Japanese Controlled Foreign Companies Rules

Introduction to the Japanese CFC Rules

**Background**

Japanese multinational corporations always need to take the impacts on the Japanese Controlled Foreign Companies (J-CFC) Rules, or so-called Japanese Anti-Tax Haven Rules, into consideration. The J-CFC Rules were fundamentally revised under the 2017 Japanese Tax Reform. Due to those law changes, certain entities or income, which had not fallen under the scope of the former J-CFC Rules, may now subject to the revised J-CFC Rules generally applicable since 1 April 2018.

Against this background, we would like to provide in the following a high-level overview on the J-CFC Rules.
What are CFC Rules in general?
Generally, CFC Rules are designed to mitigate an artificial shifting of income of multinational corporations to low tax rate/zero tax rate countries resp. having income being incurred by non-domestic operations subject to lower tax rates compared to domestic tax rates. CFC Rules generally work in a way that certain low-taxed/non-taxed income incurred by non-domestic entities/operations is added to the (domestic) taxable income of the parent company and taxed at the – normally higher – tax rate of the country of residence of the parent company. Countries, amongst others, such as UK, US, Germany or Japan have thus included CFC Rules in their domestic tax laws.

The concept resp. the detailed rules may differ between countries based on domestic tax laws.

Background of J-CFC law changes in 2017
The fundamental revision of the J-CFC Rules in 2017 was made by reflecting the basic idea of action item 3 of the OECD BEPS project that tax should be imposed based on consideration of the actual economic substance of foreign corporate entities (other operations such as permanent establishments or partnerships are generally not in the scope of the J-CFC Rules; however, this should be analyzed on a case-by-case scenario).

The main issue of the previous J-CFC regulations was that the J-CFC status was, first of all, determined by the corporate tax rate (a so-called “trigger rate”). The examination of the economic substance (the application of Active Business Exemption (“ABE”) Test) was secondary.

Therefore, on the one hand, foreign corporate entities’ income was previously subject to J-CFC taxation at Japanese parent level, if the effective tax rate was below the trigger rate of 20 percent, even if they had economic substance (“over-inclusion”). On the other hand, foreign corporate entities with an effective tax rate above 20 percent were not subject to the J-CFC taxation at Japanese parent level, regardless of economic substance (“under-inclusion”).

Under the new J-CFC Rules generally applicable since 1 April 2018, economic substance has become the decisive criteria for the status of foreign corporate entities. The new J-CFC Rules take a two-fold approach to determine the status of a foreign related company (“FRC”) that are subject to J-CFC taxation at Japanese parent level. On the one hand, a FRC is determined from its tax and economic profile such as effective tax rate and existence of active business (so-called “Entity Approach”), and on the other hand, by its income details (so-called “Income Approach”) transaction takes place in Germany or abroad.

3. income earned by a FRC which is a Paper Company, a Cash Box or a Black List Company and which is subject to an ETR of less than 30 percent will be subject to J-CFC Rules on an entity basis (i.e., all income subject to J-CFC Rules).

General overview on J-CFC Rules
Please refer to Fig. 1 on the next page for a detailed overview on the J-CFC decision process.

A Japanese company that (together with associated persons) holds 10 percent or more shares in a foreign company falls within the scope of J-CFC regulations. A Japanese shareholder with 10 percent or more shareholding in a foreign company may be subject to a disclosure obligation in its tax returns.

A foreign company is considered to be a FRC, if Japanese residents (natural persons and companies) altogether hold more than 50 percent of shares directly or indirectly in the foreign company, or de facto control the foreign company.

Under the new J-CFC Rules:
1. income earned by a FRC which satisfies the Economic Activity Test (equivalent to ABE under the former rules; see below) will only be caught by J-CFC Rules, to the extent the income is passive and the effective tax rate (ETR) is below 20 percent;

2. income earned by a FRC which does not satisfy Economic Activity Test and which is subject to an ETR of less than 20 percent will be subject to J-CFC Rules on an entity basis (i.e., all income subject to J-CFC Rules);
With the introduction of the new J-CFC Rules, the so-called ABE under the former rules was renamed to Economic Activity Test with certain adjustments implementing a stricter view on business activities of a FRC.

A FRC satisfies the Economic Activity Test, if the 4 conditions shown in Fig. 2 are satisfied (depending on the business of a FRC, either “country of location test” or “unrelated party test” applies).

**Economic Activity Test**

**Substance Test**
A FRC has an office/fixed place of business.

**and**

**Business Purpose Test**
Main business of a FRC is not shareholding, provision of IP, or leasing of ship or aircraft.

**and**

**Management and Control Test**
A FRC has management-, operation- and administration functions.

**Country of Location Test**
A FRC conducts business in its country of residence.

**or**

**Unrelated Party Test**
A FRC has business transactions with nonrelated parties.

**Definitions**

**Paper Company**
A FRC that does not meet any of followings shall be considered to be a paper company: 1) Substance Test, 2) Management and Control Test, 3) certain FRCs with shareholding function, 4) certain FRCs with real property, 5) certain FRCs with resource development projects.

**Cash Box**
FRCs with excess passive income: a) total passive income exceed 30 percent of total assets, or b) total of securities/loan receivables/intangible assets exceed 50 percent of total assets (different calculation methods apply for financial subsidiaries that satisfy certain conditions).

**Black List Company**
FRCs with head office location in a jurisdiction designated by the Finance of Minister of Japan as a non-cooperative in terms of the exchange of tax information. As of March 2020, no jurisdiction has been designated.
Passive Income

Following income as outlined in Tab. 1 are considered to be passive income under the new J-CFC Rules, which might be subject to J-CFC taxation at Japanese parent level. And there is an exception rule for certain passive income e.g. interest on adequate group finance.

Additional Remarks

Before the 2017 Japanese Tax reform, J-CFC Rules were considered to be not having a big impact on German subsidiaries, as the former J-CFC Rules were not applied, if the ETR is above the trigger rate of 20 percent; and there is rarely a German company with an ETR lower than 20 percent.

However, due to the introduction of new J-CFC Rules, more German resp. international corporate entities with an ETR between 20-30 percent (as well as those with an ETR lower than 20%) could fall under the revised J-CFC Rules and trigger J-CFC taxation at Japanese parent level.

Further, it should be noted that for the calculation of the ETR, certain tax-exempt income such as tax-exempt capital gains are added to the overall income relevant for purposes of the J-CFC Rules, thus the ETR for J-CFC purposes could be lower than the ETR/ statutory tax rate calculated based on foreign (non-Japanese) tax law. The foreign (non-Japanese) ETR may thus not be decisive but rather an analysis from a J-CFC perspective should be required.

The revised J-CFC Rules generally apply to the fiscal periods of FRC beginning on or after 1 April 2018. While Japanese multinationals should analyze their foreign subsidiaries’ taxation positions, financial data, and organizational structure, FRCs, at the same time, should be aware of the impact of J-CFC especially in case of acquisitions or reorganizations, or incurring capital gains (case-by-case analysis recommendable).

As the 2017 Tax Reforms were followed by further detailed law changes (so far rather for clarification purposes), we recommend conducting further analysis before pursuing potentially J-CFC Rules caught transactions.

Tab. 1 – Passive income in the meaning of J-CFC rules

<table>
<thead>
<tr>
<th>Enumeration of passive income in the meaning of J-CFC Rules</th>
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<tbody>
<tr>
<td>A. Interest*</td>
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<tr>
<td>B. Dividends (certain exceptions apply, e.g. dividends from FRC ≥25% shareholding)*</td>
</tr>
<tr>
<td>C. Remuneration from lending securities*</td>
</tr>
<tr>
<td>D. Capital gain/ loss on securities*</td>
</tr>
<tr>
<td>E. Profit and loss arising on derivative transactions*</td>
</tr>
<tr>
<td>F. Foreign exchange gains and losses*</td>
</tr>
<tr>
<td>G. Other income related to A.-F.*</td>
</tr>
<tr>
<td>H. Consideration from tangible fixed assets leasing</td>
</tr>
<tr>
<td>I. Royalty from intangible assets</td>
</tr>
<tr>
<td>J. Capital gain or loss on intangible assets etc.</td>
</tr>
<tr>
<td>K. Certain “irregular amount” income</td>
</tr>
</tbody>
</table>

* exempt for aggregation for financial subsidiaries that satisfy certain conditions
Do you have any more questions?
We are looking forward to your call or email to discuss opportunities and requirements in more detail tailored to your needs and your expectations.

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