Japan Tax Bulletin

Navigating the New Horizons of Japan's Controlled Foreign Company Regime

April 2024

In the ever-evolving landscape of international taxation, the Controlled Foreign Company (CFC) regime has emerged as a critical tool for jurisdictions seeking to curb tax avoidance through the strategic allocation of profits to subsidiaries in low-tax jurisdictions. This article aims to unpack the complexities of the CFC regime, with a focus on the recent amendments in Japan, providing a comprehensive understanding for businesses and tax professionals navigating these changes.

1. *Introduction to the Controlled Foreign Company (CFC) Regime*

(1) Scope and Types of Foreign Related Corporations

Under Japan's CFC regime, a Foreign Related Corporation (FRC) is identified based on the percentage of shares owned by Japanese residents or corporations, either directly or indirectly. If a Japanese resident or corporation owns more than 50% of a foreign corporation, or has de facto control over it, that foreign corporation is considered an FRC and may be subject to Japan's CFC rules.

(2) Taxation Principles

The key principle behind CFC taxation is the inclusion of undistributed profits of FRCs in the taxable income of the Japanese parent company under certain conditions. These conditions are primarily focused on the tax rate applied to the FRC in its resident country and whether the FRC meets specific economic activity criteria.

A) Entity-Based Aggregation:
All income of the CFC is taxable to the Japanese shareholder if the CFC does not engage in an 'active' business as defined by law, or if it is considered a 'paper' or 'cash box' company failing certain substance tests, and the foreign tax rate is below a specified 'trigger' rate.

B) Income-Based Aggregation:
Even if entity-based aggregation rules do not apply, certain 'passive' income categories earned by the CFC are taxable to the Japanese shareholder if the foreign tax rate is below the 'trigger' rate.

(3) Tax Burden Ratio

The tax burden ratio, a critical factor in determining whether a foreign subsidiary falls under the CFC rules, is calculated based on the taxes paid by the foreign corporation relative to its income. The recent reform has adjusted this ratio, potentially altering which FRCs are subject to CFC rules.

2. *Recent Amendments to Japan's CFC Regime*

Japan, aligning with global tax reform trends, has introduced significant amendments to its CFC regime as part of the fiscal year 2023 tax reforms. These changes are primarily aimed at simplifying the regime and adjusting it in response to the global minimum tax initiatives under Pillar Two of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

Key amendments as below:

A) Lowering of the Tax Burden Ratio:
The threshold for the tax burden ratio that exempts specific foreign subsidiaries from CFC taxation has been reduced from 30% to 27%. This adjustment is aimed at broadening the scope of foreign subsidiaries that fall under the CFC regime, ensuring that more profits are taxed at the parent company level in Japan.

B) Relaxation of Documentation Requirements:
The amendment simplifies the documentation requirements for certain foreign subsidiaries, easing the compliance burden for Japanese corporations.

C) Definition and Scope of Foreign Related Companies:
The regime's application hinges on the classification of foreign subsidiaries based on direct or indirect ownership exceeding 50% by Japanese entities or through substantial control. The amendments clarify the criteria for determining substantial control, refining the scope of what constitutes a foreign related company.

D) Taxation Methods and Exemptions:
The regime's application hinges on the classification of foreign The CFC regime employs both entity-based and income-based aggregation methods to tax the income of foreign subsidiaries. Under the recent amendments, the criteria for these methods have been adjusted, particularly lowering the trigger rate for 'paper companies' to 27% for fiscal years beginning on or after 1 April 2024.

E) Global Tax Reforms and Impact on Japanese Corporations:
The amendments also take into consideration the tax reforms in other jurisdictions, such as the changes in corporate tax rates in the UK and the US, highlighting the need for Japanese corporations to stay informed about global tax developments.

3. Implications for Japanese Corporations

The amendments to Japan's CFC regime have several implications for Japanese multinational corporations. Firstly, the lower tax burden threshold means that more foreign subsidiaries may be subject to CFC rules, increasing the tax liabilities of Japanese parent companies. Secondly, the simplified documentation requirements aim to reduce the administrative burden on companies, although they still necessitate careful compliance efforts. Finally, the changes reflect Japan's commitment to aligning its tax system with global standards, necessitating that Japanese corporations pay close attention to international tax developments.

4. Immediate Action is Required

In the labyrinth of global tax reforms, the amendments to Japan's Controlled Foreign Company (CFC) regime stand as a testament to the dynamic nature of international taxation, a challenge that demands constant vigilance and adaptability from businesses. As the world moves closer to a consensus on the minimization of tax avoidance strategies, the recent updates to the CFC regime in Japan underscore the critical need for multinational corporations to stay abreast of changes, not just within their home jurisdictions but globally.

As we navigate through these complex waters, the message is clear: inaction is not an option. The convergence of global tax reforms, including Japan's latest CFC amendments, is a clarion call to businesses and tax professionals worldwide to reassess their tax strategies, ensuring compliance, efficiency, and foresight in their operations. Now is the moment to engage with tax professionals, to delve deeper into the nuances of these changes, and to strategize proactively. Remember, in the realm of international taxation, being informed is not just about staying compliant; it's about securing a competitive edge. Let this be the nudge you need to take immediate action, seeking expert tax advice to navigate the evolving tax landscape effectively.