THE Inward Investment and International Taxation Review

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Tim Sanders

THE LAWREVIEWS

THE INWARD INVESTMENT AND INTERNATIONAL TAXATION REVIEW

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PREFACE

This edition has been revised to describe domestic tax changes that have occurred in each jurisdiction since the last edition, including those made, and proposed, in response to the covid-19 pandemic. Where appropriate, the contributors also update the progress made in their respective jurisdictions in implementing laws to comply with the Base Erosion and Profit Shifting (BEPS) Actions.

The pandemic's economic impact has been profound, and while temporary reliefs have been introduced in many countries, and are described, at this stage it is unclear how countries will change their tax laws in the longer term and balance the need to recover the enormous costs of the pandemic with the desire to stimulate economic growth in contracting economies. How this conflict will evolve and be resolved seems likely to be the major tax story of 2021. This preface will make some tentative observations in this area.

As will be seen from the chapters herein, in 2020, countries continued to implement changes to their domestic laws to comply with BEPS Actions notably in respect of hybrid entities and instruments, controlled foreign companies and transfer pricing. One key area highlighted last year, which has progressed in 2020, is the taxation of the digital economy. In October 2020, the OECD published two blueprints and launched a public consultation as part of its work on the taxation of the digital economy. These blueprints are key developments in the international conversation on the challenges of taxing the digital economy. However, although the OECD has progressed efforts in 2020 to find a consensus, many countries, frustrated by the lack of concrete law, are progressing their own unilateral measures to tax the digital economy. For example, Spain's 'Google Tax' is due to come into force on 16 January 2021 and the United Kingdom has already introduced a Digital Services Tax. Pressure for unilateral action is likely to increase as countries look for new tax sources to recover revenue spent on fighting covid-19. Potentially taxation of digital companies allows many economies to raise material amounts of tax revenue without an adverse economic impact on the recovery in their own jurisdictions, where the digital taxpayers often have minimal presence and pay little tax. However, that analysis must factor in whether the US, that has most to lose (as many of the largest digital companies are US-based), will take retaliatory action. The previous political regime showed that it is willing to impose tariffs on goods imported from countries that unilaterally impose a digital tax. This is an area to watch carefully in 2021. The increased pressure to tax the digital economy because of the covid-19 pandemic has been acknowledged by the OECD, with the OECD Secretary-General stating on an online press conference on 12 October 2020 that digital businesses that are thriving during the pandemic would 'be the targets' of countries looking for resources to 'make ends meet'.

Many countries have introduced packages of short-term tax measures to help businesses and individuals through the pandemic. These may comprise deferring tax payments and extending filing deadlines, to subsidies such as those afforded to businesses that furloughed staff and measures allowing more generous loss carry-back. The question countries must face in 2021 is how long they can afford to provide these short-term reliefs and what will replace them. There is a lot of pressure to help certain sectors particularly hard hit by the pandemic such as tourism and hospitality and, for example, Austria's reduction in VAT to 5 per cent on restaurants, and admission to cultural events for 2021 is the sort of measure one might expect to be introduced elsewhere.

The wider question is how countries can reconcile the desire to provide economic support and stimulus for growth after the pandemic with the need to recover the budget deficit caused by covid-19 pandemic-related costs: how to raise additional tax from shrinking economies, without stifling any recovery. As referred to above, one obvious target is to tax the digital economy; another possible avenue is to introduce measures that encourage inward investment. It is also likely that in the drive to increase tax revenues, many tax authorities will take a far more aggressive and proactive approach to recover tax and penalties from tax payers regarded as non-compliant or participating in perceived tax avoidance. However, it would be naïve to imagine that these sorts of measures alone will be enough and even if one factors in tax changes in areas such as personal capital taxes, it seems likely that some increase in business and personal income taxes will be needed.

How US tax reform in 2021, post the presidential election, evolves is another factor likely to impact the wider tax landscape and is an area that needs to be kept under review.

It is hoped that this volume will prove to be a useful guide to the tax rules in the jurisdictions where clients conduct their businesses. Each chapter aims to provide topical and current insights from leading experts on the tax issues and opportunities in their respective jurisdictions. While specific tax advice is always essential, it is also necessary to have a broad understanding of the nature of the potential issues and advantages that lie ahead; this book provides a guide to these.

I should like to thank the contributors to this book for their time and efforts, and above all for their expertise. I would also like to thank the publisher and the team for their support and patience. I hope that you find the work useful, and any comments or suggestions for improvement that can be incorporated into any future editions will be gratefully received.

The views expressed in this book are those of the authors and not of their firms, the editor or the publishers. Every endeavour has been made to ensure that what you read is the latest intelligence.

Tim Sanders
London
January 2021

Chapter 15

JAPAN

Kei Sasaki, Kohei Kajiwara and Yoshiko Nakamura[1]

I INTRODUCTION

The Tokyo 2020 Olympics and Paralympic Games have been postponed for a year because of the unexpected global covid-19 pandemic and globalisation was forced to slow down. However, the new Prime Minister Yoshihide Suga, from the Liberal Democratic Party, began his term in September 2020, and has declared that he would continue to develop the 'Abenomics' economic programme, targeted at increasing inbound investments in Japan and stimulating domestic demand despite the pandemic. He will also accelerate digitisation of society under the covid-19 pandemic and this may lead to significant reforms in many areas including public administration and working practices in the next year.

As for the tax reform in relation to inbound investments, localisation of base erosion and profit shifting (BEPS) actions are ongoing. Amendment to earnings stripping rules and transfer pricing rules have been introduced as well as expansion of application of rules for controlled foreign corporations.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

In Japan, with the exception of sole proprietorships, businesses generally adopt a corporate form. Under the Companies Act of Japan (Companies Act), there are four types of companies one can establish:

a stock company (KK);
b general partnership company;
c limited partnership company; and
d limited liability company (GK).

The corporate form chosen will determine whether ownership of a company is separated from the management thereof, and the extent to which shareholders or members are liable to perform the company's obligations. The main differences between these four types of corporations are as follows: a KK is owned by shareholders but managed by its directors. The three other types of companies are, however, owned and managed by their members. The shareholders of a KK and members of a GK are only liable to the extent of their investments

1 Kei Sasaki is a partner and Kohei Kajiwara and Yoshiko Nakamura are associates at Anderson Mōri & Tomotsune.

in their respective companies. On the other hand, the liability of members in a general partnership company is unlimited. By contrast, a limited partnership company has two types of members: those with limited liability and those with unlimited liability. As their names suggest, limited liability members are only liable to the extent of their investment in the company, while the liability of unlimited liability members is unlimited.

The KK is the most widely used corporate form in Japan. The GK, although not as popular as the KK, is also often used, especially as a vehicle in structured finance. Limited partnership companies and limited liability companies, on the other hand, are not so common.

In addition to the corporate forms under the Companies Act, there are also laws in Japan that enable corporations of other forms to be incorporated for special purposes. These include:

a specific purpose companies (TMKs), which are often used in asset securitisation;
b investment corporations, which are commonly used to accumulate funds for investment in securities and real estate;
c mutual companies, which are commonly used in insurance-related transactions; and
d medical corporations, which are commonly used for holding hospitals.

ii Non-corporate

Non-corporate entities (except sole proprietorships) can generally be categorised as partnerships, silent partnerships (TKs) and trusts.

Most partnerships are general partnerships formed under the Civil Code of Japan (NKs). The partners in such partnerships are subject to unlimited liability. Additionally, there are other types of partnerships such as investment limited partnerships (LPSs) and limited liability partnerships (LLPs) that are derivatives of the NK. These partnerships may be established under special legislation. An LPS has partners with both limited and unlimited liability. LPSs are usually used for forming venture capital firms. An LLP is a partnership in which all partners are liable only to the extent of their investment in the partnership, and is typically used in joint ventures for academic research and development.

A TK is formed by way of a bilateral agreement between a business operator and its silent partners. A silent partner is someone who has contributed capital toward the relevant business operations in return for a share in the profits generated from the business. TKs are often used in structured finance.

Corporations incorporated under the Companies Act (i.e., KKs, general partnership companies, limited partnership companies and GKs) are fiscally opaque. On the other hand, partnerships such as NKs, TKs and most forms of trusts are fiscally transparent (i.e., they are pass-through entities). By comparison, TMKs and investment corporations are pay-through entities, such that the amount of profits they distribute (if any) to equity holders will be deducted from their taxable income.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Under the Corporation Tax Act of Japan (CTA), taxable income is derived by subtracting deductible expenses from gross profits. Deductible expenses are similar to accounting expenses, but with some important differences, and exclude certain kinds of accounting expenses. Gross profits are similar to accounting incomes, but with some important differences, and exclude certain kinds of accounting income.

There are major differences between deductible expenses and accounting expenses under the CTA, as follows:

a in respect of depreciable or amortisable assets, the amount of depreciation or amortisation permitted to be included in deductible expenses is limited. Specifically, the amount of depreciation or amortisation deductible for each year is calculated based on the useful life of the relevant asset, which in turn is determined based on the category of the relevant asset, and on the method of depreciation or amortisation adopted by the company. Also, under the Japanese tax system, depreciation and amortisation are required to be recorded first as accounting expenses before they can be registered as expenses deductible from taxable income in the relevant financial year;

b the amount of remuneration paid to officers shall not be included in the deductible expenses unless the period of remuneration payment is a constant period of one month or less, and the amount thereof is the same at each time of payment, remuneration is paid based on a provision with registration that ascertains an amount to be paid at a fixed time or remuneration is a certain kind of performance-linked remuneration;

c the amount of contribution or donation exceeding a certain amount shall not be included in the deductible expenses; and

d the amount of entertainment account exceeding a certain amount shall not be included in the deductible expenses.

Practically speaking, taxable income is derived from accounting profits. Once accounting profits have been ascertained, taxable incomes can be calculated by adding to the accounting profits the non-deductible expenses referred to above, and deducting therefrom, exclusive of gross profits, such items as certain portions of dividends distributed from a corporation.

In Japan, profits are taxed on an accrual basis and not on a receipt basis. Japanese corporations are subject to taxation on their worldwide income. Foreign corporations, on the other hand, are only subject to taxation on Japan-source income for the purposes of Japanese taxation. A foreign corporation's taxable Japan-source income differs depending on whether the foreign corporation is deemed to have a permanent establishment (PE) in Japan. Japan's system of taxable domestically sourced income adopts the 'attributable income principle'. Under this principle, in relation to taxation on business profits of a foreign corporation, only the portion that is attributable to its PE in Japan will be recognised as Japan-source income and, therefore, subject to Japanese taxation.

Capital and income

Realisation of and taxation on capital profits are usually deferred to the time of sale of the relevant asset. Where assets are sold at a profit, corporate income and capital profits will be aggregated and subject to corporate income tax at the corporate income tax rate.

Losses

Tax loss carry back

Where a domestic corporation incurs losses in a financial year, it may, simultaneously with the filing of its tax return, also file a claim for a corporate income tax refund for a certain amount of corporate income tax for any financial year commencing within one year prior to the beginning of the relevant loss-making financial year, depending on the amount of the said loss. However, where a corporation is not a small or medium-sized company (i.e., not a corporation with stated capital of ¥100 million or less, but excluding a corporation that is completely controlled by a corporation with stated capital of ¥500 million or more), this refund will not be applicable. As an exception to this limitation, with regard to losses incurred during a financial year which terminates at any time between 1 February 2020 to 31 January 2022, where a corporation is not a corporation with stated capital of more than one billion, but excluding a corporation that is completely controlled by a corporation with stated capital of more than one billion, this refund will not be applicable.

Tax loss carry-forward

When a domestic corporation files a final tax return that indicates losses in a financial year commencing within 10 years prior to the first day of each of its financial years, an amount equivalent to the said loss will be permitted to be included within the deductible expenses for each relevant financial year. However, where a corporation is not a small or medium-sized company and the amount of said loss exceeds the maximum deductible amount; 50 per cent of the taxable income for the relevant financial year, inclusion within the deductible expenses will not apply to the amount of the said excess.

In the case of a merger, losses are not usually permitted to be succeeded by the surviving corporation unless certain requirements for exceptional treatment are satisfied.

Under the CTA, taxable income is subject to aggregate taxation and is not taxed on an income category-by-category basis. Accordingly, in cases where losses are incurred by a business, but it receives capital gains from the sale of some assets, then said losses offset the income of the capital gain and reduce the taxable income.

Rates

The corporate income tax rate applicable to small or medium-sized companies is 15 per cent (the rate applicable to companies whose annual average income for each business year ended within three years before the start of the financial year exceeds 1.5 billion yen is 19 per cent) for income up to ¥8 million and 23.2 per cent for the portion of income in excess of ¥8 million. The corporate income tax rate applicable to companies other than small or medium-sized companies is 23.2 per cent. These rates are now applicable for financial years commencing on or after 1 April 2019 to 31 March 2021. For the rates that are applicable to each financial year, please see the following table.

<table>
<tr><th colspan="3">Commencement date of the financial year</th><th>1 April 2019 to 31 March 2021</th><th>On or after 1 April 2021</th></tr>
<tr><td rowspan="3">Small or medium-sized companies</td><td rowspan="2">Up to ¥8 million</td><td>Other than those below</td><td>15 per cent</td><td rowspan="2">19 per cent</td></tr>
<tr><td>Companies whose income exceeds certain amount</td><td>19 per cent</td></tr>
<tr><td colspan="2">Portion in excess of ¥8 million</td><td>23.2 per cent</td><td>23.2 per cent</td></tr>
<tr><td>Companies other than small or medium-sized companies</td><td colspan="2">Overall</td><td>23.2 per cent</td><td>23.2 per cent</td></tr>
</table>

Other than corporate income tax, companies are also subject to, inter alia, the following taxes, which are proportional with a rate that is flat or progressive, on profits generated:

a local corporation tax;
b inhabitant tax;
c enterprise tax; and
d special enterprise tax (applicable to financial years beginning on or after 1 October 2019).

A corporation's effective corporate income tax rate is determined by the amount of its stated capital and the location of its office. Corporations that have stated capital of more than ¥100 million and offices located in an area where the excess tax rate is not applied have an effective corporate income tax rate of 29.74 per cent from the financial year beginning on or after 1 April 2018. 'Effective tax rate' means the tax rate taking into account the deductibility of special local corporation tax and enterprise tax payments from taxable income.

Administration

Corporations are required to file their final tax return before the district director of the relevant tax office for corporate income tax (national tax) within two months following the end of each financial year (final return). A corporation whose financial year exceeds six months is also required to file an interim tax return to the district director of the relevant tax office within two months of the end of the first six months of its financial year (interim return).

In some cases, the competent district director may extend the filing deadline for a final return by one month or more if such extension is requested. Regardless of whether the deadline is postponed, corporations are required to pay corporate income tax by the original tax return filing deadline. Therefore, where the tax return filing deadline is extended, corporations are liable to pay interest on payable corporate income tax for the period of extension.

The primary objectives of the National Tax Agency (NTA) include the enhancement of transparency in tax filing procedures, creating predictability for taxpayers, encouraging taxpayers' cooperation in investigations by the tax authority, improving the efficiency of the self-assessment system and strengthening accountability.

Matters of national tax (excluding internal consumption tax on imported goods, which is under the jurisdiction of the Customs and Tariff Bureau) are within the NTA's purview. The NTA has 11 regional tax bureaux, a national tax office in Okinawa and around 500 tax offices located throughout Japan.

Matters of local tax fall within the jurisdiction of the relevant prefectural tax office or city office of the relevant local government.

Tax offices have the authority to conduct tax audits for corporate income tax. The timing of such audits is not prescribed in the relevant laws and regulations. Notwithstanding this, there is a general understanding that tax audits are conducted once every few years and are typically focused on corporations whose profits swing widely from year to year.

Revised tax returns may be filed to increase tax liability when the declared tax amount is less than the correct amount stated in the new tax return.

On the other hand, if the declared tax amount is more than the correct amount, corporate income tax reassessments may be requested by taxpayers, provided such requests are conducted within the permitted time frame (as indicated in the table below).

Type of request for tax reassessment		**Permitted time frame (beginning from the deadline for filing of the relevant tax return)**
General		Five years
Tax reassessment in relation to transfer pricing	–31 March 2020	Six years
	1 April 2020–	Seven years
Tax reassessment in cases of changes to net loss amount		10 years

The district director of the relevant tax office may conduct reassessments of corporate income tax, provided such reassessments are conducted within the permitted time frame (as indicated in the table below).

Type of tax reassessment		**Permitted time frame (beginning from the deadline for filing of the relevant tax return)**
General		Five years
Tax reassessment in relation to transfer pricing	–31 March 2020	Six years
	1 April 2020–	Seven years
Tax reassessment in situations where a taxpayer evades tax through fraud or other wrongful means		Seven years
Tax reassessment in cases of changes to the net loss amount		10 years

Taxpayers wishing to appeal a tax assessment can do so through the following avenues:

a making a request for reinvestigation to the director of the relevant tax office that had performed the original tax assessment (taxpayers are not obliged but have the right to request a reinvestigation before requesting a re-examination under (b));

b making a request to the National Tax Tribunal (NTT) for a re-examination of the original tax assessment; and

c instituting a lawsuit. (Lawsuits can only be instituted, in principle, after the results of NTT's re-examination under item (b) has been released.)

As stated above, item (c) may be conducted only after following the procedure mentioned in item (b). On the other hand, a taxpayer may skip item (a) and go straight to item (b) instead.

Tax grouping

There are two regulatory frameworks in Japan in respect of tax consolidation: the full controlling interest framework and the consolidated return framework. The consolidated return framework will be replaced with the group tax relief framework from tax years beginning on or after 1 April 2022.

The full controlling interest framework applies mandatorily to intra-group transactions (including transactions involving transfers of assets, losses, dividends and interest) where all companies in the group are wholly owned (whether directly or indirectly) by the ultimate parent of the group, regardless of whether the ultimate parent is a foreign or domestic company or individual, provided that the parties to the relevant transaction are domestic companies. Under this regulatory framework, taxation on intra-group profits from transfers of certain kinds of assets, such as fixed assets, securities, monetary claims and deferred assets (qualifying assets), is deferred until those assets are transferred outside the group. Additionally, intra-group contributions, donations and dividends are disregarded. Where the full controlling interest framework applies, certain tax incentives to which corporations with stated capital of ¥100 million or less are normally entitled would no longer be available to a small or medium-sized company that is fully controlled by a large corporation with stated capital of ¥500 million or more.

On the other hand, the consolidated return framework is, where approved by the Commissioner of the NTA, only applicable to groups in which all companies are wholly owned (whether directly or indirectly) by the ultimate parent of the group and the companies consist only of domestic companies. Under this framework, corporate income tax is calculated based on the group's consolidated income and payable by the domestic controlling corporation as the taxpayer. In respect of subsidiaries in such groups, unrealised profits and losses of qualifying assets will be imputed to taxable income or losses for the financial year immediately preceding that in which the consolidated return applies to the group. In addition, under the consolidated return framework, taxation on profits from intra-group transfers of qualifying assets is deferred until those assets are transferred outside the group. Intra-group contributions, donations and dividends are also disregarded under the consolidated return framework.

The group tax relief framework is, where approved by the Commissioner of the NTA, only applicable to groups in which all companies are wholly owned (whether directly or indirectly) by the ultimate parent of the group and the companies consist only of domestic companies. Each corporation within the group shall individually calculate the amount of corporate tax, by offsetting profits and losses among the group, and file a tax return or a claim for refund as the tax payment unit. If a reason for amending the tax return or reassessment occurs later, in principle, it will not be reflected in the tax calculation of other corporations in the group. Taxation on profits from intra-group transfers of qualifying assets is deferred until those assets are transferred outside the group in principle. Intra-group contributions, donations and dividends are also disregarded under the consolidated return framework.

ii Other relevant taxes

In addition to corporate income tax and other taxes on profits, which are stated above, the taxes that generally apply to businesses are, inter alia, withholding tax under the Income Tax Act of Japan, fixed property tax, consumption tax, stamp duty, registration tax and real estate acquisition tax.

Fixed property tax is proportional to the book value of the relevant property as indicated in the property register. Consumption tax is imposed on transfers of assets, with the transferor being deemed the taxpayer, although such tax is borne by the transferee in practice. Notwithstanding the above, in certain categories of online transactions, a 'reverse charge' was introduced and the transferee is deemed the taxpayer of consumption tax. Stamp duty is generally imposed on documents such as written contracts. Registration tax is imposed when registration is undertaken with the authorities, such as when real estate is registered on the national real estate register. Real estate acquisition tax, as its name suggests, is imposed on acquirers of real estate.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

An entity becomes a Japanese tax resident (that is, it is deemed a domestic corporation for Japanese tax purposes) if its head office or principal office is located in Japan. The place where management and control are exercised is irrelevant for the purposes of determining tax residency in Japan. Accordingly, a foreign-incorporated entity cannot be a Japanese tax resident, even though it exercises its management and control functions in Japan.

ii Permanent establishment

A foreign company will be considered to have a fiscal presence for purposes of Japanese tax if it has a PE in Japan, such as a fixed place of business (branch PE), building or site (building PE), or a person who is predominantly based in Japan to act on the corporation's behalf (agent PE). Several factors are relevant in determining whether a PE exists. For example, in determining whether a foreign company has a PE in Japan, relevant factors include, inter alia, whether the corporation's business is conducted at such a fixed place.

The definition of PE has been amended for the financial years beginning on or after 1 January 2019 to align it with the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model Convention) 2017. In addition, the most notable new rule is that the definition of PE under domestic tax law will be overwritten by the definition of PE under a relevant tax treaty applicable to a foreign company if the definition under the relevant treaty is different from that of domestic tax law. The other major amendments to domestic tax law include the following:

a After the amendments to the definition of agent PE, agent PE will include not only a person who has an authority to conclude a contract in Japan on behalf of the foreign company but also a person who plays a principal role continuously in concluding a contract in Japan on its behalf. However, an agent of a foreign company will not be considered as PE if the agent is 'independent' from the foreign company and acts in the ordinary course of its business unless the agent acts only on behalf of one or more related parties.

b After the amendments to the exception of definition of PE, even places that are used only for certain purposes, such as storing, exhibiting or delivering goods, etc., would not be excluded from PE unless the activity is purely preparatory or auxiliary in nature.

Japanese tax law adopts the attributable income principle, under which only the income attributable to the PE in light of the Authorised OECD Approach is taxable. Thus, profits calculated by deeming that the PE was a distinct and separate entity from the corporation, was engaged in the same or similar activities under the same or similar conditions with the corporation, and was dealing wholly independently from the enterprise, are attributable to the PE.

Treaty tiebreakers, such as Article 4, Paragraph 3 of the US–Japan tax treaty (or the US–Japan double tax treaties (DTAs)), prescribe the method by which to determine the tax residence of a person who falls within the definition of tax resident in both the US and Japan. There is no concept of branch profit tax in Japan.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

There is no special tax regime applicable to holding companies in Japan.

ii IP regimes

There is no special tax regime applicable to intellectual property in Japan, although withholding tax on royalty payments is exempt under some tax conventions.

iii State aid

State aid is available in certain sectors, such as the agriculture and manufacturing sectors. State aid comes in various forms, including tax exemptions, tax reductions and tax-free subsidies that encourage investments and the conducting of research and development in Japan. State aid is generally available as long as the relevant taxpayer is a tax resident of Japan, regardless of whether it is controlled by a foreign entity or individual.

iv General

The government provides several tax incentives to foreign business operators to encourage their investment in some sectors in Japan. Certain areas in Tokyo have been designated to fall within the Special Zone for Asian Headquarters, established to induce foreign companies to set up their offices and facilities in Japan. Specifically, a foreign company that establishes its Asian headquarter or its research and development centre in such special areas and also satisfies certain requirements will be entitled to enjoy tax incentives in the form of special depreciation rates or investment tax credits and several local tax exemptions.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Dividends and certain forms of profit distribution (such as capital repayment or repurchase of shares) by a domestic corporation to a non-resident or a foreign corporation are subject to withholding tax at a rate of 20.42 per cent (or 15.315 per cent in the case of dividends from listed shares).

The Income Tax Act of Japan contains different rules on sources of income in respect of interest income from Japanese government bonds, certain kinds of domestic corporate bonds and deposits with financial institutions' business offices or facilities located in Japan (bond interest), and interest income from loans to business entities that conduct business in Japan (loan interest). Under Japanese law, bond interest is deemed Japan-sourced income, and is generally subject to withholding tax at a rate of 15.315 per cent if paid to a non-resident or a foreign corporation. Loan interest attributable to business conducted in Japan is also deemed Japan-sourced income, but is generally subject to withholding tax at a rate of 20.42 per cent when paid to a non-resident or a foreign corporation.

Royalties paid to non-residents or foreign corporations by entities or residents conducting business in Japan are subject to withholding tax at a rate of 20.42 per cent.

Notwithstanding the above, non-residents or foreign corporations with PEs in Japan may apply for an exemption from withholding tax on loan interest income or royalties attributable to their Japanese PEs with a competent district director of the relevant tax office. Specifically, by obtaining a certificate issued by the competent district director of the tax office and by presenting the certificate to the payers, such non-residents and foreign corporations are permitted to pay taxes on loan interest income or royalties attributable to their Japanese PEs in the form of corporate income tax instead of withholding tax.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

As stated above, bond interest is generally subject to withholding tax. However, non-residents and foreign corporations may apply for an exemption from the withholding tax on interest income from government bonds or corporate bonds received by way of the book-entry system, and interest income from corporate bonds issued outside Japan that is paid to recipients outside Japan. However, such exemption does not apply to cases where interest income on corporate bonds is paid to related parties (such as relatives or controlling shareholders with more than 50 per cent equity interest in the issuer of the relevant corporate bonds). In addition, interest income on corporate bonds that is attributable to PEs of non-residents and foreign corporations is still taxable under the self-assessment system instead of the withholding tax system.

As stated above, interest income from deposits with financial institutions' business offices or facilities located in Japan is generally subject to withholding tax. Foreign corporations may, however, apply for an exemption from the withholding tax on interest income derived from deposits in special international financial transactions accounts maintained with certain financial institutions. Interest income from the deposits that is attributable to PEs of foreign corporations is still taxable under the self-assessment system instead of the withholding tax system.

iii Double tax treaties

As of 1 November 2020, Japan is party to 78 tax treaties with 141 countries and regions. These treaties comprise 65 tax treaties on avoidance of double taxation on income with 74 countries and regions (DTAs); 11 tax treaties on exchange of information with 11 countries and regions; a tax convention on mutual administrative assistance in tax matters among 109 countries; and a tax agreement between Japan and Taiwan.

Although Japan does not publish its general policies under the tax treaties it has entered into; most of the 65 DTAs are substantially based on the OECD Model Convention. In particular, the 2004 US–Japan DTA (amended by the protocol which was signed in January 2003 and entered into force on 30 August 2019), which was based on the OECD Model Convention, serves as a base for many of the subsequent tax treaties entered into by Japan. In this connection, even though the US–Japan DTA is based on the OECD Model Convention, it provides for lower tax rates on investment income such as interest, dividends or royalties in the source country to facilitate international investments.

The following table indicates the withholding tax rates in Japan, and how such rates are reduced or eliminated based on Japan's DTAs with various developed and developing countries.

Contracting state	**Dividend**		**Interest**		**Royalties**
	General	**Received by shareholders holding certain percentage of shares**	**General**	**Received by banks**	
(Domestic standard in Japan)	20.42 per cent		15.315 per cent or 20.42 per cent		20.42 per cent
United States	10 per cent	5 per cent or zero per cent	Zero per cent	Zero per cent	Zero per cent
United Kingdom	10 per cent	Zero per cent	Zero per cent	Zero per cent	Zero per cent
France	10 per cent	5 per cent or zero per cent	10 per cent	Zero per cent	Zero per cent
Netherlands	10 per cent	5 per cent or zero per cent	10 per cent	Zero per cent	Zero per cent
Switzerland	10 per cent	5 per cent or zero per cent	10 per cent	Zero per cent	Zero per cent
Australia	10 per cent	5 per cent or zero per cent	10 per cent	Zero per cent	5 per cent
Singapore	15 per cent	5 per cent	10 per cent	10 per cent	10 per cent
Vietnam	10 per cent	10 per cent	10 per cent	10 per cent	10 per cent
China	10 per cent	10 per cent	10 per cent	10 per cent	10 per cent

Japan also signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which has come in to force in Japan as of 1 January 2019. The MLI affects Japanese bilateral tax treaties with 41 countries and regions (not including the United States), among which 27 countries (including the United Kingdom, France, the Netherlands, Australia and Singapore) have deposited the instruments of ratification as of 29 October 2020.

iv Taxation on receipt

A domestic corporation that receives dividends from a domestic or foreign corporation is required to include dividends in its taxable income, although it is eligible for withholding tax credits or foreign tax credits.

However, a domestic corporation that receives dividends from another domestic corporation may exclude all or part of such dividends from its taxable income, depending on the relationship between the payer and recipient of the dividends. Where a dividend recipient holds 100 per cent of the shares in the dividend payer, received dividends may be entirely excluded from the recipient's taxable income. Where a dividend recipient holds more than one-third but less than 100 per cent of the shares in the dividend payer, 100 per cent of received dividends after deducting the relevant interest cost may be excluded from the recipient's taxable income. Where a dividend recipient holds more than 5 per cent but one-third or less of the shares in the dividend payer, 50 per cent of received dividends may be excluded from the recipient's taxable income. Where a dividend recipient holds 5 per cent or less of the shares in the dividend payer, 20 per cent of received dividends may be excluded from the recipient's taxable income. Further, such dividends are generally subject to withholding tax at a rate of 20.42 per cent (or 15.315 per cent for dividends received in respect of listed shares). A dividend recipient is eligible for withholding tax credits.

On the other hand, dividends received by a domestic corporation from a foreign corporation are generally required to be included in the domestic corporation's taxable income. Where the dividend recipient holds 25 per cent or more of the shares in the foreign dividend payer, then 95 per cent of the dividend may be excluded from the recipient's taxable income.

If a foreign country withholds tax on dividends, interest or royalties paid to a Japanese corporation recipient, the recipient will be eligible for foreign tax credits up to a certain amount in general. However, certain types of foreign tax, including but not limited to withholding tax on dividends received by a domestic corporation holding 25 per cent or more of the shares in the foreign dividend payer, are ineligible for the foreign tax credit.

VII TAXATION OF FUNDING STRUCTURES

Entities in Japan are commonly funded through equity or debt, or both. In situations involving foreign parent companies and Japanese subsidiaries, foreign parent companies will typically provide loans to their Japanese subsidiaries until the latter achieve operational stability and necessary critical mass.

i Thin capitalisation

Japanese tax law includes thin capitalisation rules. Under these rules, if interest is paid to a foreign controlling shareholder by a domestic corporation (i.e., a Japanese corporation) when the payer's average interest-bearing debt to the foreign controlling shareholder in the financial year exceeds three times the value of the foreign controlling shareholder's equity interest in the payer in the said financial year, and the payer's average aggregate interest-bearing debt in the said financial year exceeds three times the value of the aggregate equity interest in the payer, the interest income related to the excess debt will not be deductible from the payer's taxable income. A domestic corporation may, however, apply a different debt-to-equity ratio (instead of three times) if it can prove that a different ratio is appropriate in light of the debt-to-equity ratio of similar corporations.

ii Deduction of finance costs

Finance costs such as interest or bank arrangement fees are generally considered deductible expenses. However, because Japanese tax law includes earnings stripping rules, transfer pricing rules and thin capitalisation rules, the inclusion of finance costs in deductible expenses is restricted.

Under the earnings stripping rules before the financial year 2019 tax reform, when interest payments to related foreign corporations (such as a foreign parent company or subsidiary) exceed 50 per cent of the statutory income of the payer, the portion of interest payments exceeding 50 per cent of the statutory income of the payer is not deductible from the payer's taxable income in the financial year. However, such excess portion is carried forward for seven financial years and can be used as deductible expenses until the total amount of deductible expenses reaches a 50 per cent threshold in each of the following seven financial years.

The financial year 2019 tax reform (which is effective for the financial year of foreign corporations commencing on or after 1 April 2020) substantively revised the earnings stripping rules above. Under the revised earnings stripping rules, when certain types of interest payments to another person (including an unrelated third party) exceed 20 per cent of the statutory income of the payer, the portion of interest payments exceeding 20 per cent of the statutory income of the payer is non-deductible from the payer's taxable income in the financial year. However, such excess portion is carried forward for seven financial years and can be used as deductible expenses until the total amount of deductible expenses reaches a 20 per cent threshold in each of the following seven financial years.

Under the transfer pricing rules, the portion of finance costs exceeding arm's-length prices will not be deductible from the payer's taxable income if the transaction giving rise to the relevant finance costs (including interest payments) is not conducted at arm's length.

The thin capitalisation rules also place restrictions on the amount of deductible expenses claimable as stated above.

iii Restrictions on payments

Under the Companies Act, a KK's distributable profits, which are subject to statutory limits, are calculated based on surplus funds available. A GK's distributable profits are also limited to a certain amount. By contrast, the profits distributable by a general partnership company and limited partnership company are unlimited, unless restrictions on profit distribution are contained in their articles of incorporation.

iv Return of capital

A KK is permitted under the Companies Act to repay its capital to shareholders in the form of dividends through the reduction of its capital or statutory reserves. This involves approval for the capital or statutory reduction being obtained from the KK's shareholders at a shareholders' meeting; and the notification of the KK's creditors about the reduction in capital or statutory reserves and, in the event of any objection to such reduction by any creditor, the taking of the required statutory procedures to protect the interests of the objecting creditor. Upon the implementation of the reduction, the KK will be generally deemed to have returned capital to its shareholders of an amount equivalent to the capital of reserves reduced.

However, if there is any portion as a result of a calculation subtracting the value of capital attributable to the shares held by the shareholder from the amount of such capital return, such portion is deemed to be a dividend instead of a capital return for tax purposes. Accordingly, if the shareholders of a KK are domestic corporations, a certain amount of deemed dividends may be excluded from the recipient's taxable income depending on the relationship between the payer and recipient of the dividends, as stated above. On the other hand, if the shareholders of a KK are foreign corporations, deemed dividends are subject to withholding tax at a rate of 20.42 per cent (or 15.315 per cent in the case of dividends from listed shares) as stated above.

Further, if the shareholder of a KK is a domestic corporation, then the shareholder may include the capital gain or loss in its taxable income or loss. Such capital gain or loss is calculated by subtracting the acquisition cost basis of the share held by the shareholder from the capital return amount attributable to the share. On the other hand, if the shareholder or a KK is a foreign corporation, then the shareholder may include the capital gain or loss in its taxable income or loss if certain requirements are met.

Overall, dividends distributed by a KK through the reduction of its capital or statutory reserves are viewed and taxed differently depending on which portion of the dividends is deemed to be a capital return or a dividend. Such a tax regime is not considered to be tax-neutral.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Foreign corporations often acquire businesses in Japan by acquiring shares or assets (including employees) of a target entity in Japan. Doing so obviates the need to establish a new entity in Japan. Based on the prevailing interpretation of the Companies Act, however, a Japanese corporation cannot engage in a merger or demerger with a foreign corporation. Accordingly, if a foreign acquirer wishes to merge with or demerge from a Japanese target entity, it has to establish a new wholly owned subsidiary in Japan (if it does not already have a Japanese subsidiary) through which to merge with or demerge from the target entity indirectly. In transactions where foreign corporations adopt such a structure, the new wholly owned Japanese subsidiary is typically financed by capital or debt, or both. The debt-to-equity ratio of such subsidiary is determined in light of the thin capitalisation rules and the earnings stripping rules.

Consideration for the acquisition of shares or assets is typically paid in cash. However, consideration in forms other than cash (such as shares issued by the acquirer or a parent company of the acquirer, corporate bonds and other assets) is also permissible.

ii Reorganisation

Under Japanese tax law, mergers and demergers may be classified as tax-qualified mergers or demergers if certain conditions prescribed by the CTA are satisfied. One notable condition is that the consideration in tax-qualified mergers or demergers has to consist solely of shares in the acquirer or the wholly (directly or indirectly) owning company of the acquirer in principle. The financial year 2019 tax reform accepted shares in the wholly indirectly owning company of the acquirer to be used as a consideration in tax-qualified mergers or demergers while shares to be used therein were limited to shares in the acquirer or the wholly and directly owning parent company of the acquirer before the financial year 2019 tax reform. The tax reform became effective on 1 April 2019.

In addition, the consideration in tax-qualified mergers can include cash in the case that the acquirer holds two-thirds or more of the target corporation's shares and the merger is conducted to squeeze out minority shareholders.

Assets and liabilities in non-tax-qualified mergers or demergers are transferred at fair market value. In tax-qualified mergers or demergers, however, assets and liabilities are transferred at book value. This means that capital gains or losses arising from transfers in tax-qualified mergers or demergers may be deferred at both the merged corporation level and the level of its shareholders. Notwithstanding this, tax-qualified mergers or demergers may not always offer the most favourable tax treatment to taxpayers where unrealised losses are deferred. However, taxpayers wishing to avoid requirements in respect of tax-qualified mergers or demergers can easily do so by paying consideration in forms other than shares. In this sense, Japanese tax law does not prevent consolidation between an acquired business and an existing local business, although mergers and demergers between Japanese corporations and foreign corporations are not permitted under the Companies Act, as stated above. Ultimately, the most suitable type of merger or demerger depends on the relevant situation.

iii Exit

Foreign corporations wishing to exit the Japanese market commonly do so by selling the shares in their Japanese subsidiaries. Capital gains arising from such sales are taxable under the CTA as long as the foreign corporation holds more than 25 per cent of shares in the Japanese subsidiary and sells more than 5 per cent of shares therein in the said financial year, etc. As a result, foreign corporations are required to file tax returns with the applicable tax office within two months following the end of their financial year.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Japanese tax laws contain general avoidance rules such as the disallowance of acts or calculations:

a by family-owned corporations;
b in relation to organisational restructuring;
c by consolidated corporate groups; and
d regarding foreign entity profits that are attributable to a PE.

In respect of low-tax jurisdictions, the Japanese tax authorities apply the controlled foreign corporation rules (the CFC rules) in addition to other rules such as transfer pricing rules, thin capitalisation rules and earnings stripping rules.

ii Controlled foreign corporations (CFCs)

The CFC rules will apply if: (1) more than 50 per cent of shares in a foreign corporation are held directly by one or more Japanese residents (domestic corporations or individual residents in Japan) or indirectly through one or more foreign affiliates, whose more than 50 per cent shares are held by one or more Japanese residents; or (2) the foreign corporation is substantially controlled by a Japanese resident. The foreign corporation will be considered to be substantially controlled by a Japanese resident if the Japanese resident has the right to receive most of the residual property of the foreign corporation or if the Japanese resident can determine most of the policy on property disposal of the foreign corporation based on an agreement.

The CFC rules differ depending on activity of a foreign corporation.

If a foreign corporation falls within the category of a paper company, a company deemed to be an actual cash box or a company located in a blacklisted country (a Paper Company etc.), a Japanese resident, who: (1) owns 10 per cent or more of the shares in; or (2) has a substantial controlling interest in such foreign corporation, is taxed on the retained profits of the foreign corporation: (1) in proportion to the ratio of the resident's stock ownership in that corporation; or (2) in consideration of such substantial controlling interest in that corporation unless the amount of taxes on a foreign corporation's income that is earned in a foreign country where the head office or principal office of the foreign corporation is located is 30 per cent or more of the foreign corporation's income (the Tax Burden Rate).

If a foreign corporation (which is not a Paper Company, etc.) does not satisfy any of the following requirements stated below in (a) to (d), a Japanese resident is also proportionally taxed on the retained profits of the foreign corporation; provided, however, that a Japanese resident is not taxed on the retained profits of the foreign corporation if the Tax Burden Rate is 20 per cent or more:

a the main businesses of the foreign corporation are not certain types of business, such as holding shares or bonds (business purpose test);

b the foreign corporation has the business offices necessary for its main business in the said foreign country (substance test);

c the foreign corporation has management and control functions in the said foreign country (management and control function test); and

d the foreign corporation conducts business mainly with unrelated parties (unrelated parties test) or mainly in the said foreign country (location test). Whether the unrelated parties test or location test will apply depends on the segments of the foreign corporation's main businesses that are involved.

If a foreign corporation (which is not a Paper Company, etc.) satisfies all of the requirements stated above in (a) to (d), a Japanese resident is proportionally taxed on only the statutory tainted income of the foreign corporation (such as dividends or interest income); provided, however, that a Japanese resident is not taxed on the statutory tainted income of the foreign corporation if the Tax Burden Rate is 20 per cent or more.

iii Transfer pricing

Under Japanese transfer pricing rules, a domestic corporation that transacts with related foreign entities (such as a foreign parent corporation) will, if the transaction involves a non-arm's length consideration, be liable for tax calculated based on an arm's-length consideration imputed on the transaction. In calculating the appropriate arm's-length consideration, the tax authority will apply the most suitable statutory method of calculation available.

Typically, the tax authority will request further information from the taxpayer that will aid the authority to calculate an appropriate arm's-length consideration. Where a taxpayer fails to adequately respond to such requests, or does not promptly provide such information, the tax authority will have the right to determine such arm's-length consideration as it deems fit based on reasonable assumptions applicable to the relevant statutory method of calculation.

iv Tax clearances and rulings

It is possible to obtain advance rulings from the NTA in respect of actual (as opposed to hypothetical) situations. Trade associations also frequently consult the NTA in advance for the kinds of transaction that such trade associations commonly conduct. In addition, advance pricing arrangements are also applicable under the transfer pricing rules. As a general matter, no tax clearances or rulings are required in transactions involving the acquisition of a local business.

X YEAR IN REVIEW

Court cases

On 27 June 2019, two different court departments of the Tokyo District Court rendered different judgments with regard to the Anti-Avoidance Rule for Reorganisation and the Anti-Avoidance Rule for Family Corporations (Group Corporations). In the former case, the taxpayer who merged with the group company, to decrease its tax burden, lost against the tax authority because the court found that no reasonable incentive or purposes were recognised with regard to such merger other than decrease of the tax burden. On the other hand, in the latter case, the taxpayer won the case where the tax authority challenged a type of cross-border debt push-down transaction that consisted of several intercompany transactions. Both of these cases had been appealed and the outcome at the high court level was the same (decisions of Tokyo High Court on 11 December 2019 and 24 June 2020). It will be in the interests of companies that intend to conduct similar intercompany restructuring transactions in Japan to follow up on these court decisions and the relevant Supreme Court Decisions to know how the courts will interpret and apply the Anti-Avoidance Rules above.

XI OUTLOOK AND CONCLUSIONS

Generally, we expect the tax authorities in Japan to continue keeping pace with developments in international tax laws, and to harmonise Japanese tax principles with such developments through legislative amendments and tax treaties. With regard to more specific issues, the recent reduction in corporate income tax and increase in consumption tax may lead to tax-driven business restructuring, especially in the supply chain and logistics sectors. Additionally, base erosion and profit shifting action plans are continuously introduced and localised over the next few years. These tax reforms are expected to affect business activities in Japan in a way that we hope is conducive to overall economic growth.

Appendix 1

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