Corporate Tax

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Japan

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Introduction

After the Liberal Democratic Party of Japan (the "LDP") returned to power in December 2012, Mr Shinzo Abe, the prime minister under the LDP-led coalition, identified "three arrows" as the administration's priorities to revitalise the long-sluggish Japanese economy: a massive fiscal stimulus; bold monetary easing; and structural reforms. Among the pro-industry policies adopted by the Abe administration is lowering the corporation tax rate described below.

On the other hand, as the OECD's "Action Plan on Base Erosion and Profit Shifting" ("BEPS"), published 19 July 2013, has been taking concrete shape and outputs were published in September 2014 and will continue to be so published, the Japanese government will need to adjust the domestic tax laws based on the recommendations adopted in the relevant reports or guidelines. Among those steps to be taken, a countermeasure to certain hybrid financial instruments to take advantage of mismatch (deduction and no inclusion) has been introduced under the 2015 Tax Reform.

This article is intended to introduce readers to recent developments in Japanese corporate and international taxation, principally in the context of inbound investment as well as deal planning.

Legislative highlights

Corporation tax rate to be decreased

The nominal rate of the national corporation tax has been decreased to 23.9% from 25.5%, and the effective corporation tax rate, national and local combined, is approximately 33.10% for large companies (i.e., companies with a stated capital of more than JPY100 million) operating in Tokyo for the fiscal year beginning on or after 1 April 2015. Still, Japan's corporation tax rate is among the highest compared with the U.S. (approximately 40%), France (33%), and Germany (30%), while a number of countries have a rate of less than 30%, including the UK (20%) and Canada (26.5%). Many of the eastern Asia countries, including China (25%), South Korea (24%), Singapore (17%), and Hong Kong (16.5%), have tax rates below 30%.

Given the global trend, in a package of measures to boost Japan's long-term economic growth, the Abe administration published the revised "Japan Revitalization Strategy" on 24 June 2014, proposing phased-in corporate tax cuts. Specifically, the Strategy proposes that the effective corporation tax rate, national and local combined, be reduced over several years, to below 30% ultimately, with the first phase starting from the fiscal year 2015 as stated above. Under the Strategy, alternative revenues to offset the tax cut would be secured

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through broadening the tax base. A government tax panel detailed the alternative revenue sources and proposed to: review the special tax measures for specific industries to see if they should be abolished or limited; broaden the scope of the *pro forma* standard taxation; and revisit the current favourable reduced rate for small and medium-sized companies, which is currently 15% (for up to JPY 8 million) and 23.9% (for more than JPY 8 million).

Additional limitation on loss carry-forwards

Under the current Corporation Tax Act, while losses in the past fiscal years can be carried forward to offset the taxable income of the current fiscal year, the deduction is limited up to 80% of the taxable income before the deduction. In order to seek alternative revenues for the reduced corporation tax rate (stated above), additional limitation will be put on the loss carry-forward in the following two phases. First, for the first two years, the loss utilisation will be further limited to 65% of the taxable income, effective for fiscal years (in which taxpayers claim loss carry-forwards) beginning on or after 1 April 2015 and before 1 April 2017. Second, for fiscal years (in which taxpayers claim loss carry-forwards) beginning on or after 1 April 2017, the additional limitation will kick in so that the carry-forward losses may be utilised to offset no more than 50% of the taxable income. Correspondingly, the carry-forward period will be extended from the current nine years to ten years for the losses recognised in fiscal years beginning on or after 1 April 2017. Please note that these limitations are not applicable to a small-and-medium sized company as defined in the Corporation Tax Act, which is a company with stated capital of 100 million yen or less and which is not a wholly-owned subsidiary of a company (Japanese or non-Japanese) with stated capital of 500 million yen or more).

Neutralise certain hybrid financial instruments

Under Action 2 of the BEPS project, a report titled "Neutralising the Effects of Hybrid Mismatch Arrangements" published on 16 September 2014 recommended that "[i]f the payer jurisdiction does not neutralise the mismatch, then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI [deduction / no inclusion] outcome" (paragraph 65). Under the current Japanese law, in general, any dividends received by a Japanese corporation from its non-Japanese affiliate (at least 25% owned) is 95% exempt from taxable income in Japan, whether or not it is deducted in the payer country. Under such regime, dividends paid on Mandatory Redeemable Preference Shares (MRPS) issued by an Australian company or dividends paid by a Brazilian company have presented D/NI outcome where the payment is exempt (except for 5%) in Japan. In accordance with the recommendation by the aforementioned report, the 2015 Tax Reform Act denies exemption for dividends from non-Japanese companies as long as they are deductible in the payer country, including dividends on MRPS and dividends from a Brazilian company. Correspondingly, any foreign tax imposed on dividends paid to a Japanese company, which is taxable in Japan, will be eligible for foreign tax credit in Japan. The new rules will be effective for any dividends received by a Japanese corporate taxpayer whose fiscal year begins on or after 1 April 2016. As an exception, a grandfather rule is applicable to Japanese corporate taxpayers holding stock of foreign affiliates on 1 April 2016, for which dividends received for years beginning between 1 April 2016 and 31 March 2018 will be eligible for exemption.

Consumption tax

Under the amended Consumption Tax Act, the rate of consumption tax, the Japanese version of the value-added tax, national and local combined, was increased from the former 5% to 8% for relevant transactions made on or after 1 April 2014. Although it was originally planned to

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be followed by an increase to 10% for relevant transactions made on or after 1 October 2015, the Abe administration decided to defer the increase until 1 April 2017 after the first increase (to 8% in April 2014) had significant negative impacts on the economy.

Consumption tax on cross-border digital service transactions

Separately from the BEPS, the scope of the Japanese consumption tax (the "JCT") was widened on cross-border digital service transactions. Specifically, the amendments include the adoption of the reverse charge mechanism, such as that adopted in the EU for transactions from business to business (BtoB), where (a) resident service recipients (business customers) are obliged to collect and pay the JCT, and (b) non-resident service providers are obliged to notify the resident service recipients of the transactions being subject to the reverse charge. On the other hand, for transactions from business to customer (BtoC), non-resident service providers are obliged to collect and pay the JCT by appointing a tax agent in Japan. The amendments are effective on transactions taking place on or after 1 October 2015.

New bank reporting requirements on non-resident accounts

In a global move toward transparency and exchange of information in the taxation, the Council of the OECD approved the "Standard for Automatic Exchange of Financial Information in Tax Matters" on 15 July 2014, which calls on jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. In accordance with the recommendation, the 2015 Tax Reform introduces new obligations on financial institutions to report to the Japanese tax authorities information regarding accounts of non-residents, which include identity and address, tax identification number for the relevant foreign jurisdiction, account balance and receipts of interests and dividends. The financial institution will be required to make reporting under the new regulations from 2018.

Japanese CFC threshold loosened

In response to the recent global trend to reduce corporate income rate, the Japanese version of controlled foreign corporation (CFC) regime will loosen the threshold corporate income tax rate from "20% or less" to "less than 20%", at which a non-Japanese subsidiary controlled by a Japanese parent is subject to the CFC regime.

Judicial case highlights

Two cases regarding application of anti-avoidance rules to reorganisation transactions

Overview

In late 2014 and early 2015, the Tokyo High Court rendered decisions in two high-profile cases, both involving reorganisations within a corporate group, and reached contrasting results, affirming the tax authorities' corrections in one case, and rejecting the tax authorities' claim and cancelling the correction in another. Although the decisions in both cases are on appeal to the Supreme Court of Japan, and thus, subject to being overturned, they deserve attention at this point since they could give insight into the prospective enforcement approach that could be taken by the Japanese tax authorities.

The background of these decisions is that, in recent years, the Japanese tax authorities have been taking a tougher stance on corporate reorganisations and cross-border transactions to thwart any attempts to avoid taxation. The move to implement strict investigations culminated in corrections being made in some reorganisation transactions. One case (the "Corporate Split and Merger Case") reportedly involved (1) a denial of the merging company's carried-forward losses succeeded to by the acquiring company; and (2) a denial

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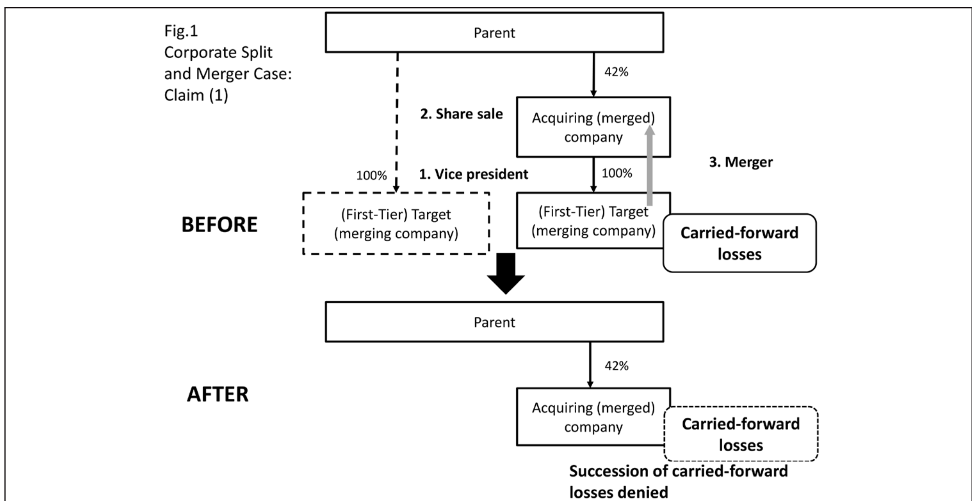
of amortisation of goodwill recognised in taxable reorganisations. Another case (the "Share Sale to Issuing Company Case") reportedly involved a denial of losses recognised by sale of shares to the issuing company due to the deemed dividends (which are generally deductible as a dividend received deduction).

The Japanese tax authorities invoked the anti-avoidance rules in these corrections: Article 132-2 for enumerated statutory reorganisations and Article 132 for acts of Japanese family corporations (i.e., a corporation over 50% of the shares of which are owned by three or less shareholders' groups). The anti-avoidance rules have the requirement of "unjustness" in common. There is no statutory breakdown or regulatory guideline for the meaning of "unjustness" in the context of such reorganisations, and thus, its interpretation, which is quite open, was heavily litigated and decided in the two cases as elaborated below.

Corporate Split and Merger Case

Claim (1) − Denial of merging company's carried-forward losses succeeded to by acquiring (and merged) company

This case involved a tax-free statutory merger under the Corporation Act of Japan, after which carried-forward losses that were accrued with the merging company, the target, could have been succeeded to and used by the acquiring company (on which the correction was made) under certain statutory conditions. In a series of transactions, the acquiring company acquired 100% of the shares of the target, which thereafter merged into the acquiring company in a tax-free merger as between the parent (the acquiring company) and its wholly-owned subsidiary (the target). In general, the succession and usage by an acquiring (merged) company of the carried-forward losses that are accrued with the merging company are subject to conditions codified in the Corporation Tax Act, which are essentially indicative of a merger being a "joint" business of both companies. The condition specifically at issue in this case stipulates that a statutory-defined Specified Director (which includes the representative director and vice president) of the merging company (target) must be (after the merger) a Specified Director of the acquiring company. The Japanese tax authorities found that, notwithstanding the fact that the representative director of the acquiring company had been appointed vice president of the merging company (before the merger), the appointment was "a mere formality" to satisfy the said condition and concluded that the transactions were "abnormal, irregular", and thus, deniable under the anti-avoidance rule.



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The Tokyo High Court Decision dated 5 November 2014 – On Claim (1)

The Court affirmed the tax correction, rejecting the taxpayers' arguments that only those actions that have no reasonableness other than tax avoidance should be subject to denial. In so doing, the Court defined "unjustness" as including not only (i) those transactions that are "unreasonable or unnatural as economic transactions (as in Article 132)", but also (ii) "those transactions that satisfy, in each constituent part, the formality of the individual conditions for statutory (tax-free) reorganisations, if allowing such tax-reducing effects would be evidently against the intentions or purposes of the tax code or relevant individual conditions".

Thereafter, the Court found that the vice president of the merging company (he was the Specified Director of the acquiring company) had: (i) assumed the position only two months before the acquisition of all the shares of the merging company by the acquiring company; and (ii) not been involved in the business proper to the merging company (target), and therefore, the assumption of the office of the vice president of the merging company is viewed as having been aimed *principally* at a tax-reducing effect, which was unnatural and unreasonable as an economic act. The Court concluded, therefore, that the two companies are not deemed to have conducted the business "jointly" (which is the quintessential rationale of tax-free reorganisations), even if the formality of the law had been satisfied. The Court decided, therefore, that allowing such tax-reducing effects (i.e., succession of carried-forward losses of the merging company) would be evidently against the intentions or purposes of the tax code, concluding that the denial of succession of carried-forward losses was affirmed.

Claim (2) − Denial of amortisation of goodwill recognised in a taxable reorganisation

In the same series of transactions subject to corrections was another constituent transaction, a corporate split, where goodwill was recognised. A part of the target (the "First-Tier Target") was carved out from the First-Tier Target under a corporate split codified in the Corporation Act of Japan, after which the subsidiary (the "Second-Tier Target") was established and wholly-owned by the First-Tier Target. After the corporate split, shares of the Second-Tier Target (wholly-owned subsidiary) were sold by the First-Tier Target to the acquiring company. Given the prospective share sale, the preceding corporate split was not qualified for tax-free status, and thus, taxable under the Corporation Tax Act of Japan, on the grounds that the share sale from the First-Tier Target to the acquiring company would result in the severing of the First-Tier Target's continuity of control over the carved-out Second-Tier Target. The Second-Tier Target (i.e., the carved-out subsidiary) had recognised as goodwill the difference of (x) the fair market value of the whole business succeeded to from the First-Tier Target, and (y) the aggregate net fair market value of the individual assets of the First-Tier Target, which would be amortised and deductible by the Second-Tier Target. After the share sale, the First-Tier Target merged into the acquiring company. The Japanese tax authorities denied a part of the amortisation, based on a finding that the corporate split was intentionally structured as "taxable" (in order to recognise goodwill), and therefore, deniable under the anti-avoidance rule.

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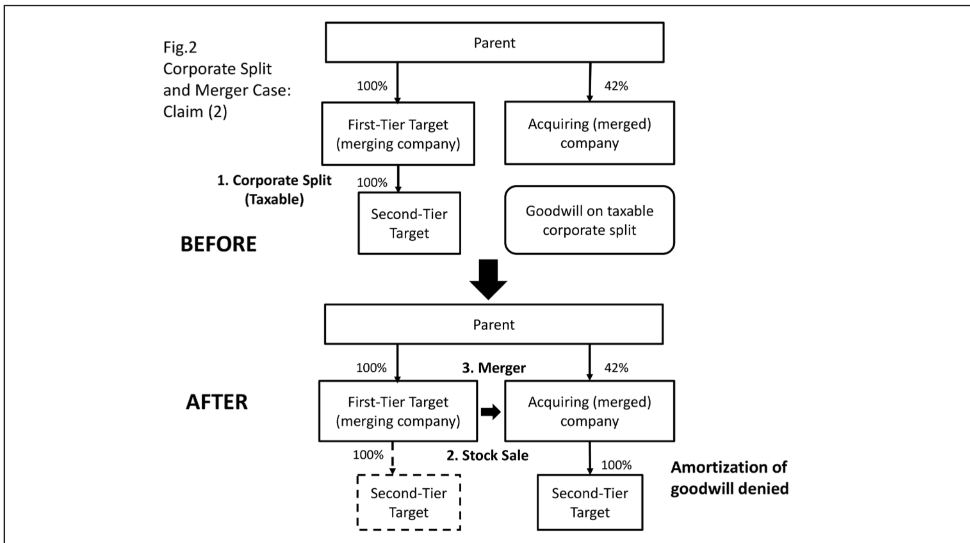

Tokyo High Court Decision dated 15 January 2015 − On Claim (2)

The Court affirmed the tax correction on Claim (2), rejecting the taxpayers' arguments that the reorganisations satisfied the statutory conditions and that denial was an undue expansion of the law. In so affirming, the Court found that the First-Tier Target "continued its control over the assets" of the Second-Tier Target. The Court elaborated this finding by saying that, although the First-Tier Target had lost its control over the assets of the Second-Tier Target "temporarily" at the time of the sale of the shares of the Second-Tier Target (to the acquiring company), the First-Tier Target soon recovered its control over the assets of the Second-Tier Target at the time the First-Tier Target merged into the acquiring company which, prior to the merger, had purchased the shares of the Second-Tier Target. The Court affirmed, therefore, the denial of the taxable corporate split and recognition of goodwill (thus denying amortisation of the goodwill).

<u>Share Sale to Issuing Company Case − Losses due to dividend received deductions, which later offset consolidated group income</u>

Denial of losses caused by sale of shares by parent to its wholly-owned subsidiary

This case concerned tax losses arising out of a sale of shares to the issuing company (or repurchase of shares by the issuing company). In general, a sale of shares to an issuing company often creates tax losses by operation of the Japanese tax law. Part of the consideration paid by the purchaser, the issuing company, is deemed a dividend, and thus, deductible (as a dividend received deduction), and the sale results in losses, since the tax law recognises as consideration the amount after deduction of the aforementioned deemed dividend. In this case, an intermediate holding company ("Holdings") acquired, from its U.S. parent, all of the shares of the operating company established in Japan ("Sub"), making Sub a 100% subsidiary of Holdings. Thereafter, Holdings sold a portion of Sub's shares that it owned to Sub, the issuing company, and recognised losses on the sale. The losses were caused by the mechanics described above. Subsequently, Holdings filed a consolidated tax return in which the consolidated group offset Sub's taxable income with the losses that had been recognised through the foregoing share sale. The Japanese tax authorities invoked Article 132 of the Corporation Act of Japan and denied the sale (and thus losses resulted from the sale). The tax authorities had alleged the reduction of corporation tax

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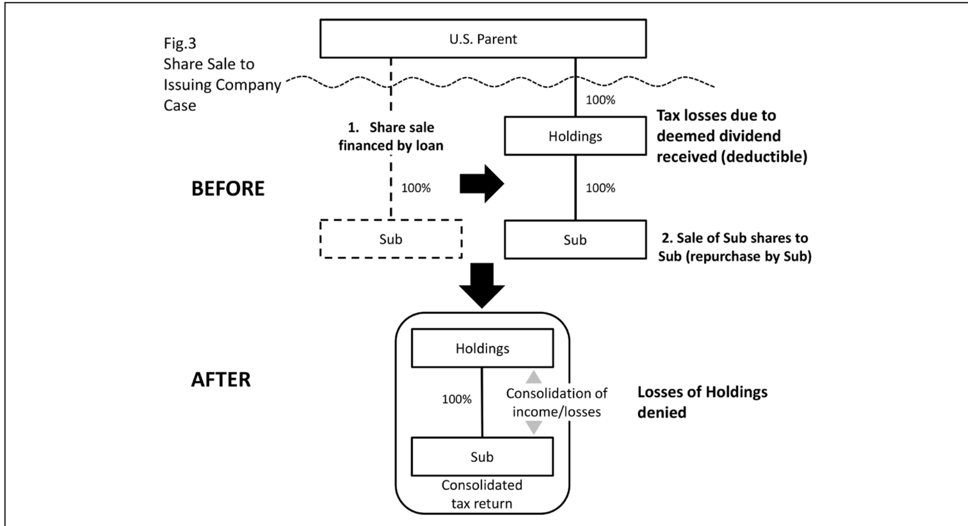
should be regarded as "unjust" based on the following allegations: (i) there is no legitimate or business purposes in making Holdings an intermediate holding company for Sub; (ii) the series of transactions were not ordinary transactions between independent parties; and (iii) the intention to commit tax avoidance was found in the sequence of acts taken by the relevant parties.



The Tokyo District Court Decision dated 9 May 2014, further affirmed by the Tokyo High Court Decision dated 25 March 2015

The District Court rejected the tax authorities' allegation that Holdings abused the Corporation Tax Act to avoid tax and ordered cancellation of the whole subject correction. The District Court denied all of these tax authorities' aforementioned allegations, saying that: (i) the Court disagreed with the tax authorities' allegation that there were no legitimate or business purposes to place Holdings as an intermediate holding company in Japan; (ii) the Court rejected the tax authorities' allegation that the constituent transaction was not an ordinary transaction; and (iii) the Court was not able to identify evidence or circumstances to sufficiently support the tax authorities' allegation that the intention of tax avoidance was evident. The High Court further affirmed the District Court's decision, holding (i) that the establishment of the intermediate holding company (Holdings) and the share transfers (which generated losses) should not be viewed as integrated, and each share transfer itself is subject to scrutiny, (ii) that each share transfer is not deemed to be unreasonable, and (iii) that the tax authorities' allegation that the losses were mere ostensible (lacking substance) ones lacks legal basis.

Please note the Corporation Act of Japan was amended in 2010 with the result that tax losses are no longer recognised from a parent's sale of shares to its wholly-owned subsidiary that issued the subject shares.

Planning perspective

The decision in the Corporate Split and Merger Case endorsed the tax authorities' stringent scrutiny over reorganisation transactions that entail tax-reducing effects. In particular, the Courts appear to have adopted a step transaction doctrine, under which the subject transactions are viewed in their entirety and scrutinised if they are against the intentions or purposes of the tax code from that perspective. Therefore, in structuring transactions,

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it may be insufficient to establish that individual actions have certain business purposes, and it is now necessary to give evidence that the transactions have reasonableness in taking certain forms and sequences of a series of transactions viewed in its entirety.

Further, it is notable that in both Cases, the Court paid significant attention to see whether, as a matter of fact, the taxpayer had tax avoidance intentions. In the Corporate Split and Merger Case, the Court appeared to emphasise that the taxpayers adopted the subject structure to utilise tax-reducing effects. In contrast, in the Share Sale to Issuing Company Case, the Court did not find sufficient facts to identify tax avoidance intentions. It is yet to be seen whether these decisions will be upheld on appeal to the Supreme Court. In practice, though, it is usual and natural to examine the tax effects in structuring transactions. At a minimum, therefore, it is advisable to clarify economic considerations underlying subject transactions in order to avoid giving the impression that tax considerations outweigh non-tax economic considerations.

Transfer pricing

The Japanese tax authorities have tended to apply the residual profit split method ("RPSM") to Japanese companies to assign relatively low operating margins to their non-Japan subsidiaries, on the grounds that they have only simple and limited functions, resulting in the recalculation of a significant amount of income for the Japanese parent. The trend received a significant blow when Honda Motor Company Limited, a major Japanese automobile manufacturer, achieved cancellation of a correction of JPY 25.4 billion in taxable income. In the Honda case, the comparability of the comparable companies selected by the Japanese tax authorities, especially in respect of the market conditions, was vigorously disputed. The Tokyo District Court, in its decision dated 28 August 2014, which was further affirmed by the Tokyo High Court decision dated 13 May 2015, held that the alleged comparable companies were inapposite to the tested party (i.e., the taxpayer's foreign affiliate) based on the finding that the tested party was doing business where tax incentives were offered (specifically, in the Free Economic Zone of Manaus in Brazil), whereas the comparable companies identified by the tax authorities were located outside such area, citing the relevant paragraphs of OECD Transfer Pricing Guidelines. The decision is significant in indicating that market conditions (including governmental regulations and interventions) are material in comparability analysis and their similarity as between the tested party and comparable companies must be demonstrated by the government. From the practitioners' perspective, this case is worth referencing when a taxpayer argues that comparable companies alleged by the tax authorities are inappropriately selected and thus lack compatibility.

Tax treaties

<u>Major recent developments with respect to tax treaties for the purpose of avoidance of double taxation since 1 January 2013</u>

Country	Signed Date	Applicable Date	Reduction or exemption on Withholding Tax at Source		
			Dividends	Interests	Royalties
Kuwait	17 February 2010	1 January 2014	5% for 10%-or-more-voting corporate shareholders (not applicable if tax deductible for payer companies); 10% for others	Exempt for governmental institutions; 10% for others	10%

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Country	Signed Date	Applicable Date	Reduction or exemption on Withholding Tax at Source		
			Dividends	Interests	Royalties
Portugal	20 December 2011 (Japan time)	1 January 2014	5% for 10%-or-more-holding (Portugal payer)/ 10%-or-more-voting (Japanese payer) corporate shareholder; 10% for others	Exempt for governmental institutions; 5% for banks; 10% for others	5%
New Zealand	10 December 2012	1 January 2014	Exempt for 10%-or-more-voting corporate shareholders; 15% for others	Exempt for governmental institutions and banks; 10% for others	5%
United States	25 January 2013 (Japan time)	Not effective yet	Exempt for 50%-or-more-voting corporate shareholders (not applicable if tax deductible for a payer company); 5% for a 10%-or-more-voting corporate shareholders; 10% for others	Exempt in general	Exempt
United Arab Emirates	2 May 2013	1 January 2015	5% for 10%-or-more-voting corporate shareholders; 10% for others	Exempt for governmental institutions; 10% for others	10%
Sweden	5 December 2013	1 January 2015	Exempt for 10%-or-more-voting corporate shareholders (not applicable if tax deductible for payer companies); 10% for others	Exempt in general	Exempt
United Kingdom	17 December 2013	1 January 2015	Exempt for 10%-or-more-voting corporate shareholders (not applicable if tax deductible for payer companies); 10% for others	Exempt in general	Exempt
Oman	9 January 2014	1 January 2015	5% for 10%-or-more-voting corporate shareholders (not applicable if tax deductible for payer company); 10% for others	Exempt for governmental institutions; 10% for others	10%
Qatar	20 February 2015	Not effective yet	5% for 10%-or-more-voting corporate shareholders; 10% for others	Exempt for governmental institutions and banks; 10% for others	5%
Germany	Will revise the current treaty (originally effective in 1967 and amended in 1979 and 1983); agreed upon in substance				

The year ahead

Amidst those rapidly changing environments, tax practitioners need to closely watch the legislative moves on various fronts as well as to be more and more prudent when dispensing advice on transactions in order to comport with the more rigorous standards.

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