Japan Tax Bulletin

2019 tax reform proposal in Japan - International Tax

February 2019

The 2019 tax reform proposal was released on December 21, 2018. This article summarizes the proposed changes, which are expected to affect international businesses.

1. *Earnings Stripping*

The earnings stripping rule will be amended to be more in-line with BEPS Action 4 – Interest Deduction. In the proposed rule, interest expenses paid to third parties will be included when considering the restriction on interest expense deductibility. Prior to the reform, only interest paid to related parties was subject to restriction. The deductible limit will be reduced to 20% of adjusted income, compared to 50% under the old rule. Additionally, the amount of net interest expense that is exempt from the rule will be increased from JPY 10 million to JPY 20 million, and a new exemption for 50% group companies will be introduced.

1.1 Net Interest expenses

The amount subject to restriction under the earnings stripping rule is the net interest expense. This is calculated as:

[(interest expense – non-qualifying interest expense) – interest income].

Non-qualifying expense includes:

- Interest expenses included in the tax base of recipients in Japan,
- Interest expenses paid to public corporations,
- Interest expenses on bond repurchase agreements,
- Interest expenses on bonds which are not held by a limited number of investors ("specified bond interests") to non-related persons, if the interest expenses are subject to withholding in Japan when paid, included in the taxable income of the recipients, or paid to public corporations.
- 95% or 25% of specified bond interests where bonds are issued in Japan or offshore if the above is not applicable.

1.2 Adjusted income amount

Before the 2019 reform, the adjusted income amount was:

Taxable income + tax loss deduction + excluded dividend income[1] + net related party expenses + depreciation + bad debt loss ± other adjustment items.

The 2019 reform, proposed that excluded dividend income is not added back when calculating the adjusted income amount. Further, the deductible limit is reduced from 50% to 20% of adjusted income amount.

1.3 Exemption

In the proposal, the exemption is increased to JPY 20 million of net interest expenses, which is currently JPY 10 million. Further, in the proposal, where the total net interest expense is 20% or less of the total adjusted income amount of a 50%-ownership domestic corporation group, the earnings stripping rule is not applicable on individual company basis.

2. *Transfer Pricing*

2.1 Transfer pricing rules for intangible property transactions

a. Definition of intangible property
The definition of intangible property for transfer pricing rule purposes is proposed to be made clear. Under the proposal, the definition of intangible property is broad and includes properties other than tangible properties and financial properties, for which arm's length payments are made when they are transferred, licensed or otherwise transacted.

b. Transfer pricing method for intangible property transactions
Where comparable transactions for an intangible property transaction cannot be identified, the discount cash flow method (DCF method) is proposed to be added to applicable transfer pricing methods.

c. Transfer pricing adjustments for Hard to Value Intangibles (HTVI)
In the proposal, the tax authority is allowed to correct taxpayer's taxable income by recalculating the arm's length price where the basis of forecast in computing an arm's length price for a specified intangible property transaction and its result differ.

A specified intangible property is an intangible property, which satisfies the all of the followings:

- To be unique and have material value,
- Its arm's length price is calculated based on forecasted revenue etc.,
- The forecast on which the calculation of the arm's length price based is uncertain.

[1] 20%-100% of dividend income from a domestic corporation is excluded from taxable income depending on the ownership ratio and 95% of dividend income from a 25% foreign subsidiary is excluded from taxable income.

Grant Thornton
An instinct for growth™

Where a taxpayer submits the documents in either (a) or (b) below within a certain period of being requested to do so, the transfer pricing adjustments are not applicable.

(a) (i) Documents describing the details of the forecasts on which the calculation of an arm's length price for a specified intangible property transaction is based.

(ii) Documents showing that the difference between the forecasts and the results are caused by disasters or equivalent and it was difficult to foresee the occurrence of them or the arm's length price was calculated taking the likelihood of the occurrence into account.

(b) Documents showing that the difference between the forecast of unrelated party revenue from the specified intangible transaction during the 5 year period from the first day of the business year when such revenue was first generated, and the actual revenue, does not exceed 20%.

2.2 Statute of limitation

In the proposal, the statute of limitations for correcting taxable income for corporation tax due to transfer pricing is extended from 6 years to 7 years.

2.3 Comparability adjustment

In relation to comparability adjustments for transfer pricing methods which refer to profit level indicators of comparable transactions, where adjustments cannot be made due to difficulty in quantifying comparability differences, adjustments may be made based on a method using an interquartile range.

3. CFC rules

3.1 Treatment of tax consolidation, pass-through entities in foreign jurisdictions

In the proposal, the treatment of tax consolidation, pass-through entities in foreign jurisdictions in applying the CFC rules has been made clear.

a. Attributable income amount of a full inclusion CFC
Under the Japan CFC rules, attributable income to Japan shareholders is calculated as follows:
Attributable income = base income of a full inclusion CFC for a fiscal year – tax losses in the 7 prior fiscal years – corporate income taxes paid or payable in the fiscal year.
The base income, which is taxable income of the CFC, can be calculated based either on the Japan corporation tax law or the local corporate income tax law with adjustments. The adjustments are made to ensure that attributable income calculated based on the tax laws of foreign jurisdictions is identical to that calculated based on the Japan tax laws.

The calculation of the base income of a CFC based on the tax laws of a foreign jurisdiction is made without regard to the tax consolidation and allocations of profits/losses from pass-through entities.

b. Tax burden rate
Where the tax burden rate of a CFC is 20% (30% for a specified CFC) or more, both full inclusion and partial inclusion are not applicable. The tax burden rate is generally calculated as:
Income tax expenses / (taxable income + non-taxable income under the law of the jurisdiction where the head office is located)
When calculating the denominator, again, tax consolidation and allocations of profits/losses from pass-through entities are ignored.
Income tax expenses are those imposed on taxable income calculated without regard to the tax consolidation and allocations of profits/losses from pass-through entities.

c. Foreign tax credit
When utilizing a foreign tax credit to avoid double taxation, the CFC's income taxes are those imposed on taxable income calculated without regard to the tax consolidation and allocations of profits/losses from pass-through entities.

3.2 Paper company

A paper company is a CFC, which does not satisfy both the substance test and management and control test of the economic activity tests, is a specified CFC [2] and its attributable income is fully attributed to shareholders in Japan unless the tax burden rate is 30% or more.

In the proposal, certain paper companies are excluded from the definition of a specified CFC.

a. Holding company

A holding company is excluded from being classed as a paper company if:

(i) 95% or more of the CFC's assets are equity investments in 25% or more subsidiaries and cash/bank deposits, and 95 % or more of its revenue consists of dividend income and interest income from those assets, or
(ii) The CFC's main business is (a) to hold share investments in specified subsidiaries, (b) is managed and controlled by a management and control company in the same jurisdiction as the holding company, (c) the management and control company performs indispensable functions in the businesses in the jurisdiction and (d) 95% or more of its revenue consists of dividends, capital gains from the investments in specified subsidiaries and interest income from bank deposits.

Specified subsidiaries are partial inclusion CFCs or a companies managed and controlled by a management and control company located in the same jurisdiction as the holding company.

---

[2] A Specified CFC includes a cash box company and a black-list company as well. A cash box company is a CFC whose passive income / total income > 30% and (securities + loan receivable + intangible properties)/total assets >50%. A black-list company is a CFC located in jurisdictions designated by the Ministry of Finance as uncooperative jurisdictions for information exchange.

A management and control company is a CFC which satisfies the economic activity tests and its officers and employees are engaged in operations necessary to conduct business in the jurisdiction.

b. Real property holding company
A real property holding company is excluded from being classed as a paper company if:

(i) The CFC's main business is (a) to hold real properties located in the same jurisdiction as the company and equity investments in specified subsidiaries, is (b) managed and controlled by a management and control company in the same jurisdiction as the real property holding company, (c) the management and control company performs indispensable functions in the businesses in the jurisdiction and (d) 95% or more of its revenue is from the real properties, the investments in specified subsidiaries and interest income from bank deposits, or
(ii) The CFC's main business is (a) to hold real properties located in the same jurisdiction as the company, which are used by a management and control company in the same jurisdiction, (b) the management and control company performs indispensable functions in the businesses in the jurisdiction and (c) 95% or more of its assets are the real property and cash/bank deposits and 95% or more its revenue is from those assets.

c. CFCs engaged in the development of natural resources or social infrastructure.
A CFC engaged in the development of natural resources or social infrastructure is excluded from being classed as a paper company if:
(i) its main business is (a) to hold equity investment in a specified subsidiary, provide funds financed from unrelated parties to the specified subsidiary and hold real properties located in the same jurisdiction as the CFC, is (b) managed and controlled by a management and control company in the same jurisdiction as the CFC, (c) the management and control company performs indispensable functions in the natural resources development business or social infrastructure development business in the jurisdiction and (d) 95% or more of its assets is the investment in the specified subsidiary, the loan receivables from the specified subsidiary, the real property and cash/bank deposits and 95% or more its revenue is from these assets.

A specified subsidiary is a 10% or more-owned foreign company located in the same jurisdiction as the CFC, which performs indispensable functions in the natural resources development or social infrastructure development projects that the management and control company conducts.

Contact us for any enquiry on our services;

tax-news@jp.gt.com

Disclaimer

The aim of this newsletter is to provide information relating to recent Japanese tax and business. The information is general in nature and it is not to be taken as a substitute for specific advice. Accordingly, Grant Thornton Japan accepts no responsibility for any loss that occurs to any party who acts on information contained herein.

太陽グラントソントン税理士法人
Grant Thornton Taiyo Tax Corporation