Additionally, the passive income aggregation rules will not apply if (i) total passive income of the SFS is no greater than 5% of the SFS’s pre-tax profits; or (ii) gross passive income of the SFS does not exceed JPY 10M.

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where the SFS’s head office is located. A foreign company is a CC if (i) at least 25% of its shares and voting rights are directly held by an RHQ; and (ii) it carries on substantive business in the country where its head office is located. Condition (i) only applies if the foreign company is a related party within the context of the unrelated party test described above.

<sup>4</sup>This does not apply if the income is derived by the SFS through activities that are “fundamental, essential, and important” to the business.

<sup>5</sup>This does not apply if the income is derived by the SFS through activities that are “fundamental, essential, and important” to the business.

# TP documentation

The 2010 tax reform included changes to Japan's transfer pricing rules, amending Article 6 of Special Taxation Measures Law Article 66-46, and Special Taxation Measures Law Enforcement Order Article 22-10.

STML 66-4 Article 6 affords the NTA greater flexibility to make adjustments if a taxpayer, in response to an NTA request, fails to provide documents which are recognized by the NTA to be "necessary for the purpose of computing the arm's length price". To date, however, the documents "necessary for the purpose of computing the arm's length price" were specified only in the Commissioner's Directive on the Operation of Transfer Pricing, referred to as the "Administrative Guidelines".

The 2010 reforms have incorporated sections 2-4 (2) and 2-4 (3) of the Administrative Guidelines into Enforcement Order 22-10, with the addition of a requirement that a taxpayer using the profit split method provide documents to support their apportionment of income between the taxpayer and the foreign affiliate. These changes give legal effect to what to date had been only an administrative guidance. These document requirements appear in revised EO 22-10 as follows:

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6 Article 7 of STML 66-4 was changed to Article 6 in the 2010 reform. STML 66-4 Article 6 became STML 66-4 Article 5. And former STML 66-4 Articles 4 and 5 were combined into STML 66-4 Article 4.

## 1. Documents showing details of the transaction with the foreign related person

- i. Documents detailing the assets or services that are the subject of the transaction with the foreign related person;
- ii. Documents containing the functions performed or risks assumed by the taxpayer and the foreign related person with respect to the transaction with the foreign related person;
- iii. Documents detailing any intangible property used by the taxpayer or the foreign related person in conducting the transaction with the foreign related person;
- iv. Contracts related to the transaction with the foreign related person, or documents outlining their contents;
- v. Documents showing pricing policies for payments made by or to the foreign related person, and documents showing details of the price negotiations;
- vi. The statement of profits and losses of the taxpayer and the foreign-related person with regard to the transaction with the foreign related person;
- vii. Documents that provide an analysis of the market related to the purchase or sale of assets or provision of services that are the subject of the transaction with the foreign related person;
- viii. Documents explaining the business strategy of the taxpayer and the foreign-related person;
- ix. If other transactions are closely connected with the transaction with the foreign related person, documents showing the details of such transaction.

## 2. Documents showing the calculation of arm's length prices

Documents explaining the selection of the calculation method of arm's length price and any other documents prepared by the taxpayer for calculating arm's length price;

- i. Documents showing the selection process of comparable transactions used and the details of the comparable transactions;
- ii. If the taxpayer has selected the profit split method, documents showing calculation of income apportionment between the taxpayer and the foreign related person;
- iii. If the taxpayer calculates arm's length prices by combining more than one transaction with a foreign related party, documents detailing each original transaction on which the calculation is based;
- iv. If adjustments are made to account for differences between tested and comparable transactions, documents detailing the adjustment method and reason for adjustment.



Contact us for any enquiry on our service.

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