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LAW AND PRACTICE: p.3

Contributed by Nagashima Ohno & Tsunematsu

The 'Law & Practice' sections provide easily accessible information on navigating the legal system when conducting business in the jurisdiction. Leading lawyers explain local law and practice at key transactional stages and for crucial aspects of doing business.

Law and Practice

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Nagashima Ohno & Tsunematsu has almost 50 years of experience in dealing with tax matters. Four partners are dedicated to tax issues, including one senior partner and three up-and-coming partners, but the firm also has as advisers Mr Mamoru Toba, a former director-general of the Tokyo Regional Taxation Bureau, and Mr Hiroshi Kaneko (not admitted to bar), the foremost authority on Japanese tax law. The teamwork of these powerful figures as well as a good combination of senior and younger partners creates the strongest tax law practice in Japan. Key practice areas are tax advice and planning (for all types of commercial transactions, particularly those involving M&A, reorganisation transactions, financing and capital markets, investment in real property and financial assets); tax disputes (including tax audits, administrative appeals and court proceedings); and issues of wealth management, business succession and inheritance.

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1. Types of Business Entities Commonly Used, Their Residence and Their Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Japanese enterprises and foreign enterprises doing business in Japan generally adopt a corporate form in the same manner as in other major jurisdictions. Japanese corporate law makes available several choices of corporate form; among these, the most commonly used one is a *kabushiki kaisha* (stock corporation; commonly referred to as a "KK"). A *godo kaisha*, which is modelled after a US limited liability company (LLC), is also common for small businesses or as subsidiaries of foreign companies (commonly referred to as a "GK").

Largely speaking, a KK is similar to a US corporation in terms of corporate structure and governance; that is, shareholders are owners of a KK, and the number or ratio of the voting rights attached to the shares held by a shareholder makes sense in terms of the governance of a KK. Shareholders elect directors, who will execute the business of the KK, either by themselves or through the board of directors; in most KKs, there is no executive officer on top of the directors, but the directors, either by themselves or through the board of directors, execute the business of the KK. Among these directors, the one who has the authority to represent and act on behalf of the KK is referred to as the "representative director". The representative director often has the title of President or CEO (however, such title has no legal significance). Some large KKs, however, adopt the US type of governance, whereby executive officers are appointed to execute the business of the KK and the board of directors is supposed to oversee and supervise the administration by the executive officers.

On the other hand, a GK is managed like a US limited liability company; that is, the business of a GK is executed by a member of the GK who has the authority of management, referred to as the "managing member". Certain important decisions of a GK such as amendments to the articles of incorporation of the GK are made by the agreement of all the managing and non-managing members. For this purpose, each member has one vote regardless of the amount of capital contributions; in such sense, there is no concept of voting rights attached to shares as in a KK. Where a corporate entity, whether Japanese or foreign, becomes the managing member of a GK, that corporate managing member must appoint a natural person who shall execute the business of the GK on its behalf (a "performer of duties").

The Japanese Ministry of Justice has abolished the long-standing practical policy that at least one of the representative directors of a KK or of the performers of duties of a GK must be a Japanese resident, so now it is allowed that a non-Japanese resident individual acts and is registered as such.

For Japanese tax purposes, both KKs and GKs are taxed as a corporation or as a separate legal entity, like US C Corporations. Despite the fact that a GK is designed after a US LLC, no transparent or pass-through taxation is available for a GK. Similarly, there is no taxation regime such as that for an S Corporation in the US Internal Revenue Code. As such, KKs and GKs are subject to corporate taxation as an independent and distinct taxpayer, and the shareholders of KKs and the members of GKs are subject to individual income taxation (if they are individuals) or corporate taxation (if they are corporations; provided that dividends-received deductions are generally available) when they receive dividends or profit distributions from the KK or the GK. However, for US federal income tax purposes, while a KK is treated as a per se corporation, a GK is treated as an eligible entity and can elect to be taxed as transparent or pass-through.

1.2 Transparent Entities

As Japanese corporations, whether they are a KK, a GK or another form, are taxed as a corporation or as a separate legal entity, only non-corporate business forms are eligible for transparent or pass-through taxation for Japanese tax purposes. These business forms take the form of a partnership (*kumiai*), which is an aggregate of partners based upon a contractual relationship, but not being an entity separate and distinct from the partners.

Japanese partnerships have three forms; that is, a *nin'i kumiai*, which corresponds to a general partnership (a "J-GPS"); a *toushi jigyo yugen sekinin kumiai* (or an investment business limited partnership), which corresponds to a limited partnership (a "J-LPS"); and a *yugen sekinin jigyo kumiai* (or a limited liability partnership), which corresponds to a limited liability partnership (a "J-LLP"). Among these, a J-LPS is commonly used as a vehicle for private equity investments in Japan, as its governance structure, comprising a general partner who has an unlimited liability in respect of the J-LPS and manages the business of the J-LPS, and limited partners who have only limited liability and basically are passive investors, is suitable for private equity investment. Also, a J-LLP, where all the partners enjoy limited liability and participate in the business of the partnership, is used for small businesses where the partners wish to enjoy transparent or pass-through taxation (explained below) and the lack of corporate personality does not cause a problem as a legal and business matter.

J-GPSs, J-LPSs and J-LLPs are all taxed as transparent or pass-through; that is, they will not be treated as an independent taxpayer, but rather their partners are taxed as taxpayers with respect to the income derived from the business of the partnership. In general, the profits and losses derived from the business of the partnership are allocated to each of the partners based upon the percentage agreed upon in the relevant partnership agreement (most commonly, the ratio of capital contributions). There are rules for limitation of allocation of losses to certain passive partners (eg, limited partners) to prevent tax avoidance using these partnership structures.

It is important to note that when a foreign investor becomes a partner of the Japanese partnership, eg, a limited partner of a J-LPS conducting private equity investments in Japan, that foreign investor would in principle be deemed to have a permanent establishment in Japan since it is deemed to be doing the investment business through the general or managing partner in Japan of that partnership. There are, however, special taxation measures allowing exemption from this permanent establishment rule, subject to certain conditions and requirements being met, in order to attract foreign investors into Japanese investment.

Japanese tax law lacks detailed rules for partnership taxation; there is no separate chapter such as Subchapter K of the US Internal Revenue Code in Japanese tax laws, and there are only several provisions provided in the administrative circular (which is not law) issued by the Japanese tax authority.

Along with J-GPS, J-LPS and J-LLP, Japanese law has another arrangement referred to as a *tokumei kumiai* (a "TK"). A TK is a contractual relationship between "TK Operator" and "TK Investor", where they mutually agree that (a) TK Investor will make capital contributions to TK Operator, (b) TK Operator will run a business under its own name and for its own account, and (c) as TK Operator generates profits from the business, TK Operator will allocate and distribute such profits to TK Investor according to its capital contributions. For Japanese tax purposes, the profit distributions by TK Operator are deductible for its corporate tax purposes, and are subject to 20.42% withholding tax (20% national tax and 0.42% special reconstruction income surtax) when paid to TK Investor who is a non-resident individual or foreign corporation having no permanent establishment in Japan. Depending upon the jurisdiction of TK Investor, such withholding tax can be exempt under the applicable tax treaty (eg, Ireland; under the "other income" provision). This means that completely tax-free repatriation of profits out of Japan is technically possible; however, such a TK structure will be subject to close scrutiny by the Japanese tax authority, and practitioners generally recognise that such a scheme will entail a substantial risk of disallowance of the treaty benefits.

1.3 Determining Residence

With regard to the residency of corporations, the Japanese tax law as well as the practice of the Japanese tax authority takes the position of looking at the jurisdiction of incorpo-

ration of the corporation under the relevant corporate law. That is, so long as the taxpayer is a Japanese corporation for Japanese corporate law purposes such as a KK or a GK, even if the place of management and control of that corporation is outside Japan, it is treated as a Japanese corporation for Japanese tax purposes. Similarly, so long as the taxpayer is a foreign corporation for Japanese corporate law purposes, such as US corporations and UK limited companies, even if the place of management and control of that corporation is within Japan, it is treated as a non-Japanese corporation for Japanese tax purposes (with a possibility that the foreign corporation is deemed to have a permanent establishment in Japan).

For transparent entities, substantially the same position is adopted; that is, J-GPSs, J-LPSs and J-LLPs are treated as being formed in Japan, and foreign transparent entities such as US or UK general or limited partnerships are treated as being formed outside Japan. Note, however, that, for Japanese tax purposes, some foreign transparent entities are treated as a foreign corporation for Japanese tax purposes, so long as that entity can enter into transactions by and under its own name rather than the partners or members. These entities include, for example, US LLCs and US limited partnerships. This principle is established by a certain landmark Supreme Court decision.

1.4 Tax Rates

Japanese corporations such as KKs and GKs are subject to corporate taxation comprised of (a) national corporation tax as well as (b) local inhabitants tax (including national local corporation tax) and (c) local enterprise tax (including special local corporation tax). National local corporation tax and special local corporation tax are independent items of tax but these are established solely for the purpose of proper allocation of the tax revenue between the national government and the municipal governments and generally do not substantially affect the overall tax burden of the taxpayers; so these may in substance be considered part of local inhabitants tax and local enterprise tax respectively. The marginal rate of national corporation tax was reduced to 23.4% (for fiscal years beginning on or after 1 April 2016) or 23.2% (for fiscal years beginning on or after 1 April 2018), by the 2016 annual tax reform. Further reduced rates of 15% or 19% are available for small corporations (those having stated capital of JPY100 million or less, unless wholly-owned by certain large corporations) with respect to the small income bracket of up to JPY8 million. Local inhabitants tax varies among the local municipalities where the corporation is headquartered and depending upon certain particulars of the taxpayer. Local enterprise tax (including special local corporation tax) is imposed at certain variable rates on the taxable income for purposes of the national corporation tax; for example, some large municipalities such as Tokyo apply certain surtax rates upon the standard rates, and corporations having a stated capital of more than JPY100 million are subject to business-scale-based local enterprise taxation whereby the tax burden is measured not only by income but also by certain business scales.

Taking into consideration the foregoing three items of corporate taxation, or (a) national corporation tax, (b) local inhabitants tax (including national local corporation tax) and (c) local enterprise tax (including special local corporation tax), the effective marginal corporate tax rate (national and local) applicable to Japanese corporations is, as a general matter and subject to specific circumstances of the taxpayer (eg, being subject to surtax rates of local enterprise tax), as follows:

- for corporations having a stated capital of more than JPY100 million:
  - (a) for fiscal years beginning on or after 1 April 2016: 29.97% (30.86% including Tokyo's local surtax rate)
  - (b) for fiscal years beginning on or after 1 April 2018: 29.74% (30.62% including Tokyo's local surtax rate)
- for other corporations:
  - (a) for fiscal years beginning on or after 1 April 2016: 33.8%
  - (b) for fiscal years beginning on or after 1 April 2018: 33.58%

Foreign corporations, if they have a permanent establishment in Japan (eg, a branch office), are taxed substantially in the same manner as Japanese corporations mentioned above upon their taxable income attributable to the permanent establishment in Japan. If they have no permanent establishment in Japan but have income subject to corporate taxation to be reported by filing a tax return (eg, income not finalised by withholding tax only), they will be subject to the national corporation tax (but not local taxes) at the rate of (i) 24.22% for fiscal years beginning on or after 1 April 2018 or (ii) 25.59% for fiscal years beginning on or after 1 October 2019.

Partners of transparent business forms such as J-GPSs, J-LPSs and J-LLPs are taxed upon the income derived from the business of the partnership, in accordance with the percentage agreed upon in the relevant partnership agreement (most commonly, the ratio of capital contributions). If the partner is a corporation, it will be subject to the corporate taxation explained above with respect to the income allocated from the partnership. If the partner is a Japanese resident individual, he/she will be subject to Japanese individual income taxation with respect to the income allocated from the partnership, where progressive rates apply. The marginal tax rate of individual taxation is 55.945% (comprised of 45% national individual income tax, 0.945% special reconstruction income surtax and 10% local inhabitants tax) for calendar years from 2015 through 2037. Due to the 2013 annual tax reform, the marginal tax rate for national

individual income tax has been increased from 40% to 45% from calendar year 2015 with respect to the income bracket exceeding JPY40 million, with a view to more heavily taxing wealthy individuals. Special reconstruction income surtax applies to national individual income tax and withholding tax, as 2.1% of the relevant national tax amount, from 2013 through 2037, with a view to funding the reconstruction from the Great East Japan Earthquake. Local enterprise tax (generally 5% of certain adjusted taxable income) will additionally apply if the business of the partnership is considered a business of the individual for local enterprise tax purposes.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable income for corporate tax purposes will basically be calculated based upon the income for corporate accounting purposes, in accordance with the generally accepted accounting principles of Japan. For this purpose, it is considered a generally accepted accounting principle that income shall be taxed on an accrual basis rather than a receipts basis.

Then, solely for tax purposes, substantial adjustments will be made. Major adjustments include:

- exclusion from taxable income of all or part of dividend income received from Japanese corporations (an equivalent of dividends-received deduction);
- exclusion from taxable income of dividend income received from foreign subsidiaries (a territorial approach to mitigate international double taxation as to income derived through foreign subsidiaries, in lieu of indirect foreign tax credit; see **6.1 Foreign Income of Local Corporations**);
- limitation on deductibility of remunerations paid to directors and officers of the corporation;
- limitation on deductibility of donations or gifts made by the corporation as well as entertainment expenses;
- denial of deductibility of allowances or reserves established internally by the corporation;
- denial of deductibility of criminal or administrative fines or damages due to wilful misconduct or gross negligence;
- deduction of net operating loss carry-forwards from prior fiscal years (see **2.4 Basic Rules on Loss Relief**);
- mark-to-market rules for trading securities and derivatives in respect of unrealised built-in gains and losses;
- Japanese consolidated tax regime (available for a 100%-owned corporate group consisting of Japanese corporations upon election; see **2.6 Basic Rules on Consolidated Tax Grouping**);
- group-based taxation regime (special rules for transactions among a 100%-owned corporate group consisting of Japanese corporations; see **2.6 Basic Rules on Consolidated Tax Grouping**); and
- special rules for acquisitive and divisive reorganisations (eg, merger, divestiture, etc) similar to section 368(a)(1) et seq of the US Internal Revenue Code, eg, deferral of recognition of gains and losses arising from reorganisation transactions.

Each of these regimes has complicated and detailed rules consisting of general principles and various exceptions and further exceptions.

2.2 Special Incentives for Technology Investments

There are some special taxation measures relating to technology investments. Tax credit is available for R&D expenses; in general, 6-14% (12-17% for certain small corporations) of the total of certain qualifying R&D expenses will be treated as credit against national corporate tax, up to 25% of the amount of national corporate tax payable for a fiscal year. In addition, on top of that tax credit, a further tax credit is available up to 10% of the amount of national corporate tax payable for a fiscal year, with respect to a certain percentage of the qualifying R&D expenses if the qualifying R&D expenses increase to exceed certain thresholds. There are a few other special taxation measures related to R&Ds. The patent box regime is not legislated, while it is being discussed as a tax policy matter.

Furthermore, a few special tax and other incentives have been established in order to attract R&D activities and/or investments into Japan by foreign multinational enterprises. For example, the Tokyo metropolitan government, in cooperation with the Japanese national government, provides a regime called the Asian headquarters special region. There, if a qualifying foreign multinational enterprise establishes a Japanese corporation as a subsidiary based upon an approval of the Tokyo metropolitan government for the purpose of conducting R&D activities in Japan or establishing an Asian regional headquarters in Japan (ie, as an intermediate holding company), that Japanese subsidiary can enjoy, among other benefits, special tax credit or special accelerated depreciation deduction for the investments made in machinery and buildings, along with total exemption of local transactional taxes such as real property acquisition tax, fixed property tax and city planning tax.

In addition, there are a few special taxation regimes; one example is the special taxation regime for promoting increase of salary payments to employees, where, in general, taxpayers can enjoy a tax credit of 15% (in some qualifying cases 20% or 25%) of the increased amount of the total deductible salary payments to their employees as compared to those of the immediately preceding fiscal year (applicable for fiscal years beginning by the end of March 2021). These measures reflect the economic policy referred to as "Abenomics" of the incumbent Prime Minister and his ruling party.

2.3 Other Special Incentives

There are numerous special taxation measures specifically applicable to particular industries, or transactions (such as financings), to businesses or to certain small corporations. Particularly, very commonly and frequently used in practice are the special taxation measures to exempt Japanese withholding tax on interest payable on certain qualifying bonds. See **4.1 Withholding Taxes**.

2.4 Basic Rules on Loss Relief

Under Japanese corporate tax law, there is no distinction between ordinary income and capital gains. Accordingly, taxable net income or loss in a given fiscal year is calculated as the balance of all items of gross income, profits, revenues and gains, less all items of costs, expenses and losses; ie, all these items are netted together.

If there remains a negative balance or a loss in a given fiscal year as a result of the foregoing calculation, such loss can be carried forward for ten future fiscal years (for the fiscal years beginning on or after April 1, 2018) as net operating loss carry-forwards subject to filing of "blue-form" tax returns (meaning tax return filing specifically authorised by the Japanese tax authority as compliant with proper accounting based upon a double-entry bookkeeping system; this is overwhelmingly common in Japan). Such duly incurred net operating loss carry-forwards can be utilised in the ten future fiscal years up to (a) 55% of the total taxable income for a fiscal year (applicable to fiscal years beginning on or after April 1, 2017) or (b) 50% of the total taxable income for a fiscal year (applicable to fiscal years beginning on or after April 1, 2018); provided that 100% deduction is possible for small corporations (those having stated capital of JPY100 million or less, unless wholly owned by certain large corporations). Loss carry-back is available only for the immediately preceding fiscal year; however, it is currently suspended due to tight governmental financial conditions except for small corporations (those having stated capital of JPY100 million or less, unless wholly owned by certain large corporations) and certain limited circumstances such as dissolution and sale of entire businesses.

2.5 Imposed Limits on Deduction of Interest

Interest payable by a Japanese corporation will generally be deductible as an expense for its Japanese corporate tax purposes. However, there are special rules limiting deductibility of interest as follows:

If the debt giving rise to the interest is owed to a foreign corporation which is a controlling shareholder (owning directly or indirectly 50% or more of the total shares) of the Japanese corporation, the 'thin capitalisation' rules apply, and, generally speaking, interest payable upon the portion of the debt exceeding three times the shareholders' equity of the Japanese corporation will be non-deductible. The thin-capitalisation rules apply not only in the case of direct financing by the controlling shareholder, but also in other similar cases, such as financing by third parties with a guarantee provided by the controlling shareholder.

Transfer pricing rules also apply to interest payable to affiliated foreign corporations of the Japanese corporation in order to require that the interest rate be arm's length (ie, the portion of the interest exceeding the arm's-length rate will be denied deduction). One Japanese court precedent indicates that the arm's-length interest rate generally refers to the rate available in the market for substantially similar finance transactions.

Further, as a result of the 2012 annual tax reform, a Japanese version of the 'earnings stripping' rules has been introduced, and applies to fiscal years beginning on or after April 1, 2013. There, if the 'net' amount of the interest paid to certain foreign related parties of the Japanese corporation in a fiscal year exceeds 50% of certain 'adjusted income' (substantially equal to EBITDA, ie, taxable income before that interest deduction, depreciation, etc) of that Japanese corporation in that fiscal year (ie, interest paid to foreign affiliates is excessive as compared to the taxable income), the excess portion of the interest will not be deductible in that fiscal year. The excess portion will be carried forward for seven future fiscal years, however, and will be deductible to the extent the above conditions are met in the relevant future fiscal year. There is a certain de minimis exception, as well as an exception where the gross amount of interest paid to foreign related parties does not exceed 50% of the total gross amount of interest (including interest paid to third parties).

It should be noted that interest deduction can be denied, even if none of the foregoing regimes is applicable, if the Japanese tax authority considers the relevant debt transaction as avoiding Japanese tax and invokes the anti-avoidance statute in the corporation tax law. Most recently, it was reported that the Japanese operating company of a multinational music company received a deficiency assessment of taxable income of JPY9 billion, arising from disallowance of deduction of interest expenses with respect to an intercompany loan that the Japanese company borrowed from its foreign affiliate to fund the restructuring of the Japanese operation. The Japanese tax authority appears to have invoked the anti-avoidance statute applicable to closely held companies to deny the interest deduction, alleging that there was little business purpose in conducting such a reorganisation where the substance of the Japanese operation remained, substantially, the same as before.

This case is significant in that:

- a 'debt pushdown' transaction, commonly employed in inbound investment practice, was disallowed;
- even an international transaction became the subject of the anti-avoidance statute; and

- the anti-avoidance statute was invoked, regardless of the individual-specific tax rules limiting interest deduction (eg, thin capitalisation, earnings stripping, etc), where the tax authority believed that there was little business purpose, to disallow the entire amount of the interest deduction.

It is crucial that taxpayers exercise the utmost care in structuring the transaction by performing thoughtful legal analysis, bearing in mind all possible challenges and allegations that could be made by the Japanese tax authority. Particularly, it is crucial in recent practice to verify that valid non-tax business purposes or reasons supporting the economic rationale of the M&A and reorganisation transactions exist, and to be prepared to establish them in accordance with the tax authority in the event of audit.

2.6 Basic Rules on Consolidated Tax Grouping

Japanese corporation tax law has a consolidated taxation regime. A Japanese corporation (a consolidated parent company) and its wholly owned direct and indirect Japanese subsidiaries form the consolidated group. Foreign corporations, whether as a consolidated parent company or as a consolidated subsidiary, cannot be included in the consolidated group. To qualify as a consolidated subsidiary, all of its issued shares must (save very limited exceptions) be wholly owned, either directly or indirectly, by the Japanese corporation as the consolidated parent company. It is not allowed to 'cherry-pick' subsidiaries to be subject to the consolidated taxation regime; so long as a subsidiary has a relationship of direct or indirect 100% shareholding with the consolidated parent company, it must be included. The consolidated taxation regime is elective, ie, it shall apply only if the Japanese tax authority has approved the consolidated return filing based upon an application by the consolidated group.

Under the consolidated taxation regime, taxable income of a member of the consolidated group will be offset against losses of another member. It must be noted, however, that, upon entering into the consolidated taxation regime, certain principal assets of all the consolidated subsidiaries shall in principle be marked to market to crystallise all unrealised built-in gains and losses pertaining to those assets, and such consolidated subsidiaries will report taxable income (or losses) accordingly. The 2017 annual tax reform has made clear that self-created goodwill or enterprise value of the to-be-consolidated subsidiaries does not need to be marked to market (thus giving rise to no mark-to-market gains). Also, net operating loss carry-forwards of all the consolidated subsidiaries shall in principle be disregarded in their entirety upon entering into the consolidated taxation regime. While there are several exceptions to these rules, they often become an obstacle for election of the consolidated taxation regime if no such exception is available. On the other hand, there is no mark-to-market requirement for the consolidated parent company and the net operating loss carry-forwards of the consolidated parent company will survive the consolidation election.

The consolidated taxation regime is currently for national corporation tax only. There is no consolidated taxation regime for local taxes (inhabitants tax and enterprise tax).

Along with the consolidated taxation regime, under Japanese corporation tax law, there is another different but similar taxation regime, referred to as a "group-based taxation regime". The group-based taxation regime applies to transactions among Japanese corporations (not including foreign corporations) having the relationship of direct or indirect 100% share ownership, or substantially the same as the relationship for the consolidated taxation regime. If a member of the group sells certain assets owned by it to another member of the group, gains and losses arising from the sale will be deferred at the seller, until the purchaser further disposes of such assets out of the group or other realisation event occurs. If a member of the group makes a donation to another member of the group, the donation is not deductible at the donor, and is not taxed as a gift (or receipt of economic benefit with no consideration) at the donee. It is important to note that the group-based taxation regime applies mandatorily, regardless of elections by the taxpayers, unlike the consolidated taxation regime.

2.7 Capital Gains Taxation

Japanese corporations are taxed on capital gains arising from sale of shares of other corporations in the same manner as ordinary business income, ie, at the effective marginal corporate tax rate (national and local) explained in **1.4 Tax Rates**. As mentioned, there is no distinction between ordinary income and capital gains for corporate tax purposes. Substantially the same taxation will apply to foreign corporations having a permanent establishment in Japan selling shares of other corporations held by the permanent establishment.

On the other hand, if the seller is a foreign corporation having no permanent establishment in Japan and sells shares of a Japanese corporation, the seller will in principle not be subject to Japanese corporate taxation upon the capital gains arising from the sale. However, as an exception, the foreign corporation is subject to Japanese taxation on the capital gains, if the foreign corporation, together with certain related persons (its affiliates and related parties, etc) as defined in Japanese tax laws and partnerships in which the foreign corporation is directly or indirectly a certain partner: (a) owns or owned 25% or more of the total shares of the Japanese corporation at any time during a period of three years on or before the close of the fiscal year of the foreign corporation in which the sale of such shares took place; and (b) sells 5% or more of the total shares of the Japanese corporation in that fiscal year. This exceptional rule is commonly referred to as the "25/5 rule" in practice. It is common in practice to

structure the offshore ownership to avoid this "25/5 rule" so as to avoid capital gains taxation in Japan in the event of the exit from the investment.

In addition, in the case where the Japanese corporation is a so-called real estate holding company (ie, if, in general, at least 50% of the total assets of that corporation consist of real estate located in Japan or of shares of another real estate holding company, on a fair market value basis), special rules apply so that more than 2% (if that corporation is not publicly listed) or more than 5% (if that corporation is publicly listed) ownership by the foreign corporation will trigger Japanese capital gains taxation. A typical example of this includes a Japanese REIT.

If capital gains fall under the above-mentioned taxation regime, the foreign corporation having no permanent establishment in Japan will be subject to the national corporation tax upon such capital gains, at the rate explained in **1.4 Tax Rates**, and must file a Japanese corporation tax return to report that income. There is no exemption or relief, such as participation exemption. These domestic tax law consequences, however, may be amended by the capital gains clause of the applicable tax treaty; some tax treaties totally exempt Japanese-source taxation upon capital gains arising from sale of shares of Japanese corporations.

2.8 Other Taxes Payable by an Incorporated Business

Consumption taxes, or Japanese VAT, are payable by individual or corporate taxpayers engaged in sale of goods or provision of services that are taxable for consumption tax purposes, ie, sale of goods or provision of services conducted in Japan (unless specifically designated as non-taxable). The tax rate is currently 8%, and will be raised to 10% from October 2019.

Consumption taxes are charged to the recipient or purchaser of the goods or services (ie, the recipient or purchaser will pay to the provider or seller the applicable consumption tax amount (8% or 10%) in addition to the purchaser price), and (a) the seller or the provider will report and pay the consumption taxes to the Japanese government by filing a tax return and (b) the recipient or purchaser may be eligible to take input tax credit as to the consumption tax amount so paid to offset against its own consumption tax liability. However, in the case of certain cross-border digital or electronic services transactions conducted by foreign enterprises that are classified as business-to-business (rather than business-to-consumer) transactions, the consumption tax liability vis-à-vis the Japanese government lies with the Japanese recipient of such services, under a so-called "reverse charge" mechanism.

Foreign individual or corporate taxpayers are also subject to the consumption taxes, regardless of whether or not they have a permanent establishment in Japan for income or corporate tax purposes, so long as they engage in sale of goods or provision of services conducted in Japan that is taxable for consumption tax purposes. However, foreign taxpayers may be exempt from the consumption tax liability because of a small business exemption, if, in general, the total taxable sale from the sale of goods or provision of services conducted in Japan (i) during a fiscal year two years preceding the relevant fiscal year (eg, 2016 for the consumption tax liability in 2018) and (ii) during the first six-month period of the fiscal year immediately preceding the relevant fiscal year (eg, January through June of 2017 for the consumption tax liability in 2018) did not exceed JPY10 million.

In addition, while being a part of income tax, Japanese withholding tax is significant. While Japanese withholding tax is imposed on some domestic payments (eg, interest and dividends paid to Japanese corporations, salary and remuneration paid to Japanese resident individuals, etc), practically significant is Japanese withholding tax imposed upon various payments made to foreign individuals or corporations. Typical ones among many subject payments include withholding tax imposed upon interest on loans, dividends and royalties paid to foreign individuals or corporations, which is imposed at 20.42% of the gross amount paid. The Japanese withholding tax is a tax liability of the payor and the payor is subject to an assessment and penalties if it fails to properly withhold. However, the Japanese withholding tax may be exempted or reduced under an applicable income tax treaty between Japan and the country of tax residence of the payee. For example, under the tax treaties with the US or the UK, royalties and certain qualifying inter-company dividends are exempt from Japanese withholding tax, subject to satisfaction of the limitation on benefits (LOB) conditions.

Furthermore, on top of the local enterprise tax explained in **1.4 Tax Rates**, businesses located in the Tokyo metropolitan area are subject to the business premises tax if they have large business premises exceeding 1,000 square metres or 100 employees as of the close of the fiscal year of the taxpayer. The rate is JPY600 per square metres or 0.25% of the total salary payments to the employees, as the case may be.

2.9 Incorporated Businesses and Notable Taxes

Transactional taxes may apply depending upon the type and nature of the transactions, regardless of the form (ie, individual or corporate) of the taxpayer. Major transactional taxes include:

- stamp duty;
- real property acquisition tax;
- registration and licence tax;
- fixed property and city planning taxes; and
- motor vehicles tax, motor vehicles acquisition tax and motor vehicles weight tax.

In addition, customs duty and import consumption taxes apply when dutiable or taxable goods are imported into Japan, which are payable by the importer of record. The rate of the customs duty differs depending upon the articles to be imported. The import consumption taxes apply at 8% or 10% as explained above.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in a corporate form, in most cases either as a KK (with a simplified governance structure) or as a GK. The next most popular form would be a sole proprietorship, ie, an individual just doing the business. A J-LLP as explained in **1.2 Transparent Entities** is also used.

3.2 Individual Rates and Corporate Rates

As a matter of marginal tax rate, corporate rates are lower than individual rates. However, as a threshold matter, even if individual professionals earn income in a corporate form, at the stage when they eventually receive dividends or profit distributions or remunerations from the corporation, they will be taxed at the individual rates. As such, whether or not there will be significant tax savings seems to depend upon the income bracket applicable to a particular individual professional.

3.3 Accumulating Earnings for Investment Purposes

Japanese corporation tax law imposes surtax at progressive rates (10%, 15% and 20%) upon accumulated earnings of certain closely held corporations, in addition to the regular corporate tax. However, this does not apply to small closely held corporations having a stated capital of JPY100 million or less, unless wholly owned by certain large corporations. As such, for most closely held corporations owned by family members, there virtually is no rule preventing them from accumulating earnings.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Japanese resident individuals are taxed on dividends received from closely-held corporations at the regular progressive rates. The marginal tax rate of individual income taxation is 55.945% (comprised of 45% national individual income tax, 0.945% special reconstruction income surtax and 10% local inhabitants tax) for calendar years from 2015 through 2037. The dividends are subject to 20.42% withholding tax (20% national tax and 0.42% special reconstruction income surtax) to be withheld by the paying corporation; however, such withholding tax can be credited against the individual income tax mentioned above by filing tax returns.

If an individual is a non-resident of Japan having no permanent establishment in Japan, the Japanese taxation upon dividends is finalised only by the 20.42% withholding tax (subject to reduction under an applicable tax treaty).

Capital gains arising from the sale of shares of a closely held corporation by Japanese resident individuals will be subject to taxation at the rate of 20.315% (15% national income tax, 0.315% special reconstruction income surtax and 5% local tax), separately from all other income. As such, in practice, it is a major planning initiative for Japanese resident individual shareholders to monetise their investment in the form of a sale, rather than as dividend distributions, in order to enjoy the lower capital gains rate.

If an individual is a non-resident of Japan having no permanent establishment in Japan, capital gains are in principle not subject to Japanese taxation, except where the "25/5 rule" mentioned in **2.7 Capital Gains Taxation** applies. If that exception applies, the capital gains are subject to separate taxation at the rate of 15.315% (15% national income tax and 0.315% special reconstruction income surtax) reportable by filing a tax return.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends and capital gains derived by Japanese resident individuals from publicly traded shares of Japanese corporations are subject to individual income taxation at the rate of 20.315% (15% national income tax, 0.315% special reconstruction income surtax and 5% local tax) through December 31, 2037. Note, however, that a Japanese resident individual shareholder who holds 3% or more of the total issued shares (ie, a substantial individual shareholder of publicly traded corporations) cannot enjoy the 20.315% rate as to dividends, but will be subject to regular progressive individual income taxation mentioned in **3.4 Sales of Shares in Closely-Held Corporations**, together with the 20.42% withholding tax.

Japan started the Japanese version of the UK's individual savings account (or NISA), where dividends and capital gains derived by Japanese resident individuals are exempt from taxation to a certain extent. To enjoy the exemption, Japanese resident individuals can purchase publicly traded securities up to JPY1.2 million in a calendar year from 2016 (ie, the principal is limited to JPY1.2 million per year from 2016) in their NISA accounts, and the dividends and capital gains arising from such securities are exempt from taxation for the period of five years. The purchase of publicly traded securities in the NISA accounts are possible for each year during the period of five years, which means that there will be a total limit of JPY6 million as to the principal that can be purchased in the NISA accounts (ie, JPY1.2 million per year for five years).

If an individual is a non-resident of Japan having no permanent establishment in Japan, Japanese taxation upon dividends on publicly traded shares of Japanese corporations is finalised only by the withholding tax of 15.315% (15% national income tax and 0.315% special reconstruction income surtax) through December 31, 2037; provided that 20.42% withholding tax (20% national tax and 0.42% special reconstruction income surtax) applies to an individual shareholder who holds 3% or more of the total issued shares. The tax rate on capital gains are the same as non-publicly listed shares explained in **3.4 Sales of Shares in Closely Held Corporations**. Each is subject to exemption or reduction under an applicable tax treaty.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest on loans (where the loan proceeds are used in Japan), dividends on shares of a Japanese corporation (which are not publicly traded), and royalties for use in Japan of intellectual property are subject to withholding tax at the rate of 20.42% (20% national tax and 0.42% special reconstruction income surtax) when paid to non-resident individuals and foreign corporations.

Interest on debt securities issued by a Japanese corporation is subject to withholding tax at the rate of 15.315% (15% national income tax and 0.315% special reconstruction income surtax) when paid to non-resident individuals and foreign corporations. However, there are special taxation measures whereby interest on (a) Japanese government bonds, Japanese municipal bonds and Japanese corporate bonds each issued in Japan and traded and owned through the Japanese book-entry system and (b) Japanese "eurobonds" (meaning bonds issued by Japanese corporations outside Japan and interest is paid outside Japan), which is paid to non-resident individuals and foreign corporations, is in principle exempt from Japanese withholding tax, subject to certain documentation and identification requirements being met.

As explained in **3.5 Sales of Shares in Publicly Traded Corporations**, dividends paid on publicly traded shares of a Japanese corporation are subject to withholding tax at the rate of 15.315% through December 31, 2037 when paid to non-resident individuals and foreign corporations; provided that 20.42% withholding tax applies to an individual shareholder who holds 3% or more of the total issued shares. No exemption or reduction will apply under Japanese domestic tax law to withholding tax on dividends.

If the non-resident individuals and foreign corporations have no permanent establishment in Japan, the Japanese taxation is finalised only by the withholding tax. The domestic tax law withholding tax rates as well as the source rules of income mentioned above may be modified by an applicable tax treaty. In particular, some tax treaties, eg, that with the US, totally exempt Japanese withholding tax on certain intercompany dividends and royalties paid to certain US-qualified residents, subject to limitation on benefits and other conditions being met. A protocol amending the tax treaty with the US signed in 2013 provides for total exemption from Japanese withholding tax on interest as well; however, this has not yet entered into force as the protocol is not yet ratified by the US as of the date of this article. The tax treaty with the UK totally exempts Japanese withholding tax on interest, certain intercompany dividends and royalties paid to certain UK qualified residents, subject to limitation on benefits and other conditions being met.

4.2 Primary Tax Treaty Countries

Setting aside non-treaty countries or regions such as the Cayman Islands and Bermuda, popular treaty jurisdictions seem to include Ireland, Belgium, Singapore and Hong Kong. None of these contains detailed limitation on benefits (LOB) provisions, which will be an obstacle when a third-country resident investor wishes to establish an investment vehicle in that treaty country. For this reason, countries such as the US and the Netherlands are in general no longer suitable as jurisdictions for establishing a special-purpose vehicle for inbound investment into Japan because of the LOB provisions, unless the third-country resident has some connections with the US or the Netherlands (eg, having operating subsidiaries there) and is able to satisfy the LOB provisions.

Ireland offers the advantage of totally exempting Japanese source taxation on: (a) capital gains arising from sale of shares of Japanese corporations (ie, effectively overriding the "25/5 rule" mentioned in **2.7 Capital Gains Taxation**); and (ii) so-called "other income", or Japanese-source income not specifically provided in the treaty (eg, donation gain arising from Japanese assets). As such, Ireland is often used as a vehicle for private equity investment into Japan, where the shareholding percentage of the target company tends to be substantial. Ireland is also good in terms of the withholding tax rate in interest (10%), dividends (15%; 10% intercompany) and royalties (10%) and the definition of the permanent establishment (which is OECD standard). Furthermore, Irish local tax regimes are said to be preferable for overseas investment. The same consideration substantially applies to Belgium. However, it should be noted that, once the so-called MLI (the Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting) enters into force to overwrite the treaty with Ireland, the principal purpose test (PPT) would come into play to deny the treaty benefits if one of the principal purposes of an arrangement or a transaction using an Irish vehicle is determined to take advantage of the treaty.

Singapore is not as beneficial as Ireland, as Singapore does not exempt capital gains arising from sale of shares of Japa-

nese corporations (ie, the "25/5 rule" mentioned above still holds) or so-called "other income" sourced in Japan. However, due to the preferable local tax regimes and the geographical proximity to Japan, Singapore appears to be one of the popular jurisdictions, especially for hedge funds investing into Japan (as most of the investments are in publicly traded shares, the shareholding will not be substantial and the "25/5 rule" is not very relevant). The same appears to apply to Hong Kong, with which Japan entered into a tax convention in 2011. In the case of Hong Kong, it is important to note that there is a very general anti-avoidance provision to the effect that certain major treaty benefits (eg, reduction of withholding taxes) will not be granted where the "main purpose" of choosing Hong Kong is to take advantage of such treaty benefits (ie, substantially the same as the PPT).

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The Japanese tax authority vigorously challenges use of a tax treaty by a non-treaty country or a third-country resident, if the Japanese tax authority considers the use abuse for avoiding Japanese-source taxation.

The challenge is made twofold:

One is as a matter of legislative or tax policy; that is, the Japanese government has pursued a policy to incorporate anti-avoidance provisions such as LOB provisions especially in the recent revisions to the tax treaties with advanced or OECD member countries. If these legislative measures are there, it is clear that non-treaty or third-country residents cannot use the treaty unless the relevant LOB and other conditions are satisfied. A good example is the treaty with the Netherlands. Before the revision in 2011, a Dutch BV was very popular as a vehicle to make inbound investments into Japan; however, after the revision where anti-avoidance provisions such as LOB provisions were incorporated, a BV was not as frequently used for the same purpose as before. In addition, Japan has signed the so-called MLI in response to the BEPS Action Plan 16, and has recently completed the ratification procedures. As a result, the MLI will take effect on January 1, 2019, first with respect to the existing tax treaties with Israel, the UK, Australia, Sweden, Slovakia, New Zealand, France and Poland.

The other is as a matter of enforcement; that is, even if no anti-avoidance provisions are provided in the relevant treaty (particularly if the treaty is old – Ireland for example), the Japanese tax authority has been very vigorous in making deficiency assessments through disallowing the benefits of the treaty by invoking various domestic tax law principles. These domestic tax law principles include the rule of attribution of income to a "substantial income earner" rather than to a nominee or shell company. By invoking that principle, the Japanese tax authority has denied the nominal or formal earner of income (who is a resident of the relevant treaty, eg, Ireland) the purported treaty benefits under the treaty, and imposed tax on the basis that the non-treaty country or third-country resident (eg, Cayman Islands company) who is behind that nominal or formal earner of income is indeed the "substantial income earner" to whom the relevant income shall be attributed.

4.4 Transfer Pricing Issues

If the Japanese corporation operates a non-financial substantive business, the biggest issue would be allocation of income relating to intangibles. It is common that the subject-controlled transactions such as sale of inventory, provision of services and grant of licence to use intangibles will be deemed to constitute one single integrated transaction for Japanese transfer pricing purposes (in the same manner as the OECD Guidelines). Therefore, it is generally very difficult to find a comparable transaction to test such integrated transaction by transaction-based transfer pricing methodologies such as comparable uncontrolled price method, resale price method and cost-plus method. Accordingly, such transactions tend in most cases to be tested by profit-based transfer pricing methodologies such as the transactional net margin method and the profit split method.

There, typical allegations that are made by the Japanese tax authority are that the local Japanese corporation not only receives a licence of intangibles from its foreign parent but also makes its own unique contributions to the combined profits, or has self-created significant intangibles through accumulating the local business experience for decades; as such, some significant portion of the combined profits should be allocated to Japan. It is common that tough debates will be had during the transfer pricing audit with respect to the functions and risks of the Japanese corporation and how significant they are for Japanese transfer pricing purposes. The Japanese tax authority concurrently tends to select comparable companies which have some significant intangibles and relatively high profit level.

As this is essentially an economic, rather than legal, discussion, it frequently happens that a difference of views between the Japanese tax authority and the taxpayer is not resolved and the Japanese tax authority proceeds with transfer pricing assessment, followed by the filing of an objection by the frustrated taxpayer.

4.5 Related Party Limited Risks Distribution Arrangements

The Japanese tax authority will scrutinise whether the attribution of functions and risks as agreed in the relevant distributorship agreement reflects the actual practice; in other words, whether in fact the risk of the distributor is limited. If the purported limited risk distributor in Japan is doing substantially more than as agreed in the distributorship agreement like a full-fledged distributor, the Japanese tax authority would try to reassess the functions and risks on the basis

of such actual practice, and accordingly to attribute more profits than originally purported. In practice, it appears that the Japanese tax authority puts more emphasis on the functions actually performed by the distributor, rather than the risks allocated by the distributorship agreement, presumably based on the belief that the former more correctly reflects the substance.

Japanese law has another arrangement similar to a limited risk distributor, referred to as a "commissionaire", which enters into contracts in Japan in its own name but economically on behalf of a foreign principal. In this instance, only the economic effects of the contracts are attributed to the foreign principal, so the commissionaire receives certain commissions from the foreign principal in consideration of acting on its behalf economically (but not legally). The Japanese tax authority approaches the problematic reduction of Japanese profits by converting the local operation from a full-fledged distributor to a commissionaire (as discussed in the recent addition to the OECD Guidelines relating to business restructuring). Under the commissionaire arrangement, only commissions received by the commissionaire will be taxable in Japan, while the resale margin would be fully taxable in Japan in the case of a full-fledged distributor. It is generally discussed among practitioners that such a commissionaire arrangement could be scrutinised on the basis of transfer pricing, or of finding the commissionaire to be an agent permanent establishment of the foreign principal.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Japanese government takes the position that Japanese transfer pricing rules and the enforcement of them should closely follow the OECD standards. For example, Japanese transfer pricing rules repealed the priority given to the three basic methods (CUP, RP and CP) over other methods (PS and TNMM), and adopted the "best method" rule. In addition, it has been made clear that the concept of a "range" of arm's-length profit level can be used for Japanese transfer pricing purposes (provided that it means a "full range" predicated upon full comparability, rather than the statistical approach of interquartile range) for the purpose of issuing a transfer pricing assessment. In addition, as a matter of enforcement or transfer pricing audit, it is very common that taxpayers make defensive arguments by referring to the OECD Guidelines along with Japanese local laws and regulations, and the Japanese tax authority generally accepts such arguments as legitimate. Indeed, some tax treaties, eg, that with the US, expressly provide that transfer pricing enforcement shall be made in accordance with the OECD Guidelines.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims are Settled

If a mutual agreement is reached with the counterparty country following an application for a mutual agreement procedure to dispute a transfer pricing assessment in Japan, it is general practice that a compensating adjustment will be made to eliminate double taxation.

5.2 Taxing Differences

Foreign corporations with a permanent establishment in Japan (eg, a branch office) are taxed by and large in the same manner as Japanese corporations. See **1.4 Tax Rates**. Particularly, Japan has made clear, by the 2014 tax reform of its domestic tax law, that taxable income of a branch or other permanent establishment of a foreign corporation shall be business profits attributable to that permanent establishment (eg, like most of the tax treaties), and calculation of the taxable income shall be made pursuant to the transfer pricing rules assuming such permanent establishment to be a standalone corporation, looking to the functions performed and risks assumed by the permanent establishment.

5.3 Capital Gains of Non-Residents

As discussed in **2.7 Capital Gains Taxation**, capital gains of non-residents on the sale of stock in Japanese corporations are taxed in Japan, only if the "25/5 rule" or the rule relating to a real estate holding company applies. However, as a general matter, the "25/5 rule" does not apply where the gain is on the shares of a foreign corporation that owns the stock of a Japanese corporation, ie, where an indirect transfer of shares of a Japanese corporation takes place. There simply is no rule providing that effect, and it would be very difficult to read the relevant regulations that way (unlike the Indian Vodafone case). On the other hand, in the case of the rule relating to a real estate holding company, an indirect transfer using shares of a foreign corporation would also trigger Japanese capital gains taxation, as stipulated the express text of the regulations. Some tax treaties totally eliminate Japanese-source taxation on capital gains (eg, Ireland, Belgium and the Netherlands, but subject to a possible amendment by the MLI), but some do not (eg, Singapore). The exemption depends on the specific capital gains provision in the relevant tax treaty (as amended by the MLI, if applicable). Note that Japan has adopted the rule concerning real estate holding companies under Article 9(4) of the MLI.

5.4 Change of Control Provisions

An indirect transfer of shares of Japanese corporations is not subject to capital gains taxation in Japan, as discussed in **5.3 Capital Gains of Non-Residents**. If, however, a Japanese corporation that is indirectly owned by a foreign corporation in multi-tier corporate structures has net operating loss carry-forwards (see **2.4 Basic Rules on Loss Relief**) and if

a change of control, even indirect, takes place at the level of that foreign holding corporation, that change of control may forfeit the net operating loss carry-forwards of that Japanese corporation, if certain additional triggering events take place (eg, where the Japanese corporation was a dormant company only holding the net operating loss carry-forwards but starts a new business after the change of control).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulae are not used to determine the income of foreign-owned Japanese affiliates selling goods or providing services. The most popular method is to apply the profit-based transfer pricing methodologies such as TNMM to the Japanese subsidiary as taxpayer/tested party, and to identify comparable companies to the Japanese subsidiary in terms of functions and risks through the search of commercial databases such as Orbis of Bureau van Dijk.

5.6 Deductions for Payments by Local Affiliates

Two standards are applied in allowing a deduction for payments by local Japanese affiliates for management and administrative expenses incurred by a non-local affiliate. The first standard is whether the purported management and administrative services are actually provided to the Japanese subsidiary as a matter of fact. If the Japanese tax authority finds that no such services are actually performed as a result of the audit, it will determine that the payments of service fees by the Japanese subsidiary are indeed a donation (or mere giving of money for nothing) to the foreign parent company, and thus are not deductible for Japanese corporate tax purposes. Accordingly, for this type of payment, it is very important not only to prepare the service agreement in good order, but also to make records of provision of the agreed services in detail. Also note that such services may not be those commonly referred to as stewardship or shareholder services.

The second standard is, even if the purported services are actually provided, whether the amount of the service fee payments is appropriate in terms of the substance of the services provided. This review includes whether the amount borne by the Japanese subsidiary is determined by reference to some good index indicating the relative significance of the Japanese operation (sales, number of employees, etc) among all other subsidiaries worldwide. A transfer pricing review can of course be made as a services transaction.

5.7 Constraints on Related Party Borrowing

As discussed in **2.5 Imposed Limits on Deduction of Interest**, thin-capitalisation rules, earnings stripping rules and transfer pricing rules are important as potential constraints upon the interest paid on the borrowing by the Japanese corporation from its foreign affiliate. Also, we have one recent precedent where interest deduction by the Japanese corporation was denied by invoking the anti-avoidance statute, where the Japanese tax authority considered the borrowing as avoiding tax without good non-tax economic and business reasons.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

A Japanese corporation is taxed on the worldwide income it earns by itself (eg, through foreign branch offices), provided foreign tax credit is available. The applicable tax rate is the same for all other income, as discussed in **1.4 Tax Rates**.

However, if a Japanese corporation earns foreign income through its foreign subsidiary, dividends to be received from the foreign subsidiary will be exempt from Japanese corporate taxation with respect to 95% of the amount of such dividends. A qualifying foreign subsidiary is defined in general as a foreign corporation 25% or more of whose total issued shares or voting rights are owned by the Japanese corporation for the period of at least six months up to when the dividends become payable. The shareholding percentage can be modified (in most cases reduced, for example, to 10%) by the indirect foreign tax credit provision of the applicable tax treaty. This means that Japan has effectively adopted a territorial-based taxation regime as long as foreign income is derived in the form of dividends from foreign subsidiaries.

6.2 Non-Deductible Local Expenses

In order to be exempt from Japanese corporate taxation on dividends received from foreign subsidiaries (discussed in **6.1 Foreign Income of Local Corporations**), 5% of the dividends are deemed to be such non-deductible (or taxable) expenses. The 5% is a predetermined and fixed amount, and the actual amount of local expenses does not affect it. In addition, withholding tax imposed by the foreign country upon the tax-exempt dividends is neither creditable against corporate tax payable (or no foreign tax credit), nor deductible from the taxable income, of the Japanese corporation.

6.3 Taxation on Dividends from Foreign Subsidiaries

See **6.1 Foreign Income of Local Corporations**.

6.4 Use of Intangibles

Intangibles developed by local Japanese corporations cannot be used by non-local subsidiaries without incurring Japanese corporate tax. Due to the Japanese transfer pricing rules, the Japanese corporation will be taxed as if it has received an arm's-length rate of royalties from the foreign subsidiary that is using the intangibles. Or, if the use is not by a de facto licence but all the title to and ownership of such intangibles were transferred to the foreign subsidiary, then the Japanese corporation would be taxed as if it sold the intangibles at the fair market value.

6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-type Rules

Japanese tax law has "anti-tax haven" rules, or a Japanese version of the CFC rules. These rules have been overhauled by the 2017 annual tax reform in response to the BEPS Action Plan 3, and apply to Japanese shareholders from the fiscal years of the CFC beginning on or after April 1, 2018.

If the Japanese CFC rules apply, the Japanese corporation that is a shareholder of the CFC will be taxed upon its pro rata share of certain adjusted income of the CFC (to be calculated based on the CFC's total income and gains). In general, Japanese CFC rules apply if (i) Japanese resident individuals and Japanese corporations collectively own directly or indirectly more than 50% of the total issued shares, voting rights or rights to receive dividends of a foreign corporation; (ii) a particular Japanese resident individual or a Japanese corporation (which is the subject taxpayer) owns directly or indirectly 10% or more of the total issued shares, voting rights or rights to receive dividends of that foreign corporation; and (iii) the effective income tax burden (rather than the face or nominal tax rate) of that foreign corporation in a given fiscal year is less than (a) 30% for certain shell-company CFCs and cash-box-company CFCs or (b) 20% for all other CFCs. Typical examples include Cayman Islands, Hong Kong and Singapore subsidiaries of a Japanese corporation. It should be noted that tax-exempt income and gains in the foreign jurisdiction will lower the effective income tax burden; for example, if a Dutch subsidiary of a Japanese corporation is exempt from a substantial amount of capital gains by the Dutch participation exemption, the effective income tax burden in that fiscal year could be less than 20%, despite the Dutch statutory corporate tax rate of 25%. That will make the Dutch subsidiary a CFC for that fiscal year. However, exemption of dividends received by the Dutch subsidiary from foreign companies by the participation exemption will not lower the effective income tax burden (this treatment is only limited to dividends).

Certain shell-company CFCs are subject to the Japanese CFC rule even if their effective tax burden is 20% or more, so long as it is less than 30%. A shell-company CFC means a CFC that neither (x) is managed and administered on its own within the jurisdiction of its incorporation, rather than from Japan, nor (y) maintains physical fixed premises (such as offices and factories) within the jurisdiction of its incorporation that are necessary to do its principal business. Accordingly, shell-company CFCs would include shell holding companies incorporated in, for example, the US and the Netherlands. Given that use of such shell holding companies in the US and the Netherlands is very active, Japanese corporations now have a significant concern over potential application of the CFC rule with respect to such shell holding companies.

Even if the Japanese CFC rules apply because all the conditions explained above are met, there is an active business income exemption. That is, if the CFC meets all of the following criteria, the Japanese CFC rules apply only to the extent of the CFC's certain enumerated passive income (rather than the CFC's total income including active income): (i) the principal business of the CFC is other than financial investments in shares, bonds or IPs or leasing of vessels, (ii) the CFC is managed and administered on its own within the jurisdiction of its incorporation, rather than from Japan, (iii) the CFC maintains physical fixed premises such as offices and factories within the jurisdiction of its incorporation that is necessary to do its principal business, and (iv) depending on the type of business, the CFC does business principally within the jurisdiction of its incorporation (eg, manufacturing) or deals with unrelated third parties to account for 50% or more of the total business transactions (eg, distribution, transportation). If all these elements are met, the CFC's income to be aggregated with the Japanese shareholder's income will be limited to passive income, such as (a) dividends and capital gains from shares, but excluding those where the shareholding ratio is 25% or more (for at least six months as to dividends), (b) interest on deposits, bonds and loans (excluding interest from certain qualifying group-financing), (c) income from derivatives (excluding certain qualifying hedges), (d) foreign exchange gains (excluding those arising in the ordinary course of business), (e) royalties and disposition gains from IPs (excluding those where the IP is developed on its own) and (f) leasing income from real properties and fixed properties (excluding real properties located and fixed properties used in the jurisdiction of incorporation of the CFC).

The active business income exemption has been expanded to a certain qualifying regional headquarters or intermediate holding company; that is, if a foreign subsidiary incorporated in the Asian-hub low-tax countries such as Singapore and Hong Kong operates as an Asian regional headquarters or as an intermediate holding company for the Japanese parent corporation, subject to certain requirements being met, the CFC will not be disqualified from meeting the condition (i) above (ie, the principal business of the CFC is other than financial investments in shares), merely because it is a holding company.

6.6 Rules Related to the Substance of Non-Local Affiliates

As discussed in **6.5 Taxation of Income of Non-Local Subsidiaries**, the active business exception to the Japanese anti-tax haven or CFC rules looks to the substance of the relevant foreign subsidiary.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

As discussed in **2.7 Capital Gains Taxation**, Japanese corporations are taxed on capital gains arising from sale of shares

of foreign corporations, in the same manner as sale of shares of Japanese corporations, or as ordinary business income, ie, at the effective marginal corporate tax rate (national and local) explained in **1.4 Tax Rates**. There is no exemption or relief from this capital gains taxation such as participation exemption, as opposed to dividends as discussed in **6.1 Foreign Income of Local Corporations**.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Japan does not have general anti-avoidance rules or GARR in a literal sense (eg, rules which could apply to all or whatever circumstances or transactions), but does have anti-avoidance provisions applicable to some specific situations.

One is an anti-avoidance provision applicable to certain closely held corporations (corporations controlled more than 50% by three or fewer shareholders); there, if an act or accounting of the subject taxpayer which is a closely held corporation unjustifiably reduces the corporation tax burden of that taxpayer, then the Japanese tax authority is entitled to disregard the legal form of the transaction adopted by the taxpayer and to impose corporation tax based upon another legal form that the Japanese tax authority finds to be more natural and reasonable. For the purpose of this rule, the term "unjustifiably reduces" is generally interpreted, by a recent landmark High Court decision, to mean that the act or accounting of the subject taxpayer is so unnatural or unreasonable as an act or accounting of a genuinely economically reasonable person from an economic and substantive viewpoint. A leading tax law scholar amplifies the foregoing requirement as meaning that the act or accounting of the subject taxpayer is so extraordinary or strange that there is no reasonable business or financial reason to do such an act or accounting other than tax avoidance.

Another one is an anti-avoidance provision applicable to corporate reorganisation transactions (eg, mergers, divestures, share exchanges, etc); there, if an act or accounting of the subject taxpayer which is a party to a corporate reorganisation transaction unjustifiably reduces the corporation tax burden of that taxpayer, the other parties to that transaction or their respective shareholders, then the Japanese tax authority is entitled to disregard the legal form of the transaction adopted by the taxpayer and to impose corporation tax based upon another legal form that the Japanese tax authority finds to be more natural and reasonable. For the purpose of this rule, the term "unjustifiably reduces", as interpreted by a recent landmark Supreme Court decision, means a situation where the taxpayer has abused the relevant tax provision regarding the corporate reorganisation rules.

Yet another one is an anti-avoidance provision applicable to the Japanese consolidated taxation regime; there, if an act or accounting of the subject taxpayer which is a member of the Japanese consolidated group unjustifiably reduces the corporation tax burden of that taxpayer, then the Japanese tax authority is entitled to disregard the legal form of the transaction adopted by the taxpayer and to impose corporation tax based upon another legal form that the Japanese tax authority finds to be more natural and reasonable. To this author's knowledge, there has been no published precedent on the interpretation of the term "unjustifiably reduces" and it remains unclear how that term will be interpreted by courts.

Recently, the first two anti-abuse provisions have been very actively invoked by the tax authority in issuing assessments, claiming a need to secure an appropriate taxation by disregarding the legal form of the transaction adopted by the taxpayer. Practitioners are generally concerned about such tendency, because these anti-abuse provisions will often result in taxation that cannot be foreseen from the text of the tax statute.

8. Other

8.1 Regular Routine Audit Cycle

There is no law, regulation or administrative circular expressly providing for a regular routine audit cycle. Whether or not to audit a particular corporate taxpayer and at what intervals are determined at the sole discretion of the office of the Japanese tax authority with audit jurisdiction upon that taxpayer. However, solely as a matter of practice, certain very large Japanese corporate taxpayers (most of them are well-known globally) seem to be audited regarding corporate tax every one or two years (except transfer pricing). For other taxpayers, it is said that an audit is likely to take place if there were some irregularities or special circumstances with recent tax returns. The Japanese tax authority has recently launched an initiative for certain large taxpayers where, if such taxpayers demonstrate that they have established a good corporate governance structure to ensure tax compliance and have agreed to disclose voluntarily their significant tax issues, the audit cycle for such taxpayer can be prolonged for additional one year as a sort of preferential treatment for good taxpayers.

Transfer pricing audits are generally triggered if the competent tax office finds some potential distortion of allocation of income (in a manner unfavourable to Japan) between the Japanese corporation and its foreign subsidiaries, based upon its review of public materials such as securities disclosure reports.

9. BEPS

9.1 Recommended Changes
To date, Japan has implemented the following BEPS Actions by amending its domestic tax law or tax treaties:

(i) Action 1: Japan has amended the consumption tax law to impose tax upon digital or electronic services transactions conducted by foreign enterprises having no base in Japan.

(ii) Action 2: Japan has amended the corporation tax law so that Japan's foreign dividend exemption system does not apply to dividends that are deductible under the local tax law of the jurisdiction of the foreign subsidiary (eg, Brazil), in order to prevent double exemption.

(iii) Action 3: Japan has overhauled its current CFC regime by amending the income tax law and the corporation tax law by the 2017 annual tax reform, in line with BEPS Action 3, to give more focus upon the substance of the business conducted by the CFC, as explained in **6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules**.

(iv) Action 6: Japan has incorporated in its tax treaties particularly with advanced countries (such as the US, the UK, the Netherlands, Switzerland and Germany) various anti-abuse measures suggested by BEPS Action 6, such as the limitation on benefits (LOB), the principal purpose test (PPT) and the beneficial-owner concept.

(v) Action 7: Japan has amended the definition of a permanent establishment in the income tax law and the corporation tax law by the 2018 annual tax reform, in response to BEPS Action 7, so as to define more properly an agent permanent establishment in order to prevent avoidance of an agent permanent establishment through artificial measures.

(vi) Action 13: Japan has amended its transfer pricing documentation rules to introduce the master file, the country-by-country reporting and the local file, in line with BEPS Action 13.

(vii) Action 16: Japan has signed the MLI (the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) and has recently completed the ratification procedures. As a result, the MLI will take effect on January 1, 2019, first with respect to the existing tax treaties with Israel, the UK, Australia, Sweden, Slovakia, New Zealand, France and Poland.

In addition, Japan expects to implement the following BEPS Actions in the near future:

(viii) Action 4: Japan is now reviewing whether the earnings-stripping rules should be tightened, in response to BEPS Action 4, by lowering the threshold percentage rate from 50% to some 10-30%.

(ix) Actions 8-10: Japan is reviewing whether it should incorporate the so-called "commensurate with income" standard as to certain hard-to-value intangibles, by amending its transfer pricing regulations, in line with BEPS Actions 8-10.

(x) Action 12: Japan is reviewing whether or not to introduce mandatory disclosure rules regarding tax planning.

9.2 Government Attitudes
In general, Japan is generally very positive towards the BEPS initiative, as the country that chaired the OECD Committee on Fiscal Affairs. Japan seeks to achieve the general principles as agreed in the form of the final reports.

9.3 Profile of International Tax
The international tax regime has a high profile in Japan, in both inbound and outbound investments. Particularly in the context of outbound investment by Japanese corporations, strengthening of the CFC rules (Action 3) and the country-by-country reporting for transfer pricing (Action 13) attract attention of particularly the private sector; Japanese corporations were generally against implementing these Actions under Japanese domestic tax law as they are expected to impose a further onerous administrative and compliance burden on Japanese corporations. While the Japanese government is generally very positive towards the BEPS initiative, from now on, Japan would need to listen carefully to the voices of the private sector and then determine whether it will implement these initiatives under Japanese domestic tax law.

9.4 Competitive Tax Policy Objective
Japan does not appear to maintain an overly 'competitive' tax regime to attract foreign investments, in a manner so-called harmful tax competition. While it is true that Japan seeks to design its corporate tax regime as competitive on a global basis (eg, further reducing the effective corporate tax rate from 2016 and after), this is mainly intended to enhance the competitiveness on a global basis of Japanese corporations doing business worldwide. As such, it would be unlikely that such a policy would be adversely affected by the BEPS initiative. Rather, the Japanese government seems to be of the view that, given the long-standing tradition and culture that Japanese corporations are not as active or aggressive in international tax planning as US and other multinational companies, the BEPS initiative is a good chance to enhance the competitiveness on a global basis of Japanese corporations, because aggressive tax planning by their foreign competitors is discouraged by the BEPS initiative.

9.5 Features of the Competitive Tax System
This author is not aware of any features of the competitive tax system that might be more vulnerable than other areas

of the tax regime. Even before the BEPS initiative was being actively discussed, Japan has endeavoured to cope with international tax avoidance by treaty abuses, by introducing various anti-avoidance concepts such as the limitation on benefits (LOB) provisions and the "beneficial owner" concepts (see **4.3 Use of Treaty Country Entities by Non-Treaty Country Residents**).

9.6 Proposals for Dealing with Hybrid Instruments

Japan has already taken measures to amend its domestic tax law such that Japan's foreign dividend exemption system (see **6.1 Foreign Income of Local Corporations**) does not apply to dividends that are deductible under the local tax law of the jurisdiction of the foreign subsidiary, in order to prevent double exemption. In addition, in many tax treaties with developed countries (eg, the US, the UK, the Netherlands), Japan already has introduced specific provisions to cope with hybrid entities, setting forth the rules to attribute income earned through a hybrid entity to the entity itself or to its members. In addition, Japan has adopted the rule concerning tax-transparent entities under article 3(1) of the MLI.

9.7 Territorial Tax Regime

Japan has a territorial tax regime only to the extent of the foreign dividend exemption system mentioned above (see **6.1 Foreign Income of Local Corporations**), and otherwise worldwide income taxation will apply. In any event, while Japan already has earnings-stripping rules to disallow interest deduction that is excessive as compared to the taxable income (see **2.5 Imposed Limits on Deduction of Interest**), in response to the BEPS initiative (Action 4), Japan is further reviewing whether it should tighten the earnings-stripping rules.

9.8 CFC Proposals

Japanese corporations were generally against the strengthening of the CFC rules (Action 3) as it was expected to impose further onerous administrative and compliance burdens on Japanese corporations. The proposal to focus upon the nature of the individual types of income earned by the foreign subsidiary to determine whether the income is subject to the CFC rules is viewed as particularly problematic, because it imposes on Japanese taxpayers the burden of telling whether the income is subject to the CFC rule on an individual basis. Principally for this reason, the amended CFC rule maintains a regime where application of the CFC rule is exempted as long as the effective tax burden of the CFC is 30% or more (in the case of certain shell-company CFCs and cash-box CFCs) or 20% or more (for all other CFCs), in order to reduce the administrative and compliance burden of Japanese taxpayers (see **6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules**).

As for the sweeper CFC rule, note that Japan already has the CFC regime where certain "portfolio income" (ie, income and gains derived from certain passive investments) derived by a foreign subsidiary will be subject to the aggregate taxation under the CFC regime, even if that subsidiary has substance and enjoys an active business exception from the CFC rule.

9.9 Anti-Avoidance Rules

The proposed DTC limitation of benefit or anti-avoidance rules are not likely to have a substantial impact. This is because, even prior to the BEPS initiative being actively discussed, Japan has endeavoured to cope with international tax avoidance by treaty abuses, by introducing various anti-avoidance concepts such as the limitation on benefits (LOB) provisions and the "beneficial owner" concepts (see **4.3 Use of Treaty Country Entities by Non-Treaty Country Residents**). The BEPS initiative just confirms this approach, and we expect no substantial impact. Having said that, the adoption of the PPT by the MLI is expected to have significant practical impact particularly with respect to "old" tax treaties (eg, the one with Ireland).

9.10 Transfer Pricing Changes

The changes to the transfer pricing regime that took place as a result of the BEPS initiative are the documentation requirements mentioned above. This can be described as a radical change in a sense that the regime will impose a further onerous administrative and compliance burden on the subject taxpayers, while it may not be very radical in terms of substance of the enforcement of the transfer pricing rules (eg, selection of transfer pricing methodology).

Taxation of profits from intellectual property is a source of difficulty also in Japan. As noted above, Japan is reviewing whether it should incorporate the so-called "commensurate with income" standard as to certain hard-to-value intangibles. However, at the same time, it is true that there is not so much controversy, particularly relating to tax avoidance, as to intangibles in Japan as compared to the US or Europe.

9.11 Transparency and Country-by-Country Reporting

As mentioned above, Japan has amended its transfer pricing documentation rules to introduce the master file, the country-by-country reporting and the local file, in line with BEPS Action 13. The gist of the new documentation requirements includes:

(i) *Country-by-country reporting:* A Japanese corporation which is the ultimate parent company of a multinational enterprise group shall provide the Japanese tax authority with information, with respect to each of the countries in which the multinational enterprise group does business, on the gross receipts, before-tax profits, tax amounts paid and other necessary information, within one year from the close of the relevant fiscal year of the Japanese corporation. This reporting obligation applies to a multinational enterprise group whose total consolidated turnover in the immediately

preceding consolidated fiscal year is JPY100 billion or more. This new rule applies to the fiscal years of the Japanese corporation beginning on or after 1 April 2016.

(ii) *Master file:* A Japanese corporation which is a constituent member of a multinational enterprise group shall provide the Japanese tax authority with information on the organisational structure, outline of business, financial conditions and other necessary information concerning the multinational enterprise group, within one year from the close of the relevant fiscal year of the ultimate parent company of the multinational enterprise group. This reporting obligation applies to a multinational enterprise group whose total consolidated turnover in the immediately preceding consolidated fiscal year is JPY100 billion or more. This new rule applies to the fiscal years of the ultimate parent company beginning on or after 1 April 2016.

(iii) *Local file:* A Japanese corporation which is subject to Japanese transfer pricing rules shall prepare, by the due date of filing, the tax return for corporation tax for the relevant fiscal year, transfer pricing documentation that will be necessary to compute the arm's-length price of the relevant controlled transaction with its foreign affiliate, if (i) the total transaction volume of that Japanese corporation with that foreign affiliate is JPY5 billion or more in the immediately preceding fiscal year or (ii) the total volume of transactions involving intangibles of that Japanese corporation with that foreign affiliate is JPY300 million or more in the immediately preceding fiscal year. This new rule applies to corporation tax for the fiscal years beginning on or after 1 April 2017. This would effectively mean that the transfer pricing documentation for those significant controlled transactions shall be prepared on a contemporaneous basis (ie, by the due date of filing the tax return - generally within two or three months after the close of a fiscal year), rather than as requested by the tax authority once the taxpayer is audited.

(iv) *Ultimate parent company report:* A Japanese corporation which is a constituent member of a multinational enterprise group shall provide the Japanese tax authority with information on the ultimate parent company of the multinational enterprise group, by the close of the relevant fiscal year of the ultimate parent company of the multinational enterprise group. This reporting obligation applies to a multinational enterprise group whose total consolidated turnover in the immediately preceding consolidated fiscal year is JPY100 billion or more. This new rule applies to the fiscal years of the ultimate parent company beginning on or after 1 April 2016.

This author is of the view that, whether or not he is in favour of the above approach in light of the confidentiality concern or for other reasons, it would be inevitable in the current environment of the international tax regime within the OECD. Particularly the administrative and compliance burden of taxpayers is significant, and some may have a question of whether the regime is worth the burden.

9.12 Taxation of Digital Economy Businesses

As mentioned above, Japan has already amended the consumption tax law to impose tax upon digital or electronic services transactions conducted by foreign enterprises having no base in Japan, in response to BEPS Action 1. It should be noted, however, this measure is limited to consumption tax, and currently this author is aware of no specific plan to amend the concept of a permanent establishment for income tax purposes to cope with the digital economy.

9.13 Other General Comments

This author seconds the voices of the Japanese private sector; ie, while it is important to take a co-operative approach towards the BEPS initiative amid the current international tax environment within the OECD, care should be taken so as not to impose an overly excessive administrative and compliance burden on Japanese taxpayers, who traditionally were not engaged in aggressive tax planning as compared to Western multinationals.

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