Japan

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Introduction

This chapter focuses on the progress and future prospects of Japanese tax reform regarding the first and second pillars of digital taxation (second and third sections below), and recent court cases regarding controlled foreign company ("CFC") taxation (fourth section below).

Tax reform regarding the first pillar of digital taxation

Outline of the system

In October 2021, under the OECD/G20 Inclusive Framework on BEPS, participant countries agreed to a broad framework for a two-pronged response to the taxation challenges associated with the digitalisation of the economy. The background to this international agreement includes the following two points:

(i) as the number of companies doing business without a permanent establishment ("PE"), such as a branch, in a country where the companies doing business (the "Market Country") increases, the existing international taxation rule that only the business income of a PE shall be taxed ("no taxation without PE") has created the problem that taxation cannot be imposed in the Market Country; and

(ii) attracting foreign companies by offering low corporate tax rates and preferential tax treatment in each country (the so-called "competition to lower corporate taxes") has weakened the corporate tax revenue base in each country and hindered fair competition among companies in terms of taxation.

As the "first pillar" to address (i) above, a mechanism to reallocate 25% of the taxation rights of residual profits exceeding 10% of the profit margin is being considered for multinational enterprises ("MNEs") with global turnover exceeding 20 billion euros and profitability above 10%, to Market Countries in which they operate and earn profits regardless of whether they have a physical presence or not. The term "MNE" refers to a corporate group consisting of constituent companies (subsidiaries, etc.) in two or more countries and are included in the consolidated group in the consolidated financial statements (including companies excluded from consolidation to a certain extent).

Schedule for introduction

The Task Force on Digital Economy ("TFDE"), a working group under the Inclusive Framework, is currently conducting intensive negotiations, with the aim of signing the multilateral treaty by the first half of 2023 and its entry into force in 2024. In addition to ratification of the treaty, domestic legislation needs to be amended for the implementation of the system of the first pillar. At this stage, however, the multilateral treaty has not been signed, and specific details and the schedule of legislation in Japan have not been announced.

Tax reform regarding the second pillar of digital taxation

Outline of the system

As the "second pillar" to address (ii) above, the introduction of global minimum taxation is being planned. Global minimum taxation is a system that ensures a minimum tax rate of at least 15% per country on income, excluding certain exemptions for MNEs with annual gross revenue of at least 750 million euros, and consists of the following three rules:

(i) Income Inclusion Rule ("IIR")

IIR is a tax system under which a corporation that is a parent company in Japan with a subsidiary in a country with a low tax rate of less than 15% is taxed until the tax burden of the subsidiary reaches the minimum tax rate of 15%. If the effective tax rate in the country in which the subsidiary is domiciled is below 15%, the ultimate parent company at the apex is subject to a minimum tax, based on the percentage of the subsidiary's taxable amount attributable to that MNE group.

In order to reduce the administrative burden on MNEs, if a subsidiary (excluding various investment companies) satisfies all of the following requirements, the "current year international minimum taxable amount by country" in the country where the subsidiary is located shall be deemed zero:

(a) Period: The subject fiscal year and the two immediately preceding fiscal years (three fiscal years).

(b) Income: The average amount of income for the three fiscal years is less than 10 million euros.

(c) Profit amount: The average amount of profit or loss for the three fiscal years shall be less than 1 million euros.

(i) Undertaxed Profits Rule ("UTPR")

UTPR is a tax system under which a corporation that is a subsidiary in Japan with a parent company or other affiliated company in a country with a light tax burden of less than 15% is taxed until the tax burden of the parent company reaches 15%.

(i) Qualified Domestic Minimum Top-up Tax ("QDMTT")

QDMTT is a tax system under which a domestic company with the tax burden falling below 15% through tax credits and other means is taxed in order to ensure that the domestic company bears a tax burden of 15%. If this system is in place, the domestic company will not be subject to IIR/UTPR taxation in other countries. In Japan, it is very unlikely that the effective tax rate will be reduced to below 15%; however, the Japanese government intends to introduce QDMTT as a defensive measure to prevent IIR/UTPR taxation in other countries.

Schedule for introduction

IIR was introduced under the 2023 tax reforms. This new rule will apply to domestic companies for the fiscal years beginning on or after April 2024, while UTPR and QDMTT are being considered for domestic legislation in the fiscal year 2024 or later.

Reform of CFC taxation

The introduction of the global minimum tax under the second pillar, which will impose additional administrative burdens on taxpayers, prompted a review of the CFC tax system, taking into account the risk of tax avoidance and the administrative burdens on taxpayers. The CFC taxation system is intended to deal with tax avoidance by subsidiaries with no economic substance, while the second pillar system is intended to curb the competition to lower corporate income taxes by introducing a common minimum tax rate in each country, and both systems have different purposes:

(i) reduction of the tax burden ratio (from 30% to 27%), which is an exemption requirement for specified foreign-affiliated companies (paper companies, etc.); and
(ii) measures such as relaxation of the obligation to attach financial documents and other documents with respect to certain foreign subsidiaries.

With regard to (i) above, since Germany, South Korea, and the U.S. states of California and New York, where many Japanese companies have established operations, have statutory tax rates of 27% to 30%, it is expected that, in principle, the exemption will apply to foreign subsidiaries in these countries and regions. As a result, it is expected that approximately 40% of certain foreign subsidiaries subject to the combined taxation of foreign subsidiaries could be exempted.

In the future, necessary revisions are being considered in light of further legislation on global minimum taxation expected after the 2024 tax reforms.

CFC taxation precedents (Tokyo District Court Judgment on January 20, 2012, and Tokyo High Court Judgment on September 14, 2022)

Outline of the case

A primary insurance contract (the "Primary Insurance Contract") was entered into between a Bermuda corporation engaged in the insurance business ("A"), which is a specified foreign subsidiary ("SFS") of a major automobile manufacturer, Nissan Motor Co., Ltd. ("X") and a Mexican corporation indirectly owned by X and engaged in the financial business ("B"), with respect to the disability of natural person customers purchasing automobiles on an instalment basis. In this case, the premium income from a reinsurance contract (the "Reinsurance Contract") entered into between A and a Mexican insurance company ("C"), under which C assumes that 70% of the insurance risk is supposed to be assumed by A in the Primary Insurance Contract, is contested to fall under the "premium income related to insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person" under the "unrelated person standard" in the CFC taxation system. The Tokyo District Court dismissed X's claim in the first instance; however, X appealed, and the Tokyo High Court revoked the original judgment and upheld X's claim.

Issues and rulings regarding the unrelated person standard

(i) Point at issue
With respect to the unrelated person standard, one of the exemptions under the CFC taxation system (i.e., a subsidiary is engaged primarily in transactions with unrelated persons), if the principal business of the SFS is insurance, the ratio of premium income from unrelated persons divided by the total premium income for the relevant fiscal year shall exceed 50%. The term "premium income from unrelated persons" is considered to be limited to "premium income related to insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person". The issue in this case was whether the premiums earned on the Reinsurance Contract fall under "premium income related to insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person".
(ii) Summary of reason for judgment
The "unrelated person standard" was pointed out to be unclear in the case where transactions between an SFS and its related persons involve unrelated persons through reinsurance. Therefore, an "unrelated person standard" for insurance business is considered to be provided in order to prevent the avoidance of CFC taxation of business activities that are not economically rational to be conducted in the country or

region where the subsidiary is located, by specifying the criterion of whether or not the majority of insurance risks secured by insurance contracts are related to the property of unrelated persons when determining whether or not premium income from unrelated persons is a majority of total premium income of the SFS. Since the purpose of such provision should apply to insurance in general, it is considered that the "assets" and the "liability for damages" are specified as mere examples. In this case, it is reasonable to conclude that "insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person" refers to "insurance covering insurance risks against assets, etc. of unrelated parties".

Under the Primary Insurance Contract, it is stipulated that each customer pays a premium in exchange for the insurance risk on his/her life, body, etc., and that insurance benefits are paid in the event of the death or other event of each customer. Therefore, the Primary Insurance Contract should be considered as insurance to secure the insurance risk for the life, body, etc. of each of the customers.

The Primary Insurance Contract falls under the "insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person", and the premium income from the Reinsurance Contract falls under the "premium income related to insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person".

Comments

In the judgment, the Tokyo High Court stated that "insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person" refers to "insurance covering insurance risks against assets, etc. of unrelated parties", and that the Primary Insurance Contract, in this case, falls under "insurance covering insurance risks against assets, etc. of unrelated parties" since the Primary Insurance Contract is structured to pay insurance benefits in the event of the death or other event of each customer, and each customer is the actual payer of the premiums. In other words, the Tokyo High Court considered that the "assets" and the "liability for damages" are specified as mere examples and that insurance covering insurance risks for the life and body of each customer (i.e., life insurance) shall be included in "insurance covering insurance risks against assets, etc. of unrelated parties".

The provision that the premium income from unrelated persons is limited to premium income related to insurance for the purpose of insuring assets owned by or liability for damages incurred by an unrelated person seems to be open to interpretation that it is limited to assets or liability for damages, assuming property insurance, and based on that view, the Tokyo District Court appeared to decide that the premiums earned on the Reinsurance Contract in question could not be calculated as premiums earned from unrelated persons in determining the unrelated person standard. In contrast, the Tokyo High Court interpreted "assets" and "liability for damages" as mere examples in light of the purpose of the relevant provisions of the CFC taxation system.

In the *Mizuho Bank* case (Tokyo High Court, March 10, 2022), the taxpayer won a reversal of the case based on an interpretation that may appear difficult to grasp immediately from the wording of the CFC tax provisions, although the issues were different to those in the case at hand. On the other hand, on August 30, 2011, the Tokyo High Court ruled against flexible interpretation in light of the purpose of the CFC taxation system. In this regard, the Supreme Court's decision on the *Nissan* case will attract much attention.

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