

**Tax Reform Proposal Issued on December 22, 2009,**  
**by the Japan Cabinet (3)**

Amendment to Anti-Tax Haven Rules

In addition to the amendments to the anti-tax haven rules discussed in Newsletter (2), under the tax reform proposal issued by the Japan Cabinet on December 22, 2009 (the "Proposal"), the anti-tax haven rules will be further amended as follows.

(1) Inclusion of Certain Passive Income in the Imputed Income

(a) Outline

As indicated in Newsletter (2), (i) the threshold effective tax rate for a Foreign Affiliate to be subject to the anti-tax haven rules will be lowered, (ii) the threshold holding rate for a Japanese Shareholder to be subject to the income imputation will be increased, and (iii) an exemption for a "Managing Corporation" will be introduced.

Although the amendments indicated in Newsletter (2) may seem to relax the burden on Japanese Shareholders of Foreign Affiliates, the Proposal will also include change that will increase the burden on the Japanese Shareholders<sup>1</sup>.

Under the current anti-tax haven rules, as long as a Foreign Affiliate satisfies the conditions for the exemption, no income of the Foreign Affiliate will be imputed to the Japanese Shareholders.

However, under the Proposal, even if a Foreign Affiliate, which would otherwise be subject to the anti-tax haven rules, meets the requirements for exemption, the following passive income of the Foreign Affiliate will still be imputed to the Japanese Shareholders:

- 1) dividends or capital gains from sale of shares in the stock exchange or the over-the-counter market, if the Foreign Affiliates holds less than 10% of the shares of the issuing corporation (except where the Foreign Affiliate is a financial institution);
- 2) interest or capital gains from the sale of bonds, notes or other form of debentures in the stock exchange or over-the-counter market (except where the Foreign Affiliate is a financial institution);
- 3) royalties or income from the transfer of patents, trademarks, copyrights or other

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<sup>1</sup> Japanese Shareholders means Japanese resident individuals or Japanese corporations whose shareholding ratio in the Foreign Affiliates is on or above the threshold rate.

- intellectual properties (with certain exceptions such as where the intellectual properties were developed by the Foreign Affiliate); and
- 4) income from the lease of vessels or aircrafts.

(b) Items to Note

**A. Calculation of Amount Imputed to Japanese Shareholders**

The calculation of the amount of passive income to be imputed to the Japanese Shareholders will be subject to the following qualifications.

First, the amount to be imputed to the passive income of each Japanese Shareholder shall not exceed the total net income of the Foreign Affiliate prorated to the shareholding ratio of each Japanese Shareholder. If the Foreign Affiliate is in an overall loss position for the fiscal year, there will be no amount to be imputed.

Second, in calculating the amount of passive income to be imputed to Japanese Shareholders, direct expenses may be deducted. However, the selling and administrative expenses may be deductible only when they can prove a clear relationship between the income and the expense. Therefore, interest of a borrowing may be deductible only when the funds are borrowed to acquire the assets which generate the income. However, in imputing the dividend of the shares or the interest of the debentures, the interest paid by the Foreign Affiliate may be deducted to the extent prorated to the shares or debentures even if the relationship between the interest and the dividends or the interest is not specific.

**B. Exemption from Imputation of Income to Japanese Shareholders**

There are certain exemptions from the rule described above imputing income to Japanese Shareholders. Specifically, passive income will not be imputed to the Japanese Shareholders if:

- (i) the aggregate amount of the passive income listed above in 1) through 4) under (a) Outline (after deducting the expense) is 5% or less of the corporate income of the Foreign Affiliate; or
- (ii) the aggregate amount of the gross revenue from the item listed in the above 1) through 4) under (a) Outline shall not exceed JPY 10 million.

In addition, the imputation of the amount of passive income listed above in 1) and 2) under (a) Outline (i.e., dividends or capital gains arising from the shares, interest or capital gains arising from the debentures) shall not be made if such dividends, interest or capital gains are essential to the business of the Foreign Affiliate. However, this exemption will not apply if the business engaged in by the Foreign Affiliate is (i) holding of the shares or bonds, notes, or other types of debentures, (ii) licensing, transferring or otherwise providing

intellectual property, or (iii) leasing vessels or aircrafts.

(2) Exclusion of the Dividend Corresponding to the Income Already Imputed

After the tax reforms were made in 2009, if a Japanese Shareholder holds shares of multilayered Foreign Affiliate, it was possible that a situation of economic double taxation would arise.

For example, assume that each of the Japanese corporations X1, X2, X3, X4 and X5 holds 20% of the shares of Foreign Affiliate A (in aggregate, 100%), and A holds all the shares of Foreign Affiliate B (there is no corporate income tax levied on A and B). Also assume that Foreign Affiliate B generates corporate income of 100 dollars and that 100 dollars was imputed to the corporate income of each of X1 to X5 (20 dollars each). Even if Foreign Affiliate B distributes that 100 dollars to Foreign Affiliate A as a dividend, the amount of dividend does not have to be imputed to the corporate income of X1 to X5. However, if tax haven corporation A distributes a dividend to X1, X2, X3, X4 and X5, then each of X1, X2, X3, X4 and X5 will have to include the entire amount of the dividend in its corporate income.

However, as a result of the amendments under the Proposal, this situation of economic double taxation will not occur. According to the Proposal, even if a Japanese corporation receives a dividend from a foreign corporation, the amount of the dividend will not have to be included in the income of the Japanese corporation to the extent the income imputed to the Japanese Shareholders from the income of the grandchild corporation occurred within the two fiscal years prior to the commencement of the fiscal year in which the Japanese corporation received the dividend.

END

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