Japan

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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 in accordance with the requirements of the BEPS Action Plans. These legislative measures include:

- Application of Transfer Pricing Rules to indirect affiliate transactions (2014).
- Exclusion of double non-taxation of dividends paid from foreign subsidiaries from the foreign dividend exemption system (2015).
- Introduction of an exit tax (2015).
- Application of a consumption tax to internet digital content services from foreign countries (2015).
- Strengthening of transfer price taxation documentation requirements (2016).
- Strengthening of rules regarding inheritance taxation on overseas assets (2017).
- Strengthening of Controlled Foreign Corporation ("CFC") Rules (2017).
- Amendment of the definition of permanent establishment ("PE") (2018).
- Additional amendment of the CFC Rules (2018).
- Strengthening of the Earnings Stripping Rules (2019).
- Amendment of the Transfer Pricing Rules (2019).
- Re-amendment of the CFC Rules (2019).
- Introduction of Specific Anti-Avoidance Rules for tax avoidance using dividends from subsidiaries and transferring the shares of the subsidiaries (2020).
- Re-amendment of the Earnings Stripping Rules (2020).
- Re-amendment of the CFC Rules (2020).

This chapter will summarise the three legislative measures that occurred in 2020: (1) the introduction of Specific Anti-Avoidance Rules for tax avoidance using dividends from a subsidiary and transferring the shares of the subsidiary; (2) amendment of the Earnings Stripping Rules; and (3) amendment of the CFC Rules.

Introduction of Specific Anti-Avoidance Rules for tax avoidance using dividends from a subsidiary and transferring the shares of the subsidiary

Background

Under Article 23 of the Corporate Tax Act, all or some of the dividends from a domestic subsidiary are not included in the taxable profit of its parent company, depending on the percentage of shares held by the parent company. Under Article 23-2 of the Corporate Tax Act, 95% of a dividend from a foreign subsidiary is not included in the taxable profit of its

parent company. As a result of these rules, if a parent company sells shares in a subsidiary after permitting the subsidiary to distribute a significant amount of dividends to the parent company, the parent company may create significant tax loss because the value of the shares would decrease as the dividend is distributed to the parent company, while all or most of the dividends are not included in the taxable profit of the parent company. The Ministry of Finance of Japan introduced the Specific Anti-Avoidance Rules in order to prevent this tax planning, which can be used as tax avoidance.

Outline of the Specific Anti-Avoidance Rules for tax avoidance using dividends from a subsidiary and transferring the shares of the subsidiary

The 2020 Tax Reform introduced the Specific Anti-Avoidance Rules, which will reduce a parent company's book value of shares in a subsidiary by an amount corresponding to the dividends received when the subsidiary distributes dividends exceeding 10% of the book value of the shares, except in the following cases:

- the subsidiary is a domestic corporation and 90% or more of shareholders of the subsidiary are domestic corporations or Japanese residents during the period between the date of incorporation of the subsidiary and the date on which the parent company achieves a Certain Dominant Relationship with the subsidiary. The parent company is required to retain a document to prove the subsidiary shareholders' status during that period. The Certain Dominant Relationship generally means a relationship in which a person directly or indirectly has more than 50% of shares or voting rights in a company;
- the subsidiary distributes dividends by using only retained earnings of the subsidiary that are obtained after a domestic corporation achieves a Certain Dominant Relationship with the subsidiary. The satisfaction of this condition is tested by a formula of whether the following item (A) minus item (B) exceeds item (C):
  - (A) amount of retained earnings on the balance sheet of the subsidiary of the fiscal year immediately preceding a fiscal year in which the subsidiary resolves the distribution of underlying dividends;
  - (B) total amount of dividends distributed during the period between the initial date of the fiscal year in which the domestic corporation receives the underlying dividends and the date for the domestic corporation to receive the underlying dividends; and
  - (C) amount of retained earnings on the balance sheet of the subsidiary as of the final date of the last fiscal year before the Certain Dominant Relationship occurs. If the amount of retained earnings decreases due to dividends distributed thereafter, and before the Certain Dominant Relationship occurs, the amount of retained earnings in this item (C) should decrease accordingly. The domestic corporation is required to retain a document to prove that item (A) minus item (B) exceeds item (C) above;
- dividends are distributed after 10 years have passed since the Certain Dominant Relationship occurred; or
- the total amount of underlying dividends and other dividends distributed during the fiscal year in which the underlying dividends are distributed does not exceed JPY 20 million.

Practical notes

The Specific Anti-Avoidance Rules were introduced to prevent tax planning using dividends from a subsidiary and transferring the shares of the subsidiary. However, regardless of whether the parent company is scheduled to transfer the shares, the Specific Anti-Avoidance Rules will apply if underlying dividends from subsidiaries meet the requirements set out above. In addition, whether the parent company is scheduled to transfer the shares to a relevant party or a third party is irrelevant. Accordingly, the application of the Specific Anti-Avoidance Rules

should be examined when a domestic parent company receives dividends from its subsidiaries regardless of whether the parent company is scheduled to transfer the shares.

As explained above, the parent company must retain a document to prove the subsidiary shareholders' status during the period between the date of incorporation of the subsidiary and the date on which the parent company achieves a Certain Dominant Relationship with the subsidiary. However, this requirement may be practically difficult for the parent company to satisfy because a shareholder does not have a right to require a company to disclose a prior shareholder list under the Companies Act of Japan.

Amendments to the Earnings Stripping Rules

Outline of Earnings Stripping Rules and Amendment pursuant to the 2020 Tax Reform

In Japan, beginning in around 2008, there was an increase in cases in which corporations would pay an excessive amount of interest for borrowings from foreign related parties (e.g., foreign parent companies, foreign subsidiaries, etc.), and include those 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 in the 2012 Tax Reform in Japan (stipulated in Section 66-5-2 of the Act on Special Measures Concerning Taxation).

Prior to the 2020 Tax Reform, the Earnings Stripping Rules provided that in a corporate fiscal year in which Net Interest Payments exceeded 20% of Adjusted Taxable Income, that excess could not be claimed as deductible expenses. For the purposes of this calculation:

- Net Interest Payments are defined as total interest paid (excluding any Excluded Interest Payments) minus the corresponding total amount of Eligible Interest Payments (i.e., the total interest received, calculated through fixed apportionment calculations).
- Excluded Interest Payments include interest payments other than Specified Bond Interest that would be included in taxable income of the recipient (meaning interest payments receipts which are declared as income in income/corporate tax returns in Japan).
- Adjusted Taxable Income means the amount of income (calculated according to a fixed formula) to be compared with Net Interest Payments.

Amendments to the scope of Excluded Interest Payments

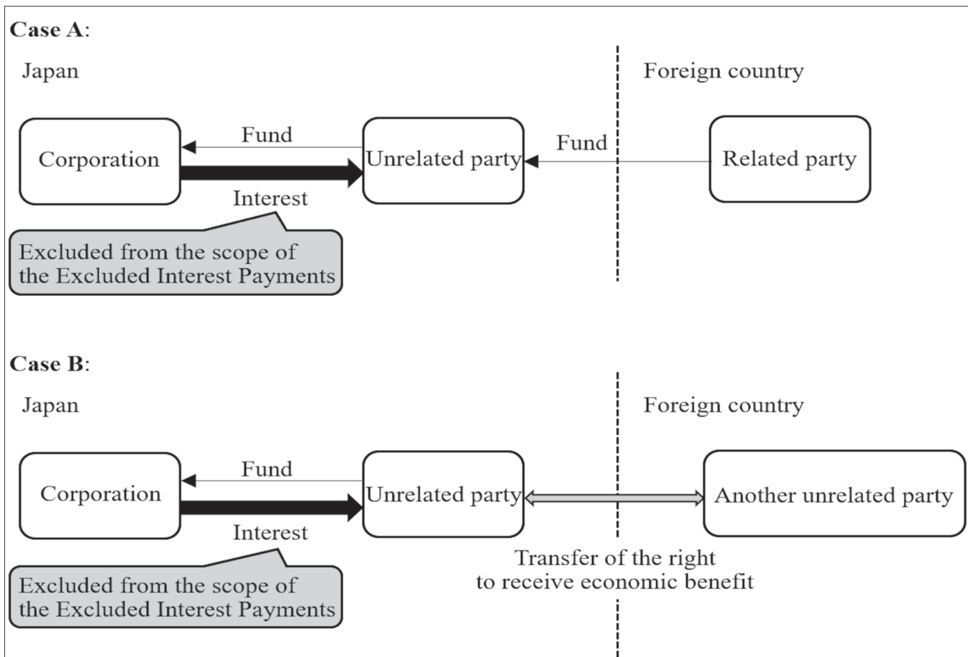
Under the 2020 Tax Reform, an interest payment to a PE of a foreign company, which would be included in the PE's taxable income, is excluded from the scope of the Excluded Interest Payments if the right to receive economic benefit with respect to a PE's underlying claim from which the foreign company accrues the interest will be transferred to the headquarters of the foreign company, unless the interest payment is subject to Japanese taxation on another basis.

These amendments to the scope of Excluded Interest Payments are reinforcements of the 2019 Tax Reform, under which the following two cases were excluded from the scope of the Excluded Interest Payments:

(A) a related party of the corporation provides the corporation with funds through an unrelated party of the corporation which receives an interest payment that is included in taxable income of the unrelated party, except that the interest payment would be included in taxable income of the related party if the interest payment was made by the corporation directly to the related party; or

(B) the right to receive an economic benefit with respect to an underlying claim from which an unrelated party accrues the interest will be transferred to another unrelated party, except that the interest payment would be included in taxable income of the other unrelated party if it was directly paid to the other unrelated party.

These two cases are illustrated by the following chart:



The rationale for the exclusionary rule above is that these two cases are considered to have substantially the same effect as a case in which an interest payment would not be included in taxable income of the recipient. The 2020 Tax Reform added a variation of Case B above. As in Case B, typically, a loan participation agreement would be executed between unrelated parties in which the right to receive an economic benefit with respect to the underlying claim from which an unrelated party accrues interest will be transferred to the other unrelated party. Similarly, it appears that an interest payment to a PE will typically be excluded from the scope of the Excluded Interest Payments under the 2020 Tax Reform if the headquarters of a foreign company and the PE have an economic relationship similar to a loan participation agreement.

Amendments to Japan's CFC Rules

The 2020 Tax Reform makes further additional amendments to the CFC Rules, which were also amended in the 2017, 2018, and 2019 Tax Reforms.

Outline of Japan's CFC Rules

If a domestic corporation holds no less than 10% of any subsidiary in a foreign country, and that domestic corporation, other domestic corporations, and/or Japanese residents hold in aggregate more than 50% of the shares of the subsidiary, that subsidiary will be categorised as a "foreign related company". If the foreign related company falls within the definition of a "specified foreign related company" (i.e., (i) a paper company, (ii) a company deemed to be an "actual cash box", or (iii) a company located in a blacklisted country, although no country has been designated as a blacklisted country as of 29 May 2020), the income of the subsidiary will be included in the domestic corporation's gross revenue for Japanese tax purposes. However, this rule 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", if the tax burden rate is less than 20%, the income

of the foreign related company will be included in that of the domestic corporation unless the "economic activity standard" is satisfied. Even if the foreign related company meets the "economic activity standard", the fixed passive income of the foreign related company will be fully included in the domestic corporation's income (partial summation system).

Amendments to the scope of passive income

Under the 2020 Tax Reform, when a foreign related company is engaged in a business that is generally necessary to help an officer or employee of a domestic corporation conduct a business of inventory sales or an associated business, the interest accruing from the inventory sales to a non-related party (i.e., "usance interest") is excluded from the scope of the passive income of the foreign related company which is included in that of the domestic corporation. The rationale for this reform is to make clear that such usance interest is considered to be related to active business income, rather than passive income.

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