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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 actions to address the requirements under the BEPS Action Plans. Those legislative actions include:

- Transfer price taxation has been made applicable to indirect affiliate transactions (2014).
- Double non-taxation of dividends paid from foreign subsidiaries has been precluded (2015).
- An exit tax has been introduced (2015).
- A consumption tax has been made applicable to digital content services provided from foreign countries via the Internet (2015).
- Transfer price taxation documentation requirements have been strengthened (2016).
- Inheritance taxation on overseas assets has 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).

This article will summarise the two legislative actions which occurred in 2018 – namely, amendments to the definition of PE and the CFC Rules. Thereafter, it will discuss an important judicial precedent relating to the application and interpretation of the CFC Rules.

Amendments to the Definition of PE

Background of the 2018 Tax Reform

If foreign corporations have a PE in Japan, the income that they derive from their businesses in Japan is subject to Japanese corporate tax. Under the Corporate Tax Act ("CTA"), there are three types of PE: (i) a branch-type PE; (ii) a construction-type PE; and (iii) an agent-type PE. PEs are defined not only in domestic tax acts, but also in tax conventions between two countries and the Model Tax Convention, which is formulated by the OECD.

In recent years, multinational companies have been conducting their businesses in such a way that they can artificially avoid being treated as having a PE in a foreign country. As a result, this has become an international issue. In December 2017, the OECD addressed this issue by updating the Model Tax Convention and amending the definition of PE. To remain consistent with international standards, the 2018 Tax Reform amended the definition of PE under the CTA. This amendment, which is set forth in more detail below, shall apply to companies' fiscal years that commence on or after 1 January 2019.

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Branch-type PE

Before the 2018 Tax Reform, a location used solely for storage did not fall within the definition of a branch-type PE. This exclusion created an issue because a huge warehouse used solely to store products did not fall within the definition of a branch-type PE even if it was the location where the foreign corporation conducted activities essential to its product-selling business (the majority of the foreign corporation's employees worked in the warehouse). Now, under the 2018 Tax Reform, a location used solely for storage, display, delivery and other specific activities does not fall within the definition of a branch-type PE, provided that the identified activities are limited to preparatory or auxiliary functions of the foreign corporation's business.

Construction-type PE

Before the 2018 Tax Reform, a foreign corporation was deemed to have a construction-type PE when it conducted any construction work, etc. in Japan for more than one year. The 2018 Tax Reform, however, addresses efforts by foreign corporations to avoid PE status by dividing an agreement of more than one year into several agreements of one year or less. Now, under the 2018 Tax Reform, in determining whether the one year requirement has been satisfied, multiple contracts can be aggregated. Thus, when an agreement is divided into several agreements in order for each agreement to be one year or less, and one of the main reasons for such division is to avoid a construction-type PE in Japan, the relevant time period for purposes of the PE requirements will be determined by aggregating the periods of the agreements.

Agent-type PE

Before the 2018 Tax Reform, an agent-type PE required, among other things, that an entity have the authority to conclude contracts in Japan on behalf of a foreign corporation. However, as a result of this requirement, the following problem was noted: if foreign company A executed a commissionaire contract (i.e., a contract pursuant to which an agent sells products in its own name, but on behalf of a foreign enterprise that is the owner of those products) with Japanese company B as a trustee, and then company B, on behalf of itself, executed a sales agreement concerning foreign company A's products, foreign company A would not have an agent-type PE in Japan.

To address this problem, the 2018 Tax Reform expanded the definition of an agent-type PE. Now, if a person acts in Japan on behalf of a foreign company, and in doing so, habitually concludes contracts or habitually plays a principal role leading to the conclusion of contracts concerning the transfer of ownership of the foreign company's property, etc., that person will fall within an agent-type PE of the foreign company.

Additionally, the CTA stipulates that a person who carries out an agent business as a regular business ("independent agent") does not fall within an agent-type PE. However, under the 2018 Tax Reform, the scope of this independent agent exemption will be narrowed so that an agent who acts exclusively or mainly on behalf of those closely related to the agent (the phrase "those closely related to the agent" means a non-resident individual or a foreign corporation that controls or is controlled by the agent such as those having a direct or indirect ownership of more than 50% of the agent) will not fall within the scope of an independent agent.

Further reform of Japan's CFC Rules

The 2017 Tax Reform made numerous changes to the CFC Rules ("2017 CFC Rules Reform"). However, additional revisions were made by the 2018 Tax Reform ("2018 CFC

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Rules Reform"). The 2018 CFC Rules Reform is applicable beginning from the fiscal year of foreign-related entities commencing on or after 1 April 2018; this is the same effective date as the 2017 CFC Rules Reform.

In order to maximise synergy arising from foreign M&As, Japanese entities sometimes reorganise unnecessary paper companies which are placed under the umbrella of the Japanese entities as part of their post-merger integration ("PMI"). An example of this is described below:

1) A Japanese entity ("Company X") acquires a company located in the United States ("Company A").
2) A paper company ("Company B") is a subsidiary of Company A and has shares of a company in the United States ("Company C") and shares of a company in Europe ("Company D").
3) Company Y is the traditional European business hub of Company X Group. In furtherance of the PMI, after the acquisition of Company A, Company B transfers its shares of Company C to Company A, while also transferring its shares of Company D to Company Y. Company X then makes Company A the U.S. business hub of the Company X Group, while Company X makes Company D a direct subsidiary of Company Y.
4) Company X dissolves Company B.

Under the 2017 CFC Rules Reform, capital gains arising from the transfer of the shares of Company C from Company B to Company A and capital gains arising from the transfer of the shares of Company D from Company B to Company Y were supposed to be aggregated with the taxable income of Company X. Nevertheless, since the capital gains arising from the transfer of shares as a result of restructuring following the acquisition of foreign groups are capital gains arising from unrealised profits of the foreign companies outside Japan, such capital gains are considered not to erode the Japanese tax base. Under the 2018 CFC Rules Reform, such capital gains can be excluded from the calculation of the amount subject to the CFC Rules if certain requirements are fulfilled.

An outline of the requirements is as follows:

- The transfer of such shares shall be carried out within two years from the day on which the direct or indirect shares of specified foreign-related entity, etc. (in the above example, Company B) held by a Japanese company exceeds 50%.
- The transfer of such shares shall be carried out in accordance with a plan document describing a basic policy relating to the integration of a foreign company which falls within the category of a foreign-related entity, the implementation method of the reorganisation accompanying the integration and so on.
- It is expected that the specified foreign-related entity, etc. that transfers such shares (in the above example, Company B) will be dissolved within two years from the day of the transfer of such shares.

As a result of the 2018 CFC Rules Reform, when a Japanese company acquires a foreign enterprise group, it is necessary to pay attention to the plan for reorganisation and consider the detailed requirements stipulated by the CTA and the regulations thereunder.

A recent judgment of the Supreme Court of Japan which is important to the application and interpretation of the CFC Rules

This section summarises a recent important judicial decision by the Supreme Court of Japan (October 24, 2017) in the Denso Case regarding the CFC Rules. In that case, the issue was

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whether the exemption criteria (specifically, the business criteria) under the CFC Rules were satisfied. The Nagoya District Court upheld the claim of the plaintiff, Denso Corporation ("Denso"). Although the Nagoya High Court later quashed the decision, the Supreme Court then quashed the High Court's decision.

The decision of the Supreme Court is important for a number of reasons. First, it shows the relationship between a regional management business (i.e., controlling and managing issuing companies which are in a certain region) and a shareholding business ("shareholding business" as used herein refers to the term as stipulated under the Act on Special Measures Concerning Taxation). Second, it identifies the criteria for determining the "principal business" when a foreign-related company operates multiple businesses.

Facts

Denso is a Japanese corporation which manufactures and sells automobile parts. It set up business enterprises in 35 countries and regions and had more than 200 group companies throughout the world. As of March 31, 2007 and March 31, 2008, Denso wholly owned a company in Singapore (the "Subsidiary").

The Subsidiary held the shares of more than 10 subsidiaries in ASEAN countries during the fiscal years 2007 and 2008. The tax burden rate on the Subsidiary's income in Singapore was 22.89% in fiscal year 2007 and 12.78% in fiscal year 2008. The Subsidiary conducted a regional management business for those subsidiaries, a shareholding business (shareholders' meetings and processing dividends, etc.), a programing business and an agency business. Denso filed a tax return in Japan without including the Subsidiary's income in its income.

However, because the Nagoya Regional Taxation Bureau considered the regional management business to be subsumed in the shareholding business, the Subsidiary's principal business was deemed to be the shareholding business. As a result, the Nagoya Regional Taxation Bureau included the Subsidiary's income in Denso's income for tax purposes. In response, Denso filed an objection to the Director-General of the Regional Taxation Bureau and an examination request with the Director of the National Tax Tribunal. Thereafter, Denso filed a lawsuit for cancellation of such reassessment.

The CFC Rules at issue in the Denso Case

The applicable CFC Rules at the time of the Denso Case were somewhat different from the current rules, as they have been revised several times. Generally, the applicable CFC Rules at the time were as follows:

> A domestic corporation that held a certain percentage of shares in a foreign company which had a head or principal office in specified low tax countries would be subject to the CFC Rules in principle. Furthermore, such domestic corporation was required to add the income of that foreign company to its own income for Japanese tax purposes. However, the CFC Rules would not apply if such domestic corporation satisfied all applicable exemption criteria (i.e., (i) business criteria, (ii) substance criteria, (iii) control criteria, and (iv) (a) location criteria, or (b) unrelated party criteria). The business criteria required, among other things, that a company's principal business not be a shareholding business.

Nagoya High Court decision

The Nagoya High Court ruled that the Subsidiary's regional management business was subsumed in its shareholding business, which the court deemed to be the Subsidiary's principal business. In its decision, therefore, the Nagoya High Court held that the Subsidiary did not satisfy the business criteria since its principal business was the shareholding

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business. Based on this decision, the issues before the Supreme Court were: (i) whether the Subsidiary's regional management business was subsumed in its shareholding business; and (ii) which business among the multiple businesses operated by the Subsidiary was its principal business.

Supreme Court decision

The Supreme Court held that a regional management business cannot be subsumed in a shareholding business since the regional management business has its own purpose which is different from that of the shareholding business. This is true even though the regional management business results in an increase in dividends and the asset value of the managed subsidiaries. On that basis and in light of the specific facts of the Denso Case, the Supreme Court ruled that the Subsidiary's regional management business was not subsumed in its shareholding business. In other words, the Supreme Court determined that the Subsidiary was separately engaged in a regional management business and a shareholding business, respectively.

The Supreme Court then held that a company's principal business is determined by identifying the particular business that was actually conducted by the company during the relevant fiscal year. If a company conducts multiple businesses, the principal business should be determined by comprehensively considering with respect to each business being conducted, factors including: (i) the gross income or net profit earned by each business; (ii) the number of necessary employees; and (iii) the status of tangible fixed assets, etc. When considering the businesses of the Subsidiary, the Supreme Court found the following:

- The sales from the Subsidiary's regional management business accounted for about 85% of the Subsidiary's gross income. Furthermore, although the dividends from its subsidiaries accounted for about 80% to 90% of the Subsidiary's net income, the extent to which the profit arose from the regional management business was considerably reflected in the dividend income.
- Most of the local employees were engaged in the regional management business.
- Most of the Subsidiary's tangible fixed assets were used in connection with the regional management business.

Based on these factual findings, the Supreme Court concluded that the regional management business was the Subsidiary's principal business. Moreover, the Supreme Court judged that all applicable exemption criteria were satisfied, and therefore CFC Rules would not apply to Denso.

Interplay between the Supreme Court decision in the Denso Case and the recent tax reforms

After the 2017 Tax Reform and 2018 Tax Reform, the framework of the CFC Rules has been fundamentally revised. By contrast, although the recent tax reforms changed the requirements relating to the determination of a company's principal business, the substance of the requirements are almost the same. Accordingly, notwithstanding the recent tax reforms, the Supreme Court decision in the Denso Case, which addressed not only the relationship between a regional management business and a shareholding business, but also the "principal business" criteria, remains a valuable judicial precedent.

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