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Chapter 27

Japan

Yuko Miyazaki

Nagashima Ohno & Tsunematsu

Hideyuki Sakamoto

1 General: Treaties

1.1 How many income tax treaties are currently in force in Japan?

As of September 1, 2009, there are 45 income tax treaties (applicable to 56 contracting states) currently in force in Japan.

1.2 Do they generally follow the OECD or another model?

Most of the income tax treaties currently in force in Japan generally follow the OECD Model Treaty with certain deviations. After the new modernised tax treaty with the United States entered into force on March 30, 2004 (the "Japan/US Treaty"), the Japanese government is understood to have been considering the Japan/US Treaty as the new model for Japan's future treaties, particularly for treaties with developed countries. The Japan/US Treaty includes some noteworthy modernised provisions (such as, for example, a fairly comprehensive limitation on benefit clause and an exemption from source country taxation with respect to dividends paid by certain qualified subsidiaries to controlling parents) not found in the OECD Model Treaty. Following the Japan/US Treaty, similarly modernised tax treaties entered into force with the United Kingdom on October 12, 2006 (the "Japan/UK Treaty"), with France on December 1, 2007 (the "Japan/France Treaty") and with Australia on December 3, 2008 (the "Japan/Australia Treaty"). In some of Japan's income tax treaties with developing countries, Japan agreed to include a tax-sparing credit clause. However, it is anticipated that Japan would generally take the approach of limiting the application of such a clause only to the necessary minimum in terms of the scope of income and the time period.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

If treaties are approved by the Diet and promulgated in Japan, such treaties take effect domestically in Japan, in accordance with those treaties, without being incorporated into domestic law. However, it is generally understood that whether or not treaties are self-executing without any domestic execution law depends on the contents of the particular clause in those treaties. In Japan matters necessary to implement tax treaties are provided for in the Act on Special Provisions of the Income Tax Act, Corporation Tax Act and Local Tax Act in Order to Implement Tax Treaties and its related laws and regulations.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

The Japan/US Treaty is the first income tax treaty executed by Japan in which a fairly comprehensive limitation on benefits clause of general application is included, and has been followed, with certain variations, by the Japan/UK Treaty, the Japan/France Treaty and the Japan/Australia Treaty.

The limitation on benefits clause included in the Japan/US Treaty provides that a resident of a contracting state that derives income from the other contracting state shall be entitled to all the benefits accorded to residents of the contracting state only if such resident satisfies any one of certain objective tests, which are the "qualified person" test, "active trade or business" test, and "competent authority's determination" test. The assumption underlying each of these tests is that a taxpayer that satisfies the requirements of one of the tests is likely to have a real business purpose for the structure which it has adopted; or has a sufficiently strong nexus to the contracting state to warrant obtaining the benefits even in the absence of a business connection; and that this business purpose or connection is sufficient to justify the conclusion that obtaining the treaty benefits under the Japan/US Treaty is not the principal purpose of establishing or maintaining residence in the contracting state.

The Japan/US Treaty, the Japan/UK Treaty, the Japan/France Treaty and the Japan/Australia Treaty also include a series of anti-conduit clauses, which provide that a resident of a contracting state shall not be considered to be the beneficial owner of dividends, interest, royalties or other income in certain "back-to-back" arrangements so that, if such arrangement exists, contemplated treaty benefits are denied.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

It is a well-established constitutional principle in Japan that no treaty is overridden by any rule of domestic law (whether existing at the time the treaty takes effect or enacted subsequently).

2 Transaction Taxes

2.1 Are there any documentary taxes in Japan?

Japan has Stamp Tax, which is imposed on certain categories of documents that are exhaustively listed in the Stamp Tax Act, including, for example, real estate sales agreements, land leasehold agreements, loan agreements, transportation agreements, merger agreements and promissory notes.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

We have value added tax, named Consumption Tax and Local Consumption Tax. The aggregate tax rate of Consumption Tax and Local Consumption Tax is at present 5%.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Taxable transactions, for the purposes of Consumption Tax and Local Consumption Tax, are defined to mean those transactions conducted by a business enterprise (regardless of whether it is a legal person, i.e. a company, or natural person, i.e. an individual; and, in the case where such business enterprise is a non-resident company or a non-resident individual, regardless further of whether or not such business enterprise has any permanent establishment in Japan) to transfer or lease goods or other assets or to provide services, for consideration, within Japan. However, certain specified categories of transactions, such as, for example, transfers and leases (other than for certain temporary purposes) of land, housing leases (other than for certain temporary purposes), transfers of securities, extension of interest-bearing loans, provision of insurance, deposit-taking and certain other specified categories of financial services, provision of certain specified scope of medical, social welfare or educational services, are excluded from taxable transactions. With respect to imported goods, they are subject to Consumption Tax and Local Consumption Tax when they are released from a bonded area, except that certain specified categories of imported goods, such as securities, stamps, exchange checks, equipment for disabled persons and textbooks, are excluded from taxable imported goods. Export transactions are generally exempt from Consumption Tax and Local Consumption Tax.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Consumption Tax and Local Consumption Tax charged on taxable transactions and incurred by a business enterprise is generally recoverable in full, by way of tax credit or refund, with certain exceptions; for example, if a taxpayer's ratio of the revenue from taxable transactions over the total revenue from transactions within Japan is less than 95% (which is typically the case for, for example, certain financial institutions) such taxpayer's recovery of Consumption Tax and Local Consumption Tax would generally be limited.

2.5 Are there any other transaction taxes?

There are some transaction taxes in Japan, including, but not limited to, Registration and Licence Tax, Real Property Acquisition Tax and Automobile Acquisition Tax.

2.6 Are there any other indirect taxes of which we should be aware?

There are various indirect taxes in Japan such as Liquor Tax, Tobacco Tax and Gasoline Tax. Depending on the business involved, these taxes may or may not be relevant.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Under the Japanese domestic tax law, generally a non-resident shareholder (either a non-resident company or a non-resident individual) of a Japanese company is subject to Japanese withholding tax with respect to dividends it receives from such Japanese company at the rate of 20%; provided, however, that, if the Japanese company paying the dividends to a non-resident shareholder is a listed company, this withholding tax rate is reduced to (i) 7% until December 31, 2011 and (ii) 15% thereafter, except for the dividends received by a non-resident individual shareholder holding 5% or more of the total issued shares of such listed Japanese company.

Most of the income tax treaties currently in force in Japan generally provide that the reduced treaty rate at the source country shall be 15% for portfolio investors and 10% or 5% for parent and other controlling shareholders. It may be worth noting that: (i) under the Japan/France Treaty and the Japan/Australia Treaty, if any controlling corporate shareholder with certain ownership percentage satisfies certain qualifications (i.e. qualified resident), then there is no source country taxation in either state with respect to dividends paid to such controlling corporate shareholder; and (ii) under the Japan/US Treaty and the Japan/UK Treaty, there is a similar, but not the same, exemption from source country taxation with respect to dividends paid by a company in either state to a shareholder who is a qualified resident (to be determined subject to the relevant limitation on benefit clause) of the other contracting state, if such shareholder is either a corporate shareholder holding a majority of the voting shares of the issuer company (subject to certain additional requirements) or a pension fund.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Under Japanese domestic tax law, royalties relating to patents, know-how or copyright used for any Japanese company's business carried on in Japan and paid by the Japanese company to a non-resident licensor (either a non-resident company or a non-resident individual) is subject to Japanese withholding tax at the rate of 20%. If such non-resident licensor is a non-resident company having a branch office within Japan, such non-resident company licensor may be exempt from the said withholding tax as long as such non-resident company licensor satisfies certain requirements, including in particular the requirement that such royalties be subject to the Corporation Tax in Japan.

Most of the income tax treaties currently in force in Japan provide that the withholding tax rate for royalties be generally reduced to 10%. It is worth noting that the Japan/US Treaty, the Japan/UK Treaty and the Japan/France Treaty all provide that no source-country taxation shall be made by either state with respect to royalties, subject to comprehensive limitation on benefits clauses, while the Japan/Australia Treaty provides that the withholding tax rate for royalties is reduced to 5%.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Under Japanese domestic tax law, interest on corporate bonds issued by a Japanese company that is paid to a non-resident bondholder (either a non-resident company or a non-resident individual) is generally subject to Japanese withholding tax at the rate of 15%; provided, however, that so long as such corporate bonds are issued outside Japan on or after April 1, 1998 and on or before March 31, 2012 and interest thereon is payable outside Japan, a non-resident bondholder may be entitled to claim an exemption from such Japanese withholding tax, subject to certain procedural requirements. Also under Japanese domestic tax law, with respect to certain specified scope of discount bonds issued by a Japanese company (except for certain qualified short-term discount bonds), such Japanese company will be required to withhold, at the time of the issuance of the discount bonds, 18% or 16%, as the case may be, of the amount equivalent to the difference between the face value and the issue price thereof. The amount so withheld will be deemed to be, and treated as, the Income Tax imposed on, and collected from, the bondholder (including a non-resident bondholder) who receives the original issue discount upon redemption.

Interest on bank deposits and other similar deposits deposited by a non-resident depositor (either a non-resident company or a non-resident individual) with any office of a bank or other institution in Japan is generally subject to Japanese withholding tax at the rate of 15%, under Japanese domestic tax law.

Interest on loans extended by a non-resident lender (either a non-resident company or a non-resident individual) to a Japanese company conducting business carried on in Japan and in relation to such business is generally subject to Japanese withholding tax at the rate of 20% under the Japanese domestic tax law. If such non-resident lender is a non-resident company having a branch office within Japan, such non-resident company lender may be exempt from the said withholding tax as long as the non-resident company lender satisfies certain requirements, including in particular the requirement that interest on such loans is subject to the Corporation Tax in Japan.

As an exception to the foregoing, if a non-resident company makes a deposit or extends a loan to any of the financial institutions designated under the Foreign Exchange and Foreign Trade Law of Japan who book such deposit or loan as a special account for offshore banking on or after April 1, 1998, such non-resident company would be exempt from Japanese withholding tax with respect to interest to be paid on such deposit or loan.

Most of the income tax treaties currently in force in Japan provide that the withholding tax rate for interest (regardless of whether it is interest on bonds, deposits or loans) is reduced generally to 10%. It is worth noting that under the Japan/US Treaty, the Japan/UK Treaty, the Japan/France Treaty and the Japan/Australia Treaty, certain specified categories of financial or other qualified institutions which are residents of the US, the UK, France or Australia, as the case may be, which qualify for treaty benefits thereunder, may be exempt from source country taxation in Japan with respect to interest, subject to certain requirements.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

The payor of interest may be denied a deduction of the interest which it paid to a non-resident recipient for its own income tax purposes in Japan, due to the application of the "thin capitalisation" rules under Japanese domestic tax law. Even in such case, the treaty relief (i.e. the application of the reduced treaty rate under the applicable income tax treaty) available to the non-resident recipient of such interest would nevertheless not be restricted.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

This is not applicable in Japan. Please see the answer to question 3.4.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Under the "thin capitalisation" rules in Japan, debt advanced by a third party and guaranteed by a parent company would generally be treated as related party debt.

3.7 Are there any restrictions on tax relief for interest payments by a local company to a non-resident in addition to any thin capitalisation rules mentioned in questions 3.4-3.6 above?

There are generally no restrictions on deductibility of interest payments by a local company to a non-resident other than the "thin capitalisation" rules in Japan, except that interest payments may be subject to transfer pricing rules. Please also see the answer to question 3.8 below.

3.8 Does Japan have transfer pricing rules?

Japan does have transfer pricing rules. Japanese transfer pricing rules are applicable to both a Japanese company and a Japanese branch of a non-resident company if either of them engages in transactions with any of their "foreign-related persons" (for example, a direct or indirect 50% share ownership would render a foreign person a "foreign-related person" for the purposes of the transfer pricing rules).

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

In Japan, there are at present five different income taxes imposed on corporate profits, namely: Corporation Tax (national tax); Prefectural Inhabitant Tax per corporation tax levy (local tax); Municipal Inhabitant Tax per corporation tax levy (local tax); Enterprise Tax (local tax); and Local Special Corporation Tax (national tax). Depending on the amount of stated capital and certain other factors, the applicable rates for each taxpayer company of these income taxes may vary. While the Enterprise Tax and the Local Special Corporation Tax paid in any fiscal year are treated as a deductible expense in such fiscal year, the other three income taxes are not deductible. Taking the foregoing into consideration, the headline effective tax rate of all income taxes mentioned above would be approximately 40%. (Please also see the answer to question 5.1 below.)

4.2 When is that tax generally payable?

The taxes on corporate profits are required to be paid, in principle, within two months after the end of each fiscal year. If a company is an ordinary company whose fiscal year is longer than six months, the company is required to prepay part of the current fiscal year's tax within two months after the end of the first six months of each fiscal year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for Corporation Tax is the net taxable income for Corporation Tax purposes; such net taxable income is calculated based on the results reflected in the taxpayer company's financials, prepared in accordance with Japanese generally accepted accounting principles, which are required to be finalised by the proper legal procedure as required under the applicable corporation law, and by making the necessary adjustments to such results as required by any applicable rules provided in the Corporation Tax Act and its related laws and regulations. The tax base for each Prefectural Inhabitant Tax per corporation tax levy and Municipal Inhabitant Tax per corporation tax levy is, in principle, the amount of Corporation Tax.

With respect to Enterprise Tax, generally the tax base is the net taxable income for Enterprise Tax purposes as determined by the relevant rules for Enterprise Tax (which is not necessarily the same as the net income for Corporation Tax purposes; for example, offshore income is excluded for Enterprise Tax purposes); provided, however, that if a taxpayer company's capital amount is more than 100 million yen, the tax base for Enterprise Tax is determined by a combination of the net taxable income, the amount of value added as determined by the compensation paid to employees, the net interest paid, the net lease rental paid and the net profit or loss in each fiscal year, and capital of such taxpayer company. As an exception to the foregoing, the tax base for Enterprise Tax of electric, gas and insurance businesses is determined by gross revenue. The tax base for Local Special Corporation Tax is, in principle, the amount of Enterprise Tax.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The main differences include, but are not limited to, the treatment of donations and entertainment expenses. Donations, including any kind of economic benefit granted for no or unreasonably low consideration, are generally deductible only up to a certain limited amount. Entertainment expenses are generally not deductible, even though such expenses are believed to be necessary for carrying on the business; provided, however, that if the amount of stated capital of a company is 100 million yen or less, entertainment expenses of such company are deductible subject to a certain ceiling.

4.5 Are there any tax grouping rules? Do these allow for relief in Japan for losses of overseas subsidiaries?

It is possible for a group of Japanese companies, where a Japanese parent company directly or indirectly owns 100% of other Japanese subsidiaries, to file, at the group's election and subject to an approval of the Commissioner of the National Tax Agency, a consolidated tax return. Once the election to file a consolidated tax return is approved, such election would, in principle, continuously apply to the group making such election.

If a group of companies elects to file a consolidated tax return, the parent company is required to file the consolidated tax return and pay all the consolidated tax. Each subsidiary is jointly responsible for payments of consolidated tax. The consolidated tax is calculated on the basis of the aggregate income of the parent company and all consolidated subsidiaries.

In Japan these consolidation rules do not allow for relief for losses of overseas subsidiaries.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Tax is generally imposed at the same rate upon all corporate profits regardless of whether such profits are distributed or retained, with the exception that a certain additional surtax may be imposed on certain types of so-called family companies' retained profits.

4.7 What other national taxes (excluding those dealt with in "Transaction Taxes", above) are there - e.g. property taxes, etc.?

As far as national taxes are concerned, there are no major taxes currently in force which may have a material impact on the business operations of a company in Japan.

4.8 Are there any local taxes not dealt with in answers to other questions?

Among local taxes other than those already mentioned above, Prefectural Inhabitant Tax per capita levy, Municipal Inhabitant Tax per capita levy, Fixed Assets Tax and Automobile Tax may be of general application to business operations in general of a company in Japan.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

For purposes of income taxes imposed on a company in Japan, generally all of the taxable income of a company is aggregated, regardless of whether such income is classified as capital gains or ordinary/business profits. Exceptions to the foregoing include a surtax which may be imposed on certain capital gains derived by disposition of real properties; provided, however, that such surtax is currently suspended until December 31, 2013. In the case where a tax-free qualified corporate reorganisation such as a qualified merger is undertaken, recognition of capital gains can be deferred.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The surtax (as referred to in response to question 5.1 above) to be imposed on capital gains derived by the disposition of real property including but not limited to land located within Japan is 5%. If certain real property such as land in Japan is disposed of within five years from its acquisition, the rate of surtax is increased to 10%. The application of these surtaxes is suspended until December 31, 2013.

5.3 Is there a participation exemption?

There is no participation exemption for taxation on capital gains. However, the 2009 Tax Reform has introduced a participation exemption for the 95% portion of the dividends paid to a Japanese company by its foreign subsidiary with respect to which the Japanese company owns at least 25% of issued shares or voting shares for at least six months. With the introduction of such participation exemption for dividends, indirect foreign tax credit system (which was previously applied up to the second tier indirect subsidiaries) was abolished. The 25% threshold requirement mentioned above may be altered if a particular taxpayer is eligible for treaty benefits under an applicable tax treaty in which lower threshold is required for a treaty-based foreign tax credit eligibility (for example, 10% shareholding threshold is provided under the Japan/US Treaty). These changes apply to dividends received during the fiscal years starting on or after April 1, 2009.

Also, as a result of the 2009 Tax Reform and with the introduction of the above-mentioned participation exemption rule for dividends, the Japanese anti-tax haven rules or controlled foreign corporations

(CFC) rules were amended to the effect that, among others, retained earnings of a Japanese company's CFC subsidiaries shall be deemed to be included in the Japanese company's taxable income subject to Japanese corporate income taxation regardless of whether or not such retained earnings are distributed as dividends and certain other adjustment amendments are made.

5.4 Is there any special relief for reinvestment?

Dividends received by a Japanese company from another Japanese company may be either 100% or 50% (subject to certain adjustments) deducted from the recipient company's taxable income, depending on whether or not the recipient Japanese company owns 25% or more of the total issued shares of the dividend paying Japanese company. Such dividend-received deduction is also available to a Japanese branch of a foreign corporation with respect to dividends received by such branch from any Japanese company. Capital gains from the disposition of certain qualified business assets (such as certain qualified land and buildings) may be entitled to certain roll-over relief (in whole or in part) if certain qualified reinvestment is made within a prescribed period. Also, a proposal to introduce deferral of taxation on capital gains from disposition of certain assets between group companies is currently discussed within the Government. Please also see question 5.3.

6 Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

If a non-resident company forms a subsidiary (i.e. establishing a company incorporated under the laws of Japan) by making a capital contribution in cash, the formation of a subsidiary is not a taxable event. However, if a non-resident company forms a subsidiary by making a contribution-in-kind (for example, contributing certain real property located within Japan), such contribution-in-kind is treated as a disposition by such non-resident company of the contributed assets. If the contributed assets fall under the category of the assets situated within Japan, it is possible that the capital gains derived from such disposition are found to constitute income sourced and taxable in Japan for the non-resident company making such contribution-in-kind, in which case such non-resident company would be subject to Japanese corporate income taxes with respect to such capital gains.

In order to form a Japanese subsidiary, the articles of incorporation of such subsidiary must be prepared, which is subject to Stamp Tax at the rate of 40,000 yen; also, such subsidiary must be registered in the commercial register kept at the competent office of the legal affairs bureau of the Ministry of Justice. Upon filing an application for such registration, such subsidiary is generally subject to Registration and Licence Tax at the rate of seven-thousandths (7/1,000) of its stated capital amount. Any subsequent increase in the stated capital of such subsidiary is also required to be registered in a timely manner in the commercial register and is generally subject to Registration and Licence Tax at the same rate. (While a branch of a non-resident company, including any change in the stated capital of such non-resident company in its home country, is also required to be registered in the commercial register in Japan, the rate of Registration and Licence Tax imposed on the branch upon application for such registration is fixed at 90,000 yen per application for establishment of a branch and 9,000 yen per application for change in the stated capital in its home country.)

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Generally, there are no other significant taxes or fees that would be incurred by a Japanese subsidiary upon its formation but not by a branch of a non-resident company.

6.3 How would the taxable profits of a local branch be determined?

Under the Corporation Tax Act, if a non-resident company which has its branch in Japan earns "profits derived from business carried on within Japan," such business profits constitute Japanese source income taxable in Japan. With respect to the question of how the amount of such business profits should be determined, certain specific rules are provided in the relevant regulations. Under such regulations, depending on the category of business involved (e.g. whether the business involved is manufacturing, sale and distribution, construction, shipping or air transportation, insurance, publication and broadcasting, or any other business), different factors are used to determine the scope of income to be treated as business profits sourced from Japan.

In the case where the subject non-resident company is a resident of a country with which Japan has an income tax treaty, generally such treaty includes a provision similar to Article 7(2) of the OECD Model Treaty (requiring that the arm's-length principle shall be applied in determining the amount of income attributable to the relevant permanent establishment). The question of to what extent the above-mentioned specific rules included in the Japanese domestic tax law should be interpreted as being altered by such treaty provision often gives rise to a serious issue in practice.

With respect to the detailed method of calculating taxable income, the rules applicable to a Japanese company are, in principle, also made applicable to a branch of a non-resident company, *mutatis mutandis*. In calculating the taxable income of a branch, only such expenses as are necessary for earning Japanese source income are treated as deductible expenses.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax or other similar tax to which a branch of a non-resident company, but not a subsidiary, is subject.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A branch of a company which is a resident in such treaty country can benefit from the treaty provisions to some extent. For example, while the so-called entire system is adopted for income taxation of a non-resident company having a branch in Japan under Japanese domestic tax law, under almost all of the income tax treaties currently in force in Japan, the attributable system is adopted. With respect to the treaty relief given to passive income such as dividends, interest and royalties, because most of the income tax treaties currently in force in Japan include provisions similar to Articles 10(4), 11(4) and 12(3) of the OECD Model Treaty, a branch of a non-resident company would not be allowed to enjoy such treaty relief.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No. No Japanese withholding tax or other tax would be imposed on the remittance of funds from the Japanese branch of a foreign corporation to its head office merely because such remittance is a repatriation of profits by the branch to its head office abroad.

7 Anti-avoidance

7.1 How does Japan address the issue of preventing tax avoidance? For example, is there a general anti-avoidance rule or a disclosure rule imposing a requirement to disclose avoidance schemes in advance of the company's tax return being submitted?

In Japan there is neither a general anti-avoidance rule nor a disclosure rule that imposes a requirement to disclose avoidance schemes. It is worth noting that recently the tax authority has tended to take a more active stance in combatting avoidance schemes and taxpayers so challenged have been more inclined to seek judgments by the courts. Thus, the courts are playing more important roles than ever in rule-making in light of tax avoidance.

Yuko Miyazaki

Nagashima Ohno & Tsunematsu
Kioicho Building, 3-12 Kioicho, Chiyoda-ku
Tokyo 102-0094
Japan

Tel: +81 3 3511 6117
Fax: +81 3 5213 2217
Email: yuko_miyazaki@noandt.com
URL: www.noandt.com

Yuko Miyazaki is a partner of Nagashima Ohno & Tsunematsu and her primary areas of practice are taxation, with a particular emphasis on international taxation, and general corporate law.
She graduated from the University of Tokyo (LL.B.) and Harvard Law School (LL.M.).
Since she was admitted to the bar in Japan in 1979, she has been with Nagashima, Ohno & Tsunematsu (and its predecessor firm, Nagashima & Ohno), except for a two-year period from 1984 to 1986 during which she worked for the Legal Department of the World Bank in Washington, D.C. as Counsel.
She is a member of the International Fiscal Association and was a visiting professor of the University of Tokyo Law School from April 2004 through March 2007, teaching taxation of financial transactions/products and international taxation.

Hideyuki Sakamoto

Nagashima Ohno & Tsunematsu
Kioicho Building, 3-12 Kioicho, Chiyoda-ku
Tokyo 102-0094
Japan

Tel: +81 3 3511 6239
Fax: +81 3 5213 2339
Email: hideyuki_sakamoto@noandt.com
URL: www.noandt.com

Hideyuki Sakamoto is an associate of Nagashima Ohno & Tsunematsu and his primary areas of practice are taxation, with a particular emphasis on international taxation and tax litigation.
He was admitted to the bar in Japan in 2001 and in New York State in 2008. He graduated from the University of Tokyo (LL.B.) and New York University School of Law (LL.M. in International Taxation). He worked for Alston & Bird LLP as a visiting attorney in the International Tax Group from 2007 through 2008.