

**Tax Reform Proposal Issued on December 22, 2009,
by the Japan Cabinet (2)**

Amendments to Anti-Tax Haven Rules

The tax reform proposal issued by the Japan Cabinet on December 22, 2009 (the "Proposal") includes several important changes with respect to existing Japanese anti-tax haven rules. The changes would, in some respects, reduce, but, in other respects, increase the tax burden associated with the anti-tax haven rules applicable to Japanese companies having foreign subsidiaries.

(1) Reduction of threshold effective tax rate

The Proposal would narrow the scope of foreign corporations subject to the anti-tax haven rules in three ways described in this memorandum.

First, the Proposal would reduce the threshold effective tax rate. The anti-tax haven rules apply to "Foreign Affiliates" (defined in footnote 1 below¹) subject to local effective tax rate that is no more than the threshold effective tax rate, unless it satisfies the conditions for exemption.

Under the current law, the threshold effective tax rate is set at 25%. However, under the Proposal, such threshold effective tax rate will be lowered to 20%.

This amendment would significantly narrow the scope of Foreign Affiliates subject to the anti-tax haven rules. This amendment is being proposed mainly to cope with recent reduction of the corporate tax rates in foreign countries where many Japanese companies have expanded their operations through local subsidiaries. In particular, each of China, Malaysia and Vietnam has recently lowered, and South Korea intends to lower in 2010, its tax rate on corporate income to 25% or less (but more than 20%). The subsidiaries of Japanese corporations in these countries account for more than 30% of the total number of subsidiaries of Japanese corporations. Therefore, the Proposal is expected to significantly reduce the number of Foreign Affiliates subject to anti-tax haven rules.

¹ Foreign Affiliates are defined as foreign corporations with respect to which more than 50% of the shares are held by one or more Japanese resident individuals or Japanese corporations (including certain non-residents related to such Japanese resident individuals or corporations) ("Japanese Shareholders")

(2) Increase of threshold holding ratio

Under the current anti-tax haven rules, a Japanese Shareholder (defined in footnote 1) who holds 5 % or more of the outstanding shares in a Foreign Affiliate Subsidiary subject to the anti-tax haven rules would be required to impute the earnings of the Foreign Affiliates to its taxable income.

Under the Proposal, this threshold holding ratio will be raised from 5% to 10%. Such reform would be, to some extent, expected to reduce the number of Japanese Shareholders who are subject to anti-tax haven rules.

(3) Introduction of the concept of "Managing Corporation"

Under current anti-tax haven rules, in order that such rules do not impede sound business operations through Foreign Affiliates, Foreign Affiliates may be exempted from anti-tax haven rules if they meet all of the following requirements (i) through (iii) and either (iv) (a) or (b):

- (i) Business Requirement
- (ii) Substance Requirement
- (iii) Managing and Control Requirement
- (iv) (a) Non-Affiliated Parties Requirement or
(b) Locality Requirement

When Japanese corporations engage in business in a certain region outside Japan (*e.g.*, South East Asia), Japanese corporations holding subsidiaries in several countries in the same region may desire to have, for the purpose of efficiency, a controlling subsidiary in charge of planning and administrating the business strategy in such region. In other cases, for the purpose of centralization of logistics, they may want to have a subsidiary in charge of procurement, storage, deliveries and other logistic functions to be used by other subsidiaries in the region.

Such controlling subsidiary and logistic service subsidiary have often failed to meet the conditions for the exemption from the anti-tax haven rules, although they are set up for legitimate business purposes. This is because a subsidiary in charge of business strategies often holds the shares of other subsidiaries in the same region and fails to meet the Business Requirement, and a logistic subsidiary often provides logistic services only to group companies and fails to meet the Non-Affiliated Parties Requirement.

To address this issue, the Proposal seeks to introduce the concepts of "Managing Corporation"(*tokatsu gaisha*) and "Managed Corporation"(*hi-tokatsu gaisha*).

More specifically, first, for the purpose of satisfying the Business Requirement, holding of shares in the Managed Corporations by a Managing Corporation will be disregarded. This

amendment would enable a Foreign Affiliate in charge of business strategies to meet the Business Requirement.

Second, for the purpose of the Non-Affiliated Parties Requirement, wholesale trading activities of the Managing Corporation with the Managed Corporations will not be considered transactions with affiliated parties, which amendment would enable a Foreign Affiliate in charge of group logistic services to meet the Non-Affiliated Parties Requirement.

Under the Proposal, a Managing Corporation is defined as a Foreign Affiliate

- (X) which is wholly owned, directly or indirectly, by a Japanese corporation,
- (Y) which has two or more Managed Corporations and operates a certain type of designated businesses (the "Designated Business") to control the business operations of such Managed Corporations, and
- (Z) which has physical facilities for the Designated Businesses and engages employees necessary to operate the Designated Business (who are exclusively engaged in the Designated Business and are not directors of such Foreign Affiliate) in the jurisdiction where it is located.

On the other hand, a Managed Corporation is defined under the Proposal as an affiliated party of a Managing Corporation,

- (X) in which 25% or more of both the outstanding shares and the voting rights are directly owned by a Managing Corporation, and
- (Y) which operates substantial businesses in the jurisdiction where it is located.

In conjunction with the introduction of the concept of "Managing Corporation," the deduction of 10% of labor costs, which is currently available to a Foreign Affiliate satisfying Requirements (i) through (iii) but not Requirement (iv), would be abolished.

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Contact Information:

Should you wish to receive further information or advice regarding the above-mentioned matters, please contact Eiichiro Nakatani, Koji Fujita, Kotaro Okamoto, or Yoshinori Aoyagi.

Eiichiro Nakatani
Partner
Email: eiichiro.nakatani@amt-law.com
Telephone: 03-6888-1039

Koji Fujita
Partner
Email: koji.fujita@amt-law.com
Telephone: 03-6888-1041

Kotaro Okamoto
Partner
Email: kotaro.okamoto@amt-law.com
Telephone: 03-6888-1090

Yoshinori Aoyagi
Associate
Email: yoshinori.aoyagi@amt-law.com
Telephone: 03-6888-1109

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