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Japan Tax Bulletin

Taxation of the Japan branch of a foreign corporation

March 2020

1. Foreign corporation with a Permanent Establishment (PE) in Japan

A foreign corporation with a PE, which includes a branch, in Japan is subject to corporate income tax on the following types of domestic source income:

A. Business income attributable to a PE

a. The income attributable to the PE is the income that would be recognized if the PE were an independent enterprise. It is determined with reference to the functions performed, and assets used, by the PE, as well as transactions between the PE and the head office or other PE.

B. Domestic source income not attributable to a PE

a. Income arising from using or holding assets located in Japan.
b. Income arising from transferring assets located in Japan.
c. Consideration for providing personal services received by a corporation whose business is to provide personal services in Japan. This covers assigning entertainers, professional athletes or specialists with scientific or management expertise.
d. Consideration for leasing real property located in Japan, any rights on real property located in Japan, quarrying rights under the Quarrying law, granting mining rights under the Mining law, and leasing aircraft or vessels to residents or domestic corporations.
e. Other income derived in Japan as provided for by Cabinet Order.

Where a treaty defines domestic source income differently from the provisions above, the provision of the tax treaty will take precedence.

2. Calculation of taxable income.

When calculating the total taxable income for a PE, the business income attributable to the PE and domestic source income not attributable to the PE (A and B above) are calculated separately. The taxable income for each is calculated as gross revenue (Ekikin) – costs, expenses and losses (Sonkin). Losses generated by one category cannot be offset against profits of the other.

There are a couple of points to note for calculating income attributable to the PE.

2.1 Intracompany transactions

a. Establishment of legal liability

If a PE purchases inventory and sells it to customers, the purchase of inventory is a deductible cost for the PE. The general rule for the deductibility of costs and expenses is that a legal liability to pay for them has been established.

As transactions between a PE and head office or other PEs are intracompany, deductions for the intracompany costs and expenses are allowed even though legal liabilities may not have been established.

b. Arm's length

Where intracompany transactions are not conducted at arm's length and gross revenues are over-reported or deductions are excessive, the intracompany transactions are recalculated so that they are at arm's length

2.2 Head office expense allocation

Common expenses incurred for a PE's business, and for business other than the PE's business that are allocated to the PE based on reasonable basis such as revenue amount, asset value, the number of employees etc. are treated as deductible expenses.

2.3 Capital transactions

Funds provided by a head office to its PE and the remittance of surplus to a head office are treated as capital transactions and do not have an impact on taxable transactions.

2.4 Certain intracompany transactions

As mentioned in 2.1, intracompany transactions are at arm's length. However, in intracompany transactions where assets producing domestic source income B (iii) and B (iv) above are transferred, the acquirer takes over the book value of the transferred assets.

2.5 Anti-avoidance rule

A tax office district director is authorized to recalculate PE attributable income at their own discretion if they believe the transactions or calculations of a foreign corporation result in an unreasonably reduced corporation tax liability. This can be caused by increased deductions, increased tax credits, or decreases or increases in profits or losses on intracompany transactions.

3. Calculation of corporation tax liability

The corporation tax liabilities for PE attributable income and other domestic source income not attributable to a PE are calculated separately.

A tax credit for domestic withholding tax is available for both categories of income, but the tax credit for foreign taxes paid is only available against the liability on PE attributable income.

In some cases, the credit for domestic withholding tax may be larger than the final liability on a particular category of income. In this situation, the excess credit is treated as a negative liability and offset against the tax liability for the other category of income.

4. Local taxes

A PE is subject to local income taxes in addition to national corporation tax. Local income taxes consist of inhabitant tax and enterprise tax. For inhabitant tax purposes, the tax liabilities for PE attributable income and other domestic source income not attributable a PE are calculated separately. For enterprise tax, the tax liability is calculated for the total of the PE attributable income and other domestic source income not attributable PE.

5. Documentation requirements

A PE is required to prepare and maintain the following documents:

- Documents on transactions with third parties which produce PE attributable income
- Documents on intracompany transactions which produce PE attributable income
- Documents on head office expense allocation
- Documents on calculating arm's length price on intracompany transactions.

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