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Introduction

In conjunction with the efforts of the Organization for Economic Co-operation and Development ("OECD") to finalise the Base Erosion and Profit Shifting ("BEPS") Action Plans, the Japanese government has implemented several legislative measures to meet the requirements of the BEPS Action Plans. Those legislative measures include:

- Transfer Pricing Rules have been made applicable to indirect affiliate transactions (2014).
- Double non-taxation of dividends paid from foreign subsidiaries has been precluded from the foreign dividend exemption system (2015).
- An exit tax has been introduced (2015).
- Consumption tax has been made applicable to internet digital content services from foreign countries (2015).
- Transfer price taxation documentation requirements have been strengthened (2016).
- Rules regarding inheritance taxation on overseas assets have been strengthened (2017).
- Controlled Foreign Corporation ("CFC") Rules have been strengthened (2017).
- The definition of permanent establishment ("PE") has been amended (2018).
- The CFC Rules have been additionally amended (2018).
- Earnings Stripping Rules have been strengthened (2019).
- Transfer Pricing Rules have been amended (2019).
- The CFC Rules have been re-amended (2019).

This chapter will summarise the three legislative measures which occurred in 2019 – amendments to the Earnings Stripping Rules, the Transfer Pricing Rules, and the CFC Rules.

Amendments to the Earnings Stripping Rules

<u>Outline of Earnings Stripping Rules and Amendment under the 2019 Tax Reform</u>

In Japan, since around 2008 there has been an increase in cases where corporations pay an excessive amount of interest for borrowings from foreign related parties (foreign parent companies, foreign subsidiaries, etc.) and include these interest payments in their deductible expenses so as to reduce their Japanese tax liability. In order to prevent these companies from claiming excess interest deductions, the Earnings Stripping Rules were introduced under the 2012 Tax Reform in Japan (stipulated in Section 66-5-2 of Special Measures Concerning Taxation).

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Prior to the 2019 Tax Reform, the Earnings Stripping Rules provided that in a corporate fiscal year where the Net Interest Payments to Related Persons exceeded 50% of Adjusted Taxable Income, that excess cannot be claimed as deductible expenses. For the purposes of this calculation:

- Net Interest Payments to Related Persons means the amount remaining after deducting the total Eligible Interest Payments (i.e. the total interest received, calculated through fixed apportionment calculations) from the total Interest Payments to Related Persons.
- Interest Payments to Related Persons means interest paid to related persons of the corporation (which is not included in the taxable income of the related persons who received the interest). They do not include any amounts paid in relation to certain specified bond repurchase transactions.
- Adjusted Taxable Income means the amount of income (calculated according to a fixed formula) to be compared with Net Interest Payments to Related Persons.

Under the 2019 Tax Reform, the Earnings Stripping Rules have been amended to align with BEPS Action 4, via (among other changes) (i) amending the scope of interest payments, (ii) amending the definition of Adjusted Taxable Income, (iii) lowering the benchmark fixed ratio from 50% to 20%, (iv) amending the exemption thresholds, and (v) amending to the threshold for the carrying over of non-deductible interest expenses. The amendment is applicable to corporate tax payable for fiscal years commencing on or after April 1, 2020.

Amendments to the scope of interest

The interest payments subject to the Earnings Stripping Rules are "Net Interest Payments to Related Persons" before the 2019 Tax Reform. Post-reform, the relevant payments will be "Net Interest Payments". The calculation of Net Interest Payments starts with total interest payments, not only interest payments to related persons. The Net Interest Payments for the purposes of the Earnings Stripping Rules are defined as total interest paid (excluding any Excluded Interest Payments, summarised below) minus the corresponding total amount of Eligible Interest Payments.

Excluded Interest Payments is defined as follows:

1) For interest payments other than Specified Bond Interest (defined below), interest payments:
    (a) subject to Japanese taxation in the possession of the recipient (this means interest payments receipts which are declared as income in income/corporate tax returns in Japan);
    (b) to certain public benefit companies; and
    (c) under bond transactions with a repurchase agreement in which the borrowing transactions clearly correspond with the lending transactions.
2) For interest on Specified Bond Interest (meaning interest on bonds issued by the corporation and paid to unrelated parties, excluding where the number of owners of the bonds falls below a certain threshold):
    (a) interest payments subject to withholding taxation at the point of payment, or interest payments included in Japanese taxable income for those who receive the Specified Bond Interest, and interest payments paid to certain public benefit companies; and
    (b) either of the following, depending on the classification of bonds:
        I. bonds issued in Japan: 95% of Specified Bond Interest; or
        II. bonds issued outside Japan: 25% of Specified Bond Interest.

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Amendments to the definition of Adjusted Taxable Income

Prior to the 2019 Tax Reform, when calculating Adjusted Taxable Income, dividends received that were excluded from gross revenue and dividends received from foreign subsidiaries that were excluded from gross revenue would be added to the income for the fiscal year. Under the 2019 Tax Reform, however, the exclusion of received dividends from gross revenue and the exclusion of dividends received from foreign subsidiaries will no longer be added to the company's income for the fiscal year.

Limitation of deduction

Under the 2019 Tax Reform, if Net Interest Payments exceed 20% of Adjusted Taxable Income in a given fiscal year (as opposed to the current threshold of 50%), the excess amount will not be included in the calculation of deductible expenses. This amendment is based on the recommendation set forth in the BEPS final report for Action 4: that the benchmark fixed ratio should be set within the range of 10% to 30%.

Exemption thresholds

Under the 2019 Tax Reform, the Earnings Stripping Rules will not apply to a company meeting either of the following criteria: (a) Net Interest Payments in a given fiscal year is 20 million (currently 10 million) yen or less; or (b) the total amount of Net Interest Payments on a Japanese corporate group basis (where there is more than a 50% capital relationship) is 20% or less of the total Adjusted Taxable Income (on the same group basis).

Prior to the 2019 Tax Reform, the Earnings Stripping Rules did not apply to a company if the company's aggregated Interest Payments to Related Persons was 50% or less of total interest payments. However, after the 2019 Tax Reform, this exception will be abolished.

Carry over of non-deductible interest expense

After the 2019 Tax Reform, when a company's Net Interest Payments are less than 20% (as opposed to the previous threshold of 50%) of Adjusted Taxable Income for a given fiscal year, the non-deductible interest incurred in the past seven years under the Earnings Stripping Rules is deductible in that fiscal year, up to the 20% threshold.

Amendments to the Transfer Pricing Rules

Under the 2019 Tax Reform, the Transfer Pricing Rules were amended in line with BEPS Action 8 and the revised OECD transfer pricing guidelines. This amendment is applicable to corporate taxes for fiscal years commencing on, or after, April 1, 2020.

Clarification of the definition of intangible assets

Although the Transfer Pricing Rules did not clearly define intangible assets before the 2019 Tax Reform, the definition of intangible assets subject to the Transfer Pricing Rules has now been clarified under the 2019 Tax Reform. According to the 2019 Tax Reform, the term "intangible assets" is defined as assets owned by a corporation, other than tangible assets and financial assets (i.e. cash, deposits, securities, and so on), for which consideration should be paid between independent parties on ordinary business terms.

Amendments to methods for calculating arm's-length pricing

Under the 2019 Tax Reform, the discounted cash flow method ("DCF method") is included as one of the methods for calculating arm's-length price. This was done on the grounds that the OECD Guidelines recognise the utility of the DCF method in ascertaining an arm's-length price for intangible assets for which no comparable transactions exist.

Due to this amendment, the addition of the DCF method would allow the Japanese tax

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authorities to use the DCF method based on the information available to the Japanese tax authorities at the time of the controlled transactions with foreign related parties, in cases where the documents required to determine an arm's-length price have not been submitted.

Introduction of the Price Adjustment Measure to HTVI transactions

Where the actual outcomes differ from the *ex ante* pricing arrangement for the arm's-length price of transactions involving hard to value intangibles ("HTVI"), Japanese tax authorities will have the power to make a tax assessment based on the arm's-length price determined by the most appropriate method to reach an arm's-length price for the HTVI transactions (after taking into account factors such as the likelihood of the result and the reason for the difference). It should be noted that this measure will not be applied if the difference between the post-assessed price and the original price does not exceed 20%.

HTVI are defined as intangible assets that meet all of the following requirements: (i) the assets are unique and have significant value; (ii) the arm's-length price is calculated based on future income projections; and (iii) assumptions used in valuing the arm's-length price are uncertain.

The above Price Adjustment Measure will not be applied if the following documents are submitted by the taxpayer within a certain period of time starting from the date of a request made by Japanese tax authorities:

(a) (i) Documents containing details of the projections used in the calculation of the arm's-length price, and (ii) documents containing evidence which proves that the event that caused the discrepancy between the projection and the actual outcome was a disaster (or similar event) that could not have been foreseen at the time the transaction was priced, or that the arm's-length price was appropriately determined taking into account the possibility of the event that caused the discrepancy between the projection and the actual outcome.

(b) Documents containing evidence which shows the ratio of the difference between the actual income and the projected income for five years from the beginning of the fiscal year in which the first revenues received from unrelated parties for the use of the HTVI is 20% or less.

Extension of the statute of limitations

The 2019 Tax Reform extended the statutory limitation period for both assessment by the Japanese tax authorities, and taxpayers requesting corrections. This limitation period was increased from six years to seven years.

Further reform of Japan's CFC Rules

The 2019 Tax Reform makes further additional amendments to the CFC Rules, which were already amended in the 2017 and 2018 Tax Reforms. Although there are several amendments under the 2019 Tax Reform, this chapter briefly describes the amendments to the definition of a "paper company".

Outline of Japan's CFC Rules

If (a) a domestic corporation holds no less than 10% of any subsidiary in a foreign country, and (b) the domestic corporation, other domestic corporations and/or Japanese residents hold in aggregate more than 50% of the shares of the subsidiary, that subsidiary is categorised to a "foreign related company". Then, if the foreign related company falls within the definition of a "specified foreign related company" (being (i) a paper company, (ii) a company deemed

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to be an "actual cash box", or (iii) a company located in a blacklist country, though no country has been designated as a blacklist country as of May 31, 2019), the profit of the subsidiary will be included in the domestic corporation's gross revenue for Japanese tax purposes. However, this does not apply if the tax burden rate in the foreign country is 30% or more. Further, even if the foreign related company does not fall within the definition of a "specified foreign related company" when the tax burden rate is less than 20%, the income of the foreign related company will be included in the domestic corporation unless the "economic activity standard" is satisfied. Even if the foreign related company meets the "economic activity standard", fixed passive income of the foreign related company will be fully included in the domestic corporation's income (partial summation system).

Amendments to the definition of a "paper company"

In December 2017, the tax system reform under the Trump administration in the United States ("Tax Cuts and Jobs Act 2017") reduced the federal corporate tax rate from 35% to 21%, and the corporate effective tax rate, including state taxes, often dropped to less than 30%. As a result, an entity such as a limited liability company ("LLC"), limited partnership ("LPS"), or a blocker corporation located in the United States is likely to be subject to Japan's CFC Rules since the corporate person may fall under the definition of a "paper company". A "blocker corporation" means an entity established to file tax returns in the United States in order to avoid direct taxation by the United States of the Japanese corporation, where a Japanese corporation has a pass-through entity in the United States.

Under the 2019 Tax Reform, the definition of a "paper company" has been amended to take into account the changes made by the Tax Cuts and Jobs Act 2017. Specifically, under the 2019 Tax Reform (i) certain foreign related companies which are holding companies, (ii) certain foreign related companies relating to the ownership of real estate, and (iii) certain foreign related companies relating to resource development projects, are excluded from the definition of a "paper company".

Category (i) above usually means a foreign related company which holds shares of subsidiaries (a subsidiary being a foreign company located in the same jurisdiction as the foreign related company and in which the foreign related company holds at least 25% of the equity) (a) where more than 95% of the foreign related company's total asset value consists of shares of subsidiaries and certain monetary assets, and (b) more than 95% of the foreign related company's total revenue comes from dividends paid by those subsidiaries and interest on deposits. As a result, blocker corporations are excluded from the definition of a "paper company" and are excluded from being subject to Japan's CFC Rules.

Category (ii) above mainly means either a foreign related real estate holding company, located in the same jurisdiction as the head office of the foreign related company, or a foreign related company which holds shares of specified subsidiaries (a specified subsidiary is a foreign related company controlled and managed by a management company located in the same jurisdiction of the real estate holding company). To fall under this definition, the latter type of company must be (a) controlled and managed by a management company located in the same jurisdiction, (b) perform functions essential to carrying out the real estate business of the management company in the same jurisdiction, (c) have more than 95% of its total assets value consist of real estate, shares of the specified subsidiaries and certain monetary assets, and (d) have more than 95% of its total revenue derived from real estate, specified subsidiaries, and/or interests on deposits. The amendment assumes this category of companies to be intermediate holding companies set up to conduct a joint real estate business venture.

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Category (iii) above means a foreign related resource development project company which holds shares of specified subsidiaries (a specified subsidiary is a foreign related company located in the same jurisdiction, in which the resource development project company holds 10% or more of the equity, and which performs functions essential to carrying out the resource development or social infrastructure development project by a management company in the same jurisdiction), provides funding raised from unrelated parties to the specified subsidiaries, or holds real estate located in the same jurisdiction as the resource development project company. Such companies must be (a) controlled and managed by a management company located in the same jurisdiction, (b) perform functions essential to carrying out the resource development or social infrastructure development by the management company in the same jurisdiction, (c) have more than 95% of the foreign related company's total asset value consisting of shares of the specified subsidiaries, loans to the specified subsidiaries, real estate and monetary assets, and (d) more than 95% of the foreign related company's total revenue is derived from dividends paid by the specified subsidiaries, interest on the loans to the specified subsidiaries, revenue from real estate and interest on deposits.

The amendments are applicable to the fiscal years of domestic entities ending on or after April 1, 2019 and to the income inclusion taxation for foreign related companies whose fiscal years began on or after April 1, 2018.

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