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Japan Tax Bulletin

Distributions of corporate surplus by a Japanese subsidiary

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If a Japanese subsidiary has a distributable surplus, its foreign parent can resolve a distribution of corporate surplus out of capital surplus, profit surplus or both under Company Law. This issue illustrates the tax treatments of distributions of corporate surplus.

1. *Distribution of corporate surplus by a KK (Kabushiki Kaisha: limited liability stock company) under Company Law*

   Under Company law, the distribution of a surplus by a KK to its shareholders is regulated in the same way regardless of whether it is a dividend of profit or a return of capital surplus. Under Article 446 of Company Law, distributable corporate surplus is defined as the total value of assets + the total book value of treasury stock – the value of liabilities – stated capital – capital reserve – other adjustments items as provided by the regulation at fiscal year end.
   Corporate surplus consists of capital surplus and profit surplus. Therefore when distributing corporate surplus, it is necessary to identify whether the distribution is made out of capital surplus or profit surplus.

2. *Tax treatment of a distribution of corporate surplus*

   The tax treatment of a distribution of corporate surplus is different depending on whether the distribution is made out of capital for tax purposes (shihonkin to) or earnings and profits for tax purposes (rieki tsumitatekin). Both capital for tax purposes, and earnings and profits for tax purposes are different from capital and accumulated profits for financial reporting purposes under Company law.
   Where a distribution is made out of profit surplus under Company law, the distribution is deemed to be made entirely out of earnings and profits for tax purposes. A distribution made to a foreign parent is subject to withholding tax at 20.42%. Where tax treaty benefits are available, the withholding tax rate is reduced or withholding tax is exempt.
   Where a distribution is made out of capital surplus under Company Law, the distribution is pro-rated to a portion made out of capital for tax purposes and a portion made out of earnings and profits for tax purposes. The portion made out of earnings and profits is deemed a dividend and subject to withholding tax.

   The calculation is as follows:
   Capital (for tax purposes) portion = capital for tax purposes before distribution x [(the amount of distribution of capital surplus/ (the amount of net asset book value at the previous year end)].

   Earnings and profits (for tax purposes) portion = amount of distribution of capital surplus - portion made out of capital for tax purposes (as calculated above)

3. *Dividends of profits and return of capital by a GK*

   A GK is another form of limited liability company. In a GK, the interest holders are involved in the management of the company and it has greater freedom of self-government through its articles of incorporation.
   Unlike a KK, a dividend of profits and a return of capital are provided for separately under Company law. Dividends of profits are deemed to be made out of earnings and profits for tax purposes. A return of capital under Company law is pro-rated to a portion made out of capital (for tax purposes) and a portion made out of earnings and profits (for tax purposes). The calculation is the same as that the calculation for a KK.

4. *Tax treaty procedures*

   Dividends of profits and deemed dividends are subject to withholding tax in Japan. The withholding tax rate can be reduced or exempted if an application for tax treaty benefits, Form 1 as linked in the table below, is filed with the tax office before payments are made.

   https://www.nta.go.jp/taxes/tetsuzuki/shinsei/annai/joyaku/annai/pdf2/250.pdf

   If the relevant tax treaty includes a limitation of benefits clause, Form 17 is also required to be filed with the tax office.

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