International Comparative Legal Guides

Corporate Tax 2021

A practical cross-border insight into corporate tax law

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1 Tax Treaties and Residence

1.1 How many income tax treaties are currently in force in your jurisdiction?

There are 66 income tax treaties (including an agreement between private associations of Japan and Taiwan) applicable to 75 jurisdictions currently in force in Japan as of November 1, 2020. Japan has entered into 11 tax information exchange agreements, and the Convention on Mutual Administrative Assistance in Tax Matters which was executed by 109 countries.

1.2 Do they generally follow the OECD Model Convention or another model?

Yes. Most of the income tax treaties currently in force in Japan generally follow the OECD Model Convention with certain deviations.

1.3 Has your jurisdiction signed the tax treaty MLI and deposited its instrument of ratification with the OECD?

Yes. Japan signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI") on June 7, 2017. Japan ratified the MLI on May 18, 2018, and deposited its instrument of ratification with the OECD on September 26, 2018. Based on such ratification, with respect to certain countries, including the United Kingdom, Australia, France, Israel, Sweden, New Zealand, Poland, and Ireland, the MLI became effective as of January 1, 2020. With the important exception of the US, which has not signed (and currently does not intend to sign), the MLI should cover 39 existing tax treaties that Japan has entered into when all of the counterparty countries enter into and ratify the MLI.

1.4 Do they generally incorporate anti-abuse rules?

No, although the new modernised tax treaty with the United States which entered into force on March 30, 2004 (the "Japan/US Treaty"), and some other recent treaties do incorporate certain limitations on benefits ("LOB") clauses. The Japan/US Treaty is the first income tax treaty executed by Japan in which fairly comprehensive LOB clauses of general application are included, and have been followed, with certain variations, in the most recent modernised tax treaties. As the US has not signed the MLI, the current Japan/US Treaty will remain effective without change.

Other treaties that have similar LOB clauses include those with Australia, France, New Zealand, Sweden, Switzerland and the United Kingdom. The amended Japan/Germany Treaty, signed on December 17, 2015, introduced a principal purpose test ("PPT") in its Article 21, Paragraph 8, for anti-avoidance in line with BEPS Action 6, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances", which entered into force on October 28, 2016. Some treaties or agreements (other than the abovementioned modernised tax treaties) also include a simple anti-treaty shopping clause (examples of which are Article 22, Paragraph 2 of the tax agreement between Japan and Singapore and Article 26 of the tax agreement between Japan and Hong Kong). However, these agreements will be modified by the MLI if a relevant country signs the MLI and the MLI takes effect between Japan and such country.

The BEPS Action 6 Final Report recommended (1) the inclusion of a clear statement in tax treaties that the States that enter into a tax treaty intend to avoid creating opportunities for non-taxation through tax evasion or avoidance, and (2) that countries include in their treaties either (i) the combined approach of an LOB and PPT rule, (ii) the PPT rule alone, or (iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

For the preamble, Japan chose to adopt the language in accordance with Article 6(1) of the MLI, i.e., "Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance".

For anti-tax treaty shopping measures, Japan chose to adopt the PPT clause in accordance with Article 7(1) of the MLI, i.e., "a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude...that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit". Therefore, a significant number of treaties that Japan has entered into will be modified to include the foregoing PPT clauses once the MLI is effective between Japan and a relevant country. For example, the Japan/Singapore tax treaty incorporates the PPT clauses as provided in Article 7(1) of the MLI, which became fully effective as of January 1, 2020.

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

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

1.6 What is the test in domestic law for determining the residence of a company? Has the application of the test been modified in response to COVID-19?

The applicable test is the "location of head or principal office" test. Under Japanese domestic tax law, a corporation is treated as a Japanese corporation (having a corporate residence in Japan) if such corporation has its head office or principal office in Japan, regardless of the place of effective management. No modification has been made to the test for determining the residence of a company in response to COVID-19.

1.7 Is your jurisdiction's tax authority expected to revisit the status of dual resident companies in cases where the MLI changes the treaty "tiebreaker"?

Yes. The Japanese government chose to apply "Dual Resident Entities" clause in Article 4 of the MLI, and the tiebreaker rule included in the existing treaties can be changed depending upon the counterparty countries' choices. For example, under the MLI, the tiebreaker rule of the MLI will replace the existing clause in the treaties with United Kingdom and Australia.

2 Transaction Taxes

2.1 Are there any documentary taxes in your jurisdiction?

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

2.2 Do you have Value Added Tax (VAT), or a similar tax? If so, at what rate or rates? Please note any rate reduction in response to COVID-19.

Yes. Japan has Consumption Tax, which is a Japanese version of Value Added Tax, consisting of a national consumption tax and a local consumption tax. The current aggregate tax rate is 10% (national 7.8% and local 2.2%), which became effective as of October 1, 2019. No rate reduction is implemented, announced or planned so far by the Japanese government in response to COVID-19. In fact, the Minister for Economic Recovery responded in the negative to the request of a rate reduction by the opposition party in August 2020, citing financial needs for social securities.

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

Consumption Tax is generally charged on all transactions, subject to certain exclusions. Specifically, taxable transactions, for the purposes of Consumption Tax, are broadly defined to mean those transactions conducted by a business enterprise (including any resident and non-resident companies and individuals, regardless of whether they have any permanent establishment in Japan) to transfer or lease goods or other assets or to provide services, for consideration, within Japan. However, certain specified categories of transactions, such as, for example, transfers and leases (other than for certain temporary purposes) of land, housing leases (other than for certain temporary purposes), transfers of securities, extension of interest-bearing loans, provision of insurance, deposit-taking and other certain specified categories of financial services, and provision of certain specified medical, social welfare or educational services, are excluded from taxable transactions for the purposes of Consumption Tax. With respect to imported goods, they are, when released from a bonded area, subject to Consumption Tax, except for certain specified categories of imported goods. The tax rate was increased to 10% on October 1, 2019 although an 8% preferential rate applies to food items (excluding alcoholic beverages and dining-out) and certain newspapers.

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

Generally, yes. At present, Consumption Tax charged on taxable purchases and incurred by a business enterprise is generally recoverable in full, by way of a tax credit or refund. By way of exception: (i) if the ratio of a taxpayer's revenue from taxable transactions to the taxpayer's total revenue from transactions within Japan is less than 95%; or (ii) if a taxpayer's revenue from taxable transactions in the relevant fiscal year exceeds 500 million yen, such taxpayer would recover only the Consumption Tax incurred from the taxable purchases that correspond to its taxable sales.

For recovery of the Consumption Tax incurred from taxable purchases, taxpayers are obliged to keep books and records, but not invoices, of purchased goods and services as the Japanese Consumption Tax has yet to adopt an invoice system, though it will be introduced on October 1, 2023.

2.5 Does your jurisdiction permit VAT grouping and, if so, is it "establishment only" VAT grouping, such as that applied by Sweden in the *Skandia* case?

No, VAT grouping is not permitted.

2.6 Are there any other transaction taxes payable by companies?

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

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

Yes. There are various indirect taxes in Japan such as Tonnage Tax, Special Tonnage Tax, Liquor Tax, Tobacco Tax and Gasoline Tax.

3 Cross-border Payments

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

Generally, yes. Under Japanese domestic tax law, generally, a non-resident shareholder (either a non-resident company or a non-resident individual) of a Japanese company is subject to Japanese withholding tax with respect to dividends it receives from such Japanese company at the rate of 20.42%; however, if the Japanese company paying the dividends to a non-resident shareholder is a listed company, this withholding tax rate is reduced to 15.315%, excluding the dividends received by a non-resident individual shareholder holding 3% or more of the total issued shares of such listed Japanese company, to whom the rate of 20.42% is applicable.

However, most of the income tax treaties currently in force in Japan generally provide that the reduced treaty rate in the source country shall be 15% or 10% for portfolio investors and 10% or 5% for parent and other certain major shareholders. Furthermore, under the Japan/US Treaty and a certain limited number of other modernised tax treaties recently executed by Japan (including those with Australia, France, the Netherlands, Sweden, Switzerland and the United Kingdom), the withholding tax rate is reduced to 10% for portfolio investors and 5% or 0% for parent and other certain major shareholders.

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

Generally, yes. Under Japanese domestic tax law, royalties relating to patents, trademarks, design, technology know-how, and copyrights used for any Japanese company's business carried on in Japan and paid by the Japanese company to a non-resident licensor (either a non-resident company or a non-resident individual) are subject to Japanese withholding tax at the rate of 20.42%, with certain exemptions.

Most of the income tax treaties currently in force in Japan provide that the withholding tax rate for royalties be reduced to 10%. Furthermore, under the Japan/US Treaty and a certain limited number of other modernised tax treaties recently executed by Japan (including those with France, the Netherlands, Sweden, Switzerland and the United Kingdom), an exemption from source country taxation with respect to royalties may be available. The royalty clause in most of the tax treaties executed by Japan does not cover fees for technical services, and such fees paid by Japanese residents to non-residents having no permanent establishment in Japan are not taxed in Japan under most of the tax treaties executed by Japan, with some exceptions including the Japan/India tax treaty, where Indian residents providing technical services to Japanese residents may be taxed in Japan under Article 12(2)(6) of the treaty.

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

(1) Generally, yes.
   (a) Interest on corporate bonds issued by a Japanese company that is paid to a non-resident bondholder (either a non-resident company or a non-resident individual) is generally subject to Japanese withholding tax at the rate of 15.315%.
   (b) Also, under Japanese domestic tax law, with respect to a certain specified scope of discount corporate bonds issued by a Japanese company (except for certain qualified short-term discount bonds), such Japanese company was required to withhold, at the time of the issuance of the discount corporate bonds, 18.378% (or 16.336% for certain bonds), of the amount equivalent to the difference between the face value and the issue price thereof (original issue discount). There are important exceptions to the foregoing (a) and (b): (i) corporate bonds issued outside Japan by Japanese corporations; and (ii) book-entry corporate bonds.

   The 2013 Tax Reform, which came into force on January 1, 2016, introduced, among others, a new rule for withholding tax to be applied to discount corporate bonds. Under such new rule, a withholding tax imposed at the time of the issuance of discount corporate bonds was lifted, and a withholding tax imposed at the time of the redemption was introduced. An issuer company of discount corporate bonds is generally required to withhold, at the time of the redemption of such discount corporate bonds, 15.315% of the amount equivalent to (i) 0.2% of the amount of the redemption (if the term of the bond in question is one year or less), and (ii) 25% of the amount of the redemption (if the term of the bond in question is more than one year).

(2) Interest on bank deposits and other similar deposits made by a non-resident depositor (either a non-resident company or a non-resident individual) with any office of a bank or other institution in Japan is generally subject to Japanese withholding tax, under Japanese domestic tax law, at the rate of 15.315%.

(3) Interest on loans extended by a non-resident lender (either a non-resident company or a non-resident individual) to a Japanese company in relation to such company's business carried on in Japan is generally subject to Japanese withholding tax, under Japanese domestic tax law, at the rate of 20.42%, with certain exemptions.

(4) As an exception to the foregoing, if a certified non-resident company makes a deposit or extends a loan to certain qualified financial institutions through a special Japan Offshore Market account, such non-resident company will be exempt from Japanese withholding tax with respect to interest to be paid on such deposit or loan.

(5) Most of the income tax treaties currently in force in Japan provide that the withholding tax rate for interest (regardless of whether it is interest on bonds, deposits or loans) is reduced generally to 10%. It is worth noting that under the modernised tax treaties, beginning with the Japan/US Treaty, certain specified categories of financial or other qualified institutions (the scope of which may slightly vary from treaty to treaty) that are residents of the contracting states, may be exempt from source country taxation with respect to interest, subject to certain requirements.

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

No. The payor company of interest may be denied a deduction of the interest paid to a non-resident recipient for its own corporation tax purposes, due to the application of the "thin capitalisation" rules under Japanese domestic tax law. Such rules deny deductibility of interest expenses paid to the payor company's foreign affiliates when such company's annual average ratio of debt to equity exceeds 3:1, subject to other conditions and an exemption available based on separate criteria. However, even when the deductibility is denied under the thin capitalisation rules, the relief under a treaty (i.e., the reduced withholding tax rate) available to the non-resident recipient of such interest, would nevertheless not be restricted.

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

No, this is not applicable. Please see question 3.4.

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

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

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident, for example pursuant to BEPS Action 4?

Yes. Japan has earnings stripping rules, under which deduction for "net interest payments" (as defined in such rules) to certain "related persons" (as defined in such rules) in excess of 20% (or 50% until April 1, 2020) of an "adjusted taxable income" (as defined in such rules) will be disallowed, and the disallowed amounts may be carried forward for seven ensuing business years. If the disallowed interest amount under the earnings stripping rules is smaller than the amount disallowed for deduction under the thin capitalisation rules, then deduction is disallowed to the extent of the larger of the two disallowed amounts.

The old 50% (of an adjusted taxable income) threshold was less rigorous than the standard recommended by BEPS Action 4 Report, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" (i.e., 10% to 30%). In 2019, accordingly, the Japanese government tightened its earnings stripping rules, (a) by lowering the threshold from 50% to 20%, and (b) by widening the scope of the rules (subjecting interest on third-party loans to the rules, and excluding dividends from an adjusted taxable income), in line with the OECD recommendations and suggestions.

Even if deductibility is denied under the earnings stripping rules, the relief under a treaty (i.e., the reduced withholding tax rate) available to the non-resident recipient of such interest would nevertheless not be restricted.

3.8 Is there any withholding tax on property rental payments made to non-residents?

Generally, yes. Rental fees for leasing real property located within Japan and paid by a Japanese company to a non-resident (either a non-resident company or a non-resident individual), are subject to Japanese withholding tax at the rate of 20.42%, subject to certain exemptions. Payments for the use of machinery or equipment are subject to Japanese withholding tax at the rate of 20.42%, for which exemption is provided under a majority of the treaties executed by Japan.

3.9 Does your jurisdiction have transfer pricing rules? Is their application expected to be materially affected by COVID-19?

Yes. Japanese transfer pricing rules are applicable to both a Japanese company and a Japanese branch of a non-resident company if either of them engage in transactions with any of their "foreign-related persons" (measured by, in principle, a direct or indirect 50%-or-more shared ownership). Japanese transfer pricing rules by and large follow the OECD Transfer Pricing Guidelines. As for transfer pricing issues caused by COVID-19, it is premature to speculate on how the tax authorities will react. However, it seems inevitable that the application of transfer pricing rules would be materially affected, as companies will likely suffer significant losses. It would raise the question of which party will assume such losses, or, if both parties/governments are to assume such losses, how the losses will be allocated between the parties for transfer pricing purposes. In accordance with the transactional net margin method ("TNMM"), which is the prevailing transfer pricing method in Japan, a party who performs simple or routine functions is deemed as a contractor who does not assume business risk and could be argued to be compensated based on fixed fees, regardless of any economic losses from an overall transaction. If some governments take such position, the taxpayer would be required to pay corporate income tax despite its economic losses. Even if a taxpayer tries to defend itself by benchmarking based on comparable companies, identifying comparable transactions may not be easy given the extraordinary nature of the crisis. Taxpayers are advised to take extra precautions for coming transfer pricing audits.

4 Tax on Business Operations: General

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

The nominal rate of corporation tax (national tax) is 23.2%, and the effective corporation tax rate – national and local combined – is: (a) approximately 31% for large companies (i.e., companies with a stated capital of more than 100 million yen); and (b) approximately 35% with a certain favourable rate for up to the first eight million yen for small and medium-sized companies (i.e., companies with a stated capital of 100 million yen or less), operating in Tokyo for the fiscal year beginning on or after April 1, 2020.

4.2 Is the tax base accounting profit subject to adjustments, or something else?

Yes. The tax base for corporation tax is the net taxable income; such net taxable income is calculated based on the results reflected in the taxpayer company's profit and loss statements, prepared in accordance with Japanese generally accepted accounting principles.

4.3 If the tax base is accounting profit subject to adjustments, what are the main adjustments?

The main differences include, but are not limited to, the treatment of donations and entertainment expenses. Donations, including any kind of economic benefit granted for no or unreasonably low consideration, are generally deductible only up to a certain limited amount. The deductibility of entertainment expenses is subject to certain qualifications and a certain ceiling. Please also see questions 5.2 and 5.3.

4.4 Are there any tax grouping rules? Do these allow for relief in your jurisdiction for losses of overseas subsidiaries?

Yes. There are two categories of tax grouping rules under Japanese tax law: (a) the consolidated tax return rules; and (b) the group taxation rules.

(a) A group of Japanese companies, where a Japanese parent company directly, or indirectly through other Japanese companies, owns no less than 100% of other Japanese subsidiaries, can elect to file, subject to the approval of the Commissioner of the National Tax Agency, a consolidated tax return. The consolidated tax is calculated on the basis of the aggregate net taxable income of the parent company and all consolidated subsidiaries. With certain exceptions, when a company participates in the consolidated tax return group from outside, the participating company's carry-forward losses will be lost and cannot be used to offset the income of the existing companies in the consolidated tax return group. The consolidated tax return rules were significantly amended in 2020 and the new rules will be applicable to tax years beginning on or after April 1, 2022, under which restrictions on the carry-forward of losses will be more stringent.

(b) Separate from the abovementioned consolidated tax return rules, there are special rules for intra-group transactions (the "Group Taxation Rules"), which apply to group companies in a "100% group" (i.e., companies that have a direct or indirect 100% shareholding relationship), even if they do not elect to file a consolidated tax return. The Group Taxation Rules apply to Japanese companies wholly owned by a foreign or Japanese company or an individual (to which certain family members' ownership is attributed). The Group Taxation Rules include the following rules, among others: (i) deferral of capital gains/losses from transfer of certain assets between Japanese companies in a 100% group; and (ii) denial of deduction and exclusion of income on donations between Japanese companies in a 100% group. Under the Group Taxation Rules, the losses of one company are not allowed to be used to offset income of other group companies.

In Japan, neither the consolidation rules nor Group Taxation Rules allow for relief for losses of overseas subsidiaries.

4.5 Do tax losses survive a change of ownership?

Generally, yes.

(a) A change of ownership does not restrict a corporation from utilising its accumulated tax losses that the corporation incurred in prior years, in general. However, for a company under certain specified events which shall take place within five years from the date of the ownership change (measured, in principle, by more than 50% of the issued and outstanding shares), utilisation of the tax losses of the company may be restricted. The restriction applies, for example: (i) when a company was dormant before the ownership change and begins its business after the ownership change; or (ii) when a company ceases its original business after the ownership change and receives loans or capital contributions, the amount of which exceeds five times the previous business scale.

(b) In respect of a merger, a surviving company is able to utilise the carried-forward losses of a merging company, if:
   (i) the merger falls under a "qualified merger"; and
   (ii) (a) the merger takes place five years after there is a relevant change of more than 50% of issued and outstanding shares, or (b) the merger satisfies "joint-business" requirements.

(c) In general, the tax losses of the past fiscal years can be carried forward to offset (by deduction) the taxable income of the current fiscal year, while such deduction is limited to a maximum of 50% (for a fiscal year beginning after April 1, 2018) of the taxable income (before the deduction). Losses survive for 10 years (or nine years for losses accrued in a fiscal year beginning before April 1, 2017). Please note that these limitations are not applicable (thus, a deduction of losses of up to 100% of the income is available) to small and medium-sized companies as stipulated under Japanese tax law, which are companies with a stated capital of 100 million yen or less that are not a wholly owned subsidiary of a company (Japanese or non-Japanese) with a stated capital of 500 million yen or more.

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

Japanese corporation tax is generally imposed at the same rate upon all corporate taxable profits regardless of whether such profits are distributed or retained. As an exception, a certain additional surtax (at the rate of 10%, 15% or 20%) may be imposed on certain portions of retained earnings of certain types of so-called family companies, unless such family company is a small and medium-sized company as stipulated under Japanese tax law, which is a company with a stated capital of 100 million yen or less that is not a wholly owned subsidiary of a company (Japanese or non-Japanese) with a stated capital of 500 million yen or more.

There are certain special qualified corporate entities used for investment purposes, including Investment Corporations and *Tokutei Mokuteki Kaisha* ("TMK"), which can deduct as expenses dividends paid to their shareholders if they distribute more than 90% of their distributable profits.

4.7 Are companies subject to any significant taxes not covered elsewhere in this chapter – e.g. tax on the occupation of property?

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

5 Capital Gains

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

Generally, no. For purposes of income taxes imposed on a company (not an individual) in Japan, generally all of the taxable income of a company is aggregated, regardless of whether such income is classified as capital gains or ordinary/business profits.

5.2 Is there a participation exemption for capital gains?

There is no participation exemption for taxation on capital gains. However, with respect to dividends paid to a Japanese company by its foreign subsidiary, a participation exemption from Japanese income taxation is granted for a 95% portion of such dividends if the Japanese company owns at least 25% of such foreign subsidiary's issued and outstanding shares or voting shares for at least six months. The 25% threshold requirement may be altered if a tax treaty explicitly so provides or if a particular taxpayer is eligible for treaty benefits under an applicable tax treaty in which a lower threshold is required for a treaty-based indirect foreign tax credit eligibility (for example, a 10% shareholding threshold is provided under Article 23(1)(b) of the Japan/US Treaty).

5.3 Is there any special relief for reinvestment?

Generally, yes. Dividends received by a Japanese company from another Japanese company may be either 100%, 50% or 20% (subject to certain adjustments) excluded from the recipient company's taxable income, depending on whether or not the recipient Japanese company owns more than a third, more than 5%, or 5% or less of the total issued and outstanding shares of the dividend-paying Japanese company. Such dividend-received exclusion is also available to a Japanese branch of a foreign corporation with respect to dividends received by such branch from any Japanese company.

5.4 Does your jurisdiction impose withholding tax on the proceeds of selling a direct or indirect interest in local assets/shares?

Generally, no. However, Japan imposes withholding tax on the proceeds of selling a direct interest in real property located within Japan. See questions 8.1 and 8.2 below. With respect to capital gains from shares of a company, when a non-resident shareholder (either a non-resident company or a non-resident individual) having no permanent establishment in Japan alienates its shares in a Japanese company, such shareholder is not subject to any Japanese taxation, with certain exceptions, including the case where such shareholder owns 25% or more of the issued shares of a Japanese company in a three-year period and sells 5% or more of the issued shares in aggregate in a single fiscal year, in which case such non-resident alienator is required to file a tax return in Japan and is subject to Japanese personal income tax or corporation tax (but not withholding tax), as the case may be, on a net income basis.

6 Local Branch or Subsidiary?

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

In order to form a Japanese subsidiary, the articles of incorporation of such subsidiary must be submitted, which is subject to Stamp Tax in the amount of 40,000 yen. Further, such subsidiary must be registered in the commercial register kept at the competent office of the legal affairs bureau of the Ministry of Justice, subject to Registration and Licence Tax at the rate of seven thousandths (7/1,000) of its stated capital amount, but no less than 150,000 yen in the case of a joint-stock company (*Kabushiki Kaisha*).

If a non-resident company forms a subsidiary in Japan (i.e., establishing a company incorporated under the laws of Japan) by making a capital contribution in cash, the formation of the subsidiary is not a taxable event for corporation tax purposes.

6.2 Is there a difference between the taxation of a local subsidiary and a local branch of a non-resident company (for example, a branch profits tax)?

Yes. If a foreign parent forms a Japanese subsidiary that is a corporation, such Japanese subsidiary will be treated as a Japanese taxpayer and will be subject to Japanese corporation tax on its worldwide income in the same manner as any other domestic Japanese corporation, subject to the exclusion of 95% of dividends from certain foreign subsidiaries (see question 5.2 above). A branch of a non-resident corporation, by contrast, is generally only subject to Japanese corporation tax on the profits attributable to its permanent establishment in Japan under an applicable tax treaty or under Japanese domestic tax law. There is no branch profits tax or other similar tax that is applicable to a branch of a non-resident company, but not a subsidiary.

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

Under the Corporation Tax Act, if a non-resident company that has its branch in Japan earns profits attributable to its permanent establishment in Japan, such business profits constitute Japanese source income that is taxable in Japan in line with the Authorised OECD Approach. Rules similar to the transfer pricing regulations for foreign-related persons are applicable to the Japan branch. With respect to the question of how the amount of such business profits should be determined, certain specific rules are provided in the relevant regulations. With respect to the detailed method of calculating taxable income, rules that are applicable to a Japanese company are, in principle, also applicable to a Japan branch of a non-resident company, *mutatis mutandis*. In calculating the taxable income of a Japan branch, only the expenses that are related to the business carried on through the Japan branch (permanent establishment), are treated as deductible expenses. Specifically, the expenses of the relevant foreign corporation must be allocated to (a) the business carried on through the Japan branch, and (b) other business in accordance with reasonable criteria, such as revenue, value of assets, number of employees, etc.

6.4 Would a branch benefit from double tax relief in its jurisdiction?

A Japan branch of a company that is a resident in a treaty country can benefit from the treaty provisions to some extent. However, with respect to the treaty relief given to passive income such as dividends, interest and royalties, a Japan branch of a non-resident company would not be allowed to enjoy such treaty relief, since most of the income tax treaties currently in force in Japan include provisions similar to Articles 10(4), 11(4) and 12(3) of the OECD Model Convention, which deny treaty benefits to the beneficial owner of dividends, interest, or royalties who carries on business through a permanent establishment situated in the source country (i.e., Japan) if its relevant shares, debt-claims, or intellectual properties are effectively connected with such permanent establishment (i.e., the Japan branch).

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

Generally, no. For a remittance, banks are obligated to file a report with the competent tax office regarding any remittance to a foreign country in the amount of more than one million yen.

7 Overseas Profits

7.1 Does your jurisdiction tax profits earned in overseas branches?

Yes. A Japanese company is generally subject to Japanese corporation tax with respect to its worldwide income, subject to the exclusion of 95% of dividends from certain overseas subsidiaries. Please see question 7.2 below.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Ninety-five per cent of the dividends paid to a Japanese company by its overseas subsidiaries is excluded from Japanese corporation tax, subject to a certain shareholding threshold and holding period requirements. Please see question 5.2 above.

7.3 Does your jurisdiction have "controlled foreign company" rules and, if so, when do these apply?

Yes. Japan has its own CFC rules and if such CFC rules are applied to any particular overseas subsidiary, such CFC subsidiary's net profits (but not its net losses) shall be deemed to constitute the Japanese parent company's taxable income in proportion to its shareholding percentage, regardless of whether or not such profits are distributed to the parent. These rules apply to Japanese companies that own 10% or more of the shares in a certain overseas subsidiary more than 50% owned, in aggregate, by Japanese resident individuals or companies directly or indirectly.

The Japanese CFC rules were overhauled in 2017 in line with BEPS Action 3, "Designing Effective Controlled Foreign Company Rules", and the new rules will be applicable for the relevant subsidiaries' fiscal years beginning on or after April 1, 2018. Under the new rules:

(1) profits of foreign subsidiaries that are either a (a) "<u>paper company</u>", (b) "<u>cash box company</u>", or (c) "<u>company located in black-list jurisdictions</u>" will be included in the taxable income of the Japanese parent unless the effective tax rate for the relevant subsidiaries is "30%" or higher;

(2) profits of foreign subsidiaries that do not fall under the foregoing categories (1)(a)–(c), but do not satisfy the "<u>Economic Activity Test</u>" (i.e., the test to see whether the subsidiary is engaged in active business by examining the subsidiary's (a) category of business, (b) fixed facility, (c) management, and (d) volume of unrelated sales/purchases or manufacturing) will be included in the taxable income of the Japanese parent, unless the effective tax rate for the relevant subsidiaries is "20%" or higher; and

(3) even if the foreign subsidiaries satisfy the "Economic Activity Test", its "<u>passive income</u>" will be included in the taxable income of the Japanese parent, unless the effective tax rate for the relevant subsidiaries is "20%" or higher.

As a notable development in 2019, the scope of a "paper company" in (1)(a) above, which is subject to the Japanese parent's inclusion under the Japanese CFC rules, was significantly narrowed in response to the concern that a number of Japanese companies' U.S. subsidiaries would be subject to the Japanese CFC rules due to the decrease of the U.S. corporation tax rate to 21%. For example, a U.S. holding company which is owned by a Japanese parent is not viewed as a company from the "paper company", if it performs functions such as (a) shielding one business' risk from another for financing purposes, (b) facilitating a joint venture with local companies, (c) facilitating management or disposal of assets, or (d) shielding litigation risks.

8 Taxation of Commercial Real Estate

8.1 Are non-residents taxed on the disposal of commercial real estate in your jurisdiction?

Generally, yes. If real property, commercial or otherwise, that is located within Japan is alienated by a non-resident (either a non-resident individual or a non-resident company), the gross amount of the consideration received by such non-resident for such alienation is subject to Japanese withholding tax at the rate of 10.21% if it is paid, or deemed paid, within Japan, with certain exceptions (including no withholding tax for an alienation to an individual for use as a personal or family residence for consideration of 100 million yen or less) and exemptions.

Regardless of the imposition of the aforementioned withholding tax, if a non-resident (either a non-resident individual or a non-resident company) alienates real property located within Japan, such non-resident alienator is required to file a tax return in Japan and is subject to Japanese personal income tax or corporation tax, as the case may be, on a net income basis with respect to any capital gains (after cost basis and expenses deducted) derived from such alienation. If such non-resident alienator is subject to the aforementioned withholding tax, the amount of such withholding tax may be credited against such income tax or corporation tax, subject to certain procedural requirements.

8.2 Does your jurisdiction impose tax on the transfer of an indirect interest in commercial real estate in your jurisdiction?

Yes. When a non-resident individual or a non-resident company and his/her/its special related parties, in aggregate, hold:

(i) <u>more than 5%</u> of the shares issued by a company with 50% or more of its assets' value attributable directly or indirectly to real property, commercial or otherwise, that is located within Japan ("Real Property Related Company") and such shares are either <u>listed on a stock exchange</u> or traded over-the-counter; or

(ii) <u>more than 2%</u> of the shares issued by a Real Property Related Company that is <u>not so listed</u>,

the special rules apply.

If the special rules are applicable and the non-resident individual or the non-resident company transfers the Real Property Related Company shares, such non-resident company or the non-resident individual is required to file a tax return in Japan and is subject to Japanese personal income tax or corporation tax, as the case may be, on a net income basis with respect to any capital gains (after cost basis and expenses deducted) derived from such transfer.

8.3 Does your jurisdiction have a special tax regime for Real Estate Investment Trusts (REITs) or their equivalent?

REITs structured in Japan ("J-REITs") are generally structured in the form of a company, although it is legally possible to structure J-REITs in the form of a trust under Japanese law. Thus, dividends from J-REITs are, practically, subject to the same taxation as dividends paid by a local resident company to a non-resident (please see question 3.1 above), and transfers of investment equity in J-REITs are subject to the same taxation as transfers of Real Property Related Company shares (please see question 8.2), in general. J-REITs are often structured in the form of certain special qualified corporate entities established under Japanese law, such as Investment Corporations and TMK, which can deduct as expenses dividends paid to their shareholders if they distribute more than 90% of their distributable profits. As another alternative, real estate investments are sometimes made in the form of a *Godo Kaisha* ("GK") corporation contributed to by silent partners through a *Tokumei Kumiai* ("TK"), under which dividends to investors are fully deductible by the GK but subject to withholding tax at the rate of 20.42% under Japanese domestic tax law. Some tax treaties in Japan (including those with France, the Netherlands and the U.S.) allow the said Japanese withholding tax, while other tax treaties (including that with Ireland) do not allow it under a provision equivalent to Article 21 (Other Income) of the OECD Model Convention.

9 Anti-avoidance and Compliance

9.1 Does your jurisdiction have a general anti-avoidance or anti-abuse rule?

No. Japanese tax law does not have a general anti-avoidance rule. However, Japanese tax law includes a so-called "specific" anti-avoidance rule for a family company (i.e., a company where more than 50% of its shares are held by three or fewer shareholders and certain related persons). Japanese tax law also has specific anti-avoidance rules that involve corporate reorganisation transactions and consolidated tax return filing. In addition, an anti-avoidance rule was introduced for transactions regarding income attributable to a permanent establishment of overseas corporations, which is applicable to internal and other dealings between a non-Japanese company and its Japanese branch. Under these specific anti-avoidance rules, if transactions are viewed as "unjust", the transactions can be recharacterised and reconstructed to a "normal" or "natural" form of transactions with different tax implications (presumably higher tax burdens). The Japanese tax authorities invoke anti-avoidance rules against corporate reorganisation transactions utilising intra-group losses, sometimes successfully in cases such as the *Yahoo Japan* case (the Supreme Court judgment dated February 29, 2016) and sometimes unsuccessfully in cases such as the *IBM* case (the Tokyo High Court judgment dated March 25, 2015).

9.2 Is there a requirement to make special disclosure of avoidance schemes or transactions that meet hallmarks associated with cross-border tax planning?

No. Japanese tax law does not have a disclosure rule that imposes a requirement to disclose avoidance schemes. The Japanese tax authorities are studying the potential adoption of mandatory disclosure rules in line with BEPS Action 12. However, given the ambiguity of the scope of the "avoidance schemes", the tax authorities are apparently being cautious in introducing new rules and a specific proposal has yet to be seen as of October 1, 2020.

9.3 Does your jurisdiction have rules which target not only taxpayers engaging in tax avoidance but also anyone who promotes, enables or facilitates the tax avoidance?

No. The Japanese tax authorities are studying the potential adoption of mandatory disclosure rules applicable to promoters, enablers or facilitators of tax avoidance in line with BEPS Action 12. However, the tax authorities are apparently being cautious in introducing new rules, and a specific proposal has yet to be seen as of October 1, 2020.

9.4 Does your jurisdiction encourage "co-operative compliance" and, if so, does this provide procedural benefits only or result in a reduction of tax?

Yes. The Japanese tax authorities encourage corporations to cooperate with them and to voluntarily disclose certain information for compliance purposes. As an incentive, if the authorities acknowledge that a certain taxpayer is well in compliance with tax laws, the authorities may refrain from auditing that taxpayer for one year in addition to the period that the authorities customarily took to audit that taxpayer in the past. However, it is up to the discretion of the authorities and a voluntary disclosure will not necessarily entail exemption or relaxation of any tax audit or other procedural requirements. It will not reduce any substantive tax burden either.

10 BEPS and Tax Competition

10.1 Has your jurisdiction implemented the OECD's recommendations that came out of the BEPS project?

Yes. Japan implemented most of the OECD's recommendations on the BEPS project. Japan introduced legislation in response to BEPS Action 2 Report, "Neutralising the Effects of Hybrid Mismatch Arrangements", which denies exclusion for dividends received from 25%-owned non-Japanese companies (see question 5.2) as long as they are deductible in the payer country, including dividends on Mandatory Redeemable Preference Shares ("MRPS") issued in Australia and dividends from a Brazilian company.

In addition, in response to BEPS Action 13, "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting", the Japanese government introduced new transfer pricing legislation to adopt the three-tiered documentation approach consisting of a country-by-country report, a master file and a local file. Please see question 10.3.

Also, please see questions 3.7, 7.3 and 10.2.

10.2 Has your jurisdiction adopted any legislation to tackle BEPS which goes beyond the OECD's recommendations?

No. The Japanese tax authorities appear to intend to adopt legislation to tackle BEPS in line with, but not beyond, the OECD's BEPS reports. In addition to the new rules in line with Actions 2 and 13 set forth in question 10.1 above, the Japanese government introduced the new CFC rules in line with BEPS Action 3, "Designing Effective Controlled Foreign Company Rules". Further, the government revised the transfer pricing regulations in line with the revised OECD Transfer Pricing Guidelines under BEPS Actions 8–10, "Aligning Transfer Pricing Outcomes with Value Creation". Specifically, in 2019, Japan introduced new transfer pricing rules for transfers of hard-to-value intangibles ("HTVI"), such as (a) discount cash flow method as another transfer pricing method, and (b) *ex post* price adjustment measures, aimed at preventing base erosion and profit shifting by moving intangibles among group members, in line with the "Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles" published by the OECD on June 21, 2018.

10.3 Does your jurisdiction support information obtained under Country-by-Country Reporting (CBCR) being made available to the public?

No. While Japan adopted CBCR as stated below, the Japanese government is reluctant to make information available to the public or to the countries that may make information public. According to the Japanese tax authority, it provided CBCR information filed by Japanese taxpayers only to the jurisdictions that satisfied the standards set by the OECD, including those for confidentiality and appropriate use of CBCR information. Under such policy, Japan provided CBCR information to 51 jurisdictions for 831 multinational enterprise groups and received CBCR information from 42 jurisdictions for 2,100 multinational enterprise groups in 2018.

For the CBCR generally, the Japanese government adopted the three-tiered documentation approach, under which a separate "master file" and a "local file" as well as a "country-by-country report" are required. Any Japanese corporations and foreign corporations with permanent establishments in Japan that are a constituent entity of a multinational enterprise ("MNE") group with total consolidated revenues of 100 billion yen or more in the previous fiscal year ("Specified MNE Group") are subject to the documentation rules. Such corporations must file (i) a notification as to the ultimate parent entity, (ii) a country-by-country report, and (iii) a master file with the tax authority online ("e-Tax").

(a) The local file (reporting material transactions of the local taxpayer) is mandated to be prepared simultaneously with the filing of the relevant corporation tax return (and to be presented to the local tax authority upon instruction within a maximum of 45 days of receiving such instruction) for transactions with a certain foreign-affiliated person, with whom either (1) the sum of payments and receipts is 5 billion yen or more, or (2) the sum of payments and receipts for intangible transactions is 0.3 billion yen or more, in the previous fiscal year. In addition, presentation of the local file for any transaction, the value of which is below the foregoing threshold amounts, is also to be made with the local tax authority, upon instruction by the auditor, within a certain period designated by the auditor, which is no more than 60 days.

In the local file, a taxpayer is required to report the items as described in Annex II to Chapter 5 of the revised OECD Guidelines, which includes a description of the local entity, a description of controlled transactions, and financial information.

(b) In the master file, a taxpayer is required to report the items as described in Annex I to Chapter 5 of the revised OECD Guidelines, which includes a description of the businesses of the MNE, the MNE's intangibles, the MNE's intercompany financial activities, and the MNE's financial and tax positions.

(c) In the CBCR, a taxpayer is required to report the items as described in Annex III to Chapter 5 of the revised OECD Guidelines, which includes an overview of allocation of income, taxes and business activities by tax jurisdiction, and a list of all the constituent entities of the MNE group included in each aggregation per tax jurisdiction.

10.4 Does your jurisdiction maintain any preferential tax regimes such as a patent box?

No. Japan does not maintain any preferential tax regimes such as a patent box.

Japanese tax law does, however, provide for special tax credits and deductions on certain research and development costs.

11 Taxing the Digital Economy

11.1 Has your jurisdiction taken any unilateral action to tax digital activities or to expand the tax base to capture digital presence?

No. No unilateral action or specific legislation has been created to capture digital presence so far. However, in enforcement, the Japanese tax authority appears to be eager to capture digital presence. For example, in 2009, it was reported that the Japanese tax authority made adjustments on a certain Japanese affiliate of Amazon.com for the reason that such affiliate was a permanent establishment of Amazon based on the finding that Amazon U.S.'s computers were used in Japan, Japanese employees were instructed by Amazon U.S. and the Japanese affiliate functioned in more than just a logistical capacity. Amazon sought relief from a mutual agreement procedure with competent authorities and the U.S. and Japanese tax authorities reached an agreement in 2010 with a result of no significant tax expense to Amazon. If the OECD makes specific recommendations for taxing digital activities, the Japanese government may move to enforce or take legislative actions in line with them.

11.2 Does your jurisdiction favour any of the G20/OECD's "Pillar One" options (user participation, marketing intangibles or significant economic presence)?

Generally, yes. Although the Japanese government has not officially announced its position, it appears to favour a unified form of the "Pillar One" options. Mr. Akira Amari, the Chair of the Tax Research Commission of the controlling Liberal Democratic Party told news outlets that the Japanese government is wary of supporting a revenue-based tax (such as that adopted by France) and instead, is eager to make a proposal that is balanced and will ensure support from developing countries (Nihon Keizai Shimbun, September 30, 2019).

Shigeki Minami is a lawyer licensed in Japan (admitted in 1997) and a partner at the Tokyo office of Nagashima Ohno & Tsunematsu. He is an expert in tax law matters, including transfer pricing, cross-border mergers and acquisitions, international reorganisations, anti-tax-haven (CFC) rules, withholding tax issues, tax treatment on various financial instruments, corporate tax issues and other general tax issues. With respect to such matters, he has acted as counsel in various tax disputes on behalf of major Japanese and foreign companies and his recent achievements include the following:

- successfully represented a Japanese multinational company in a transfer pricing dispute before the National Tax Tribunal of Japan, which resulted in the cancellation of an assessment of more than USD 200 million;
- successfully represented a US-based multinational company in a tax dispute involving an international reorganisation before a Japanese court, which resulted in the cancellation of an assessment of more than USD 1 billion;
- successfully represented an international air carrier against its trading partners in commercial disputes that originated from VAT-related matters;
- successfully represented a prominent professional sports association on cross-border withholding tax issues; and
- advised various international funds on tax matters for structuring investments into Japanese assets.

For the past several years, Mr. Minami has been selected as one of the leading practitioners in the corporate tax categories in *Who's Who Legal* and listed as one of the top lawyers in Japan (Tax Law) in *The Best Lawyers in Japan*. He is also recognised as an "Indirect Tax Leader" and a "Tax Controversy Leader" by the *International Tax Review*.

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