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Tax Exemption of the Dividends Paid by Foreign Subsidiaries and Abolishment of Indirect Foreign Tax Credit

Outline of 2009 Tax Reform (International Tax) Issued by LDP and MOF (1)

As of December 12, 2008 Liberal Democratic Party announced Outline of 2009 Tax Reform and as of December 19, 2008, Ministry of Finance announced Outline of 2009 Tax Reform. We will touch upon major changes in the area of international tax.

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1. Dividends received from certain foreign subsidiaries will be exempted from the corporate income taxation in Japan. Under the tax reform plan, the dividends paid by a foreign corporation will be excluded from the taxable corporate income of the Japanese parent corporation. This applies if the parent corporation holds 25% or more of the outstanding shares of the foreign corporation for six (6) months or more immediately before the date on which the dividend payment obligation is finalized.

2. Under the current taxation, indirect foreign tax credit is available for the Japanese parent corporation if the Japanese corporation receives dividend from foreign subsidiaries which meet the same holding requirement as described in the preceding paragraph. Under the indirect foreign tax credit system, Japanese corporation is permitted a tax credit for the foreign taxes on the income that was earned by the foreign subsidiaries out of which the dividend distribution was made. Where a Japanese parent corporation uses the indirect foreign tax credit, it will add to its taxable corporate income (i) the amount of dividend (including the withholding tax levied on the dividend) and (ii) a portion of the taxes paid by the subsidiaries which correspond to the dividend received, and then, it credits from the Japanese corporate taxes the amounts corresponding to (i) and (ii). This results in that double taxation is avoided, but the income of the subsidiaries is effectively taxed at the corporation tax rate of Japan.

3. Under the tax reform of 2009, the indirect foreign tax credit will be abolished and the new rule will allow that the dividend received from the foreign subsidiaries may be excluded from the corporate income taxation on the Japanese parent, and remains subject only to taxation at the corporate income tax rate applicable to the subsidiaries..

4. Please note that 5% of the dividend received from such foreign subsidiaries must be included in the corporate income of Japanese corporation. Therefore, 95% of the dividend paid by the foreign corporation will be excluded from the corporate income taxation.

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5. The dividend exclusion rule replaces the indirect foreign tax credit and will be available only to Japanese corporations which meet the conditions described in paragraph 1 above. This rule is not available to individuals or Japanese corporation which holds less than 25% of the outstanding shares of a foreign corporation.

6. Where the Japanese parent corporation utilizes the benefit of this dividend exclusion rule with respect to foreign subsidiary subject to the tax haven rule, the rule of income imputation to the parent will be modified to prevent tax avoidance. We will write about this rule in the separate memorandum.

7. This amendment, if enacted, will be applicable to dividends received in the fiscal year of the Japanese corporations commencing on or after April 1, 2009.

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