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Japan Tax Newsletter

Deloitte Tohmatsu Tax Co.

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Japanese Anti-Tax Haven Rules - Japan Tax Reform Proposals 2017

The Japanese Government ruling parties agreed on an outline of the 2017 Tax Reform proposals[1] on 8 December 2016. This newsletter sets out the key measures proposed and the practical aspects relating to the Japanese Controlled Foreign Company rules ("CFC" or so-called the "Japanese Anti-Tax Haven rules"), which may give rise to potential tax implications for Japanese owned groups.

1 Background

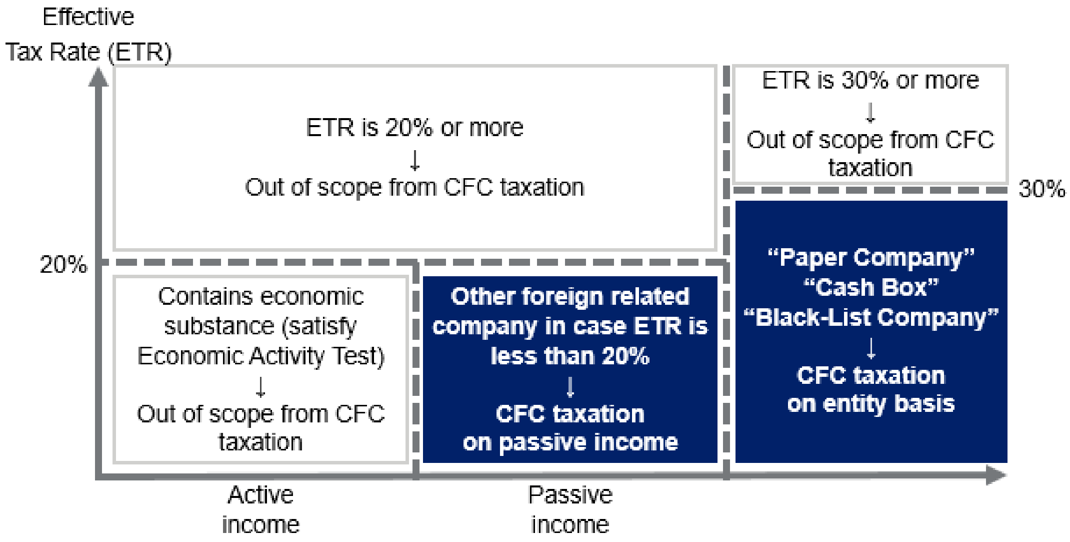
Under the "Controlled Foreign Company" ("CFC") rules in Japan, income arising in a foreign subsidiary (located in countries with lower tax rates under current law) that meets certain conditions is deemed to arise as the income of the parent company in Japan and taxed in Japan in order to prevent tax avoidance arrangements using a foreign subsidiary.

However, there has been much discussion of the need to update the existing CFC rules. Under the current CFC rules, if the effective tax rate of a foreign subsidiary is 20% or more (i.e. higher than the CFC trigger rate), none of the income earned by a corporation lacking sufficient economic substance is subject to taxation at the Japanese parent company level nor is there a requirement to file a return in Japan ("Under-Inclusion"). On the other hand, where the effective tax rate of the foreign subsidiary is less than 20% (the current trigger rate), in certain circumstances, income earned by such a company even with actual economic substance may be subject to Japanese taxation ("Over-Inclusion").

Thus, under the basic concept of the "BEPS[2] project" that tax should be imposed based on consideration of the actual economic substance of foreign subsidiaries, the proposed Tax Reforms attempt to revise the current CFC rules so that so-called "passive income" arising in a foreign subsidiary corporation without sufficient economic substance will be aggregated with the Japanese parent's income, while income earned by businesses with sufficient economic substance will not be included in the total income amount of the Japanese parent, regardless of the effective tax rate of such a subsidiary.

A diagram that illustrates conceptually the aggregated income under the proposed new CFC rules as outlined in the Tax Reform Proposals is as follows:

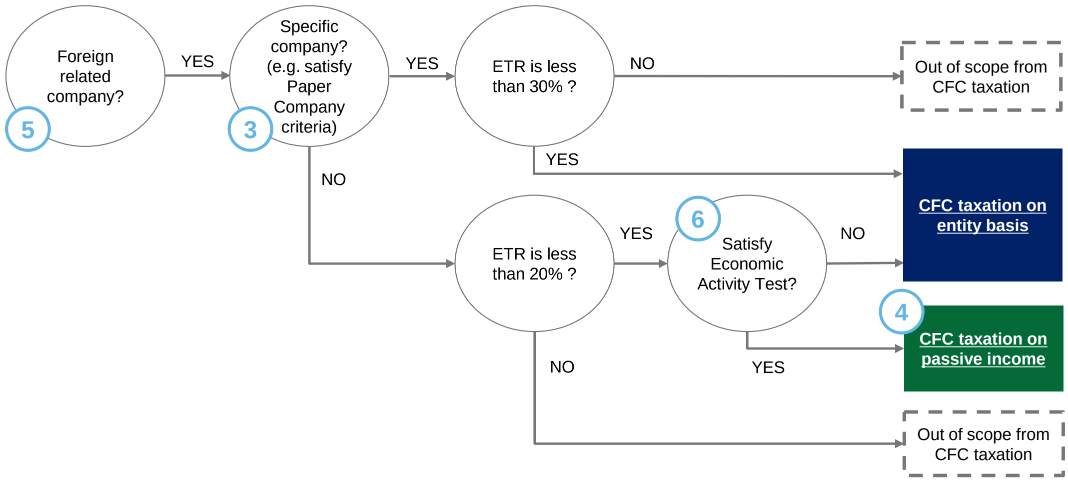
1 2017 tax reform is posted on the Liberal Democratic Party's website. (Japanese/PDF)
2 Base Erosion and Profit Shifting



2 Overview of the new Japanese CFC rules

The new Japanese CFC rules will be based on an "Entity approach" which is the main framework under the current CFC rules, where certain characteristics of the company are taken into consideration (e.g. the effective tax rate of the subsidiary or the overall extent of active business undertaken in the subsidiary etc.). In addition, the new CFC rules further incorporates an "Income approach" where the judgement is made based on the details of income earned by the foreign subsidiary.

An overview of the proposed new CFC rules is as follows8:An overview of the proposed new CFC rules is as follows[3]:



3 Change in scope for specified foreign subsidiaries ("Paper Company" etc.)

(1) Overview

Under the current CFC rules, where the effective tax rate of a foreign subsidiary exceeds the trigger tax rate, the income of such companies is not subject to Japanese taxation. Under the proposed new Japanese CFC rules, the income of specified companies categorised as a 'Paper Company', 'Cash Box' or resident in a 'black-list' jurisdiction ('Black-List Company'), will be subject to Japanese taxation on an entity basis even if their effective tax rate is higher than the trigger rate. However, there will be an exemption where the effective

3 Although the effective tax rate criteria (i.e. the trigger tax rate) is said to be abolished according to the opening section of the proposed Tax Reforms, it is in fact substantially preserved, as an exemption to a Japanese CFC charge is applied under the entity based approach or the passive income approach based on the effective tax rate of the foreign subsidiary.

tax rate of those specified foreign subsidiaries is 30% or more. Further details of the following are outlined below:

① "Paper Company"
② "Cash Box"
③ "Black-List Company"

① Paper Company

A Paper Company means a foreign related company that meets neither of the following conditions:
Substance Test：The specified foreign company maintains an office or other fixed place of business necessary to conduct its main business (for certain specified foreign companies that perform insurance business, the test is satisfied where similar conditions are met).

Management and Control Test：The specified foreign company functions with its own administration,control, and management in the country where the head office of the specified foreign company is located (for certain specified foreign companies that perform insurance business, the test is satisfied where similar conditions are met).

② Cash Box

a. Other than financial subsidiaries etc.[4]

A Cash Box means a foreign related company that meet both of the following conditions (a) and (b)

(a) $$\frac{\text{Total passive income (total of items outlined below under 4(1) ① excluding k)}}{\text{Total assets}} > 30\%$$

(b) $$\frac{\text{Securities} + \text{Loan receivables} + \text{Intangible assets etc.}}{\text{Total assets}} > 50\%$$

b. Financial subsidiaries etc.

A Cash Box means a foreign related company that meet both of the following conditions (a) and (b)

(a) Numerator: Whichever is larger
- Total passive income on financial subsidiaries (total of below 4(1) ② a)
- Total passive income on financial subsidiaries (total of below 4(1) ② (from b to d))

Denominator: Total assets

$> 30\%$

(b) $$\frac{\text{Securities} + \text{Loan receivables} + \text{Intangible assets etc.}}{\text{Total assets}} > 50\%$$

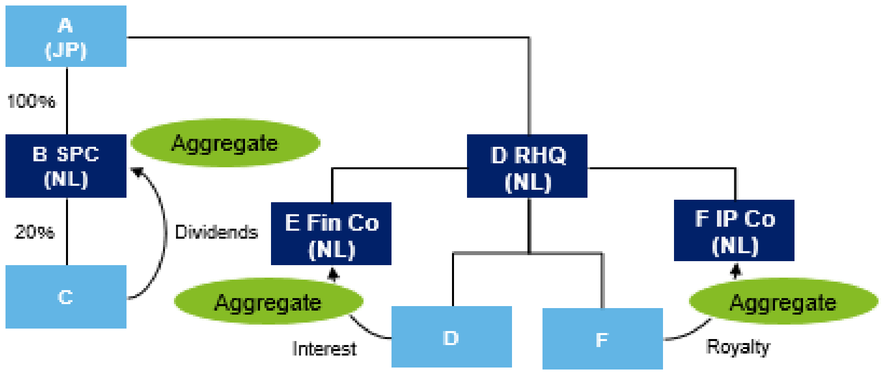
③ Black-List Company

A Black-List Company means a foreign related company whose head offices is located in a jurisdiction designated by the Finance Minister in Japan as a non-cooperative jurisdiction with respect to exchange of tax information.

(2) Practical implications

This may give rise to major implications for minority investments, intellectual property management, group finance, etc. performed out of countries where the subsidiary's effective tax rate is 20% or more but under 30% (e.g. the Netherlands), which is not within the scope of the current CFC rules.

4 Financial subsidiaries" is defined as foreign related subsidiaries whose business is banking, financial services, or insurance meeting certain conditions (e.g. the directors or employees of the foreign related subsidiary engage in all the work which is generally required to manage these businesses.)



Under the current CFC rules, since the effective tax rate of B, E and F in the above diagram is 20% or more, these companies are not considered to be specified foreign subsidiaries, and therefore not subject to the CFC rules. As a result of the amendments made in the proposed Tax Reforms, B, E and F may potentially fall within the definition of a ‘Paper Company’ under the new rules. If so, the CFC rules would apply so that the entire income of each of B, E and F will be aggregated and subject to Japanese taxation.

It will therefore be necessary to identify overseas affiliates that may be categorised as Paper Companies falling within the new CFC rules, and to consider possible reorganisation in order to mitigate the Japanese tax risks where necessary. In addition, when considering acquisitions of overseas operating groups, Japanese headquarters will also be required to perform an analysis of whether there are any entities within the group that may be categorised as a Paper or other specified company.

4 Changes of scope to Passive Income

(1) Overview

The scope of income that is subject to the passive income inclusion rules has been substantially expanded as follows. Where the effective tax rate is less than 20%, passive income under the new rules will be subject to the Japanese CFC rules, even if the foreign subsidiary meets the Economic Activity Test and is not defined as “Paper Company”, “Cash Box”, or “Black-List Company”.

The scope of passive income under the proposed new rules compared against the current rules is summarised as follows:

Passive income (current law)	
Bond interest	※
Profits arising from bond redemption	※
Dividend from a company less than 10% is owned by the foreign related company	※
Capital gains arising on the disposal of shares that are less than 10% owned by the foreign related company	※
Capital gains on the disposal of bonds	※
-	
-	
-	
Consideration from ship/aircraft leasing	
Royalties on patent right etc. (except for those royalties that are self-developed patent rights etc.)	
-	
-	

※ : Exempt from CFC taxable income where those income is derived from activities that are fundamental, important and necessary to the business (other than shareholding business etc.).

Passive income (Proposal)	
a. Interest	◎
b. Dividend (except for dividend from a company 25% or more is owned by the foreign related company)	◎
c. Consideration from lending securities	◎
d. Capital gain/loss on securities	◎
e. Profit and loss arising on derivatives transactions	◎
f. Foreign exchange gain or loss	◎
g. Other income related to above a to f.	◎
h. Consideration from tangible fixed assets leasing	
i. Royalties from intangible assets etc.	
j. Capital gain or loss on intangible assets etc.	
k. Certain “irregular amount” income	

◎ : Exempt from CFC taxable income for financial subsidiaries etc. who satisfy certain conditions.

Details of the above types of passive income are set out below:

① **Applicable to other than financial subsidiaries etc.**

a. Interest

However, the following types of interest have been specifically excluded from the definition as out of scope:

- Loan interest where the borrower is a related company of the foreign related company that satisfies certain conditions (e.g. the directors or employees of the foreign related company engage in all the work that is generally required to manage the money lending business.)
- Loan interest arising to a lender that is a foreign related company and related to the borrower, where the borrower is a foreign related company that satisfies the conditions as outlined above.
- Loan interest received by a foreign related company whose business is a money lender and satisfies certain conditions (the directors or employees of the foreign related company engage in all the work which is generally required to manage the money lending business.)
- Bank interest, which derived in the ordinary course of business by the foreign related company

(Deloitte comment) There should be further clarification on the definition of "ordinary" and "generally" as outlined above.

b. Dividends etc.

- Dividends from a company owned 25% or more by the foreign subsidiary (other than dividends that are tax deductible in the hands of the dividend paying company) is excluded from scope.
- Where the main business of the dividend paying company is mining of fossil fuels (including businesses that are closely related to the mining of fossil fuels), the above ownership ratio is reduced to 10% or more.

(Deloitte comment) It should be noted that the reduced ownership percentage of 10% is only limited to fossil fuel businesses and those countries that Japan has tax treaties with.

c. Consideration from securities lending activity

d. Capital gain/loss on disposal of securities

- A capital gain/loss derived from the disposal of shares in a company with 25% or more ownership and satisfy certain conditions is excluded from scope.

e. Profit/loss arising from derivatives transactions

Profit/loss arising from the following derivatives transactions are out of scope:

- Where it is apparent that the derivatives transaction is carried out for the purpose of hedging
- Gain or loss arising from commodity futures transactions derived by a foreign related company that is a commodity futures dealer in the country where its head office is located and meets certain conditions (e.g. the directors or employees of the foreign related company engage in all the work which is generally required to manage the commodity futures transaction)

f. Foreign exchange gain or loss

A foreign exchange gain or loss arising from the ordinary course of the business of the foreign related company (except for where the purpose of the business is derived from earning incomefrom fluctuations of foreign exchange rates) is out of scope.

g. Other income similar to the above income types *a* to *f* arising from assets that could generate such income.

However, where it is apparent that the transactions carried out are for the purpose of hedging, this is out of scope.

h. Consideration from tangible fixed assets leasing

However, the following is out of scope.

- Consideration arising from the leasing of tangible fixed assets where the fixed assets is in use by the company and is used in the country where its head office is located.

- Consideration arising from the leasing of tangible fixed assets derived by a foreign related company meeting certain conditions (e.g. the directors or employees of the foreign related company engage in all the work which is generally required to manage the tangible fixed assets leasing business)

i. Royalties from intangible assets etc.

Royalties arising from intangible assets that have been self-developed, purchased, or licensed for substantial consideration that are used for certain businesses by a foreign related company are out of scope.

(Deloitte comment) It should be highlighted here that the scope has been expanded to include "royalties from intangible assets" rather than royalties arising from industrial property rights such as patents etc. under the current rules.

j. Capital gain or loss on intangible assets etc.

A capital gain or loss on intangible assets that have been self-developed, purchased, or licensed for substantial consideration that are used for certain businesses by a foreign related company are out of scope.

k. A certain amount of the foreign related company calculated by the following formula is subject to the passive income inclusion rules.

Profit of the fiscal year － (total income above (from a to j) + (total assets + accumulated depreciation expenses + labour costs) ×50%)

(Deloitte comment) This calculation gives rise to ‘excessive earnings’ or ‘irregular income’ that exceeds a certain level to be regarded as passive income regardless of the type of income arising. As a concept, this can be considered similar to making a transfer pricing adjustment, and therefore businesses that do not contain much fixed assets or human resources may be particularly affected.

② Applicable to Financial subsidiaries etc.

Whichever is higher, a below, or total of b to e below:

a. Income derived from over capitalisation of the financial subsidiary
b. Above ① h（Consideration from tangible fixed assets leasing）
c. Above ① i（Royalties from intangible assets etc.）
d. Above ① j（Capital gain or loss on intangible assets etc.）
e. Above ① k（Certain amount of excessive earnings/irrecular income）

Losses (“NOL”) carried forward is newly recognised for certain types of passive income subject to CFC taxation. Losses arising on the following types of passive income can be carried forward to offset against future income:

- Other than financial subsidiaries etc.: above ① d to g, and j
- Financial subsidiaries etc.: above ② d

(2) Practical impact

In practice, the extent to which a CFC taxation charge may arise on income from foreign subsidiaries that currently satisfy the Active Business Exemption rule or the Economic Activity Test under the new rules is likely to be increased. For example, Japanese owned groups that have established regional headquarters in countries with lower tax rates such as Singapore and Hong Kong and are investing in Asian countries through those regional headquarters, should review the nature of income received by such regional headquarters. In particular, dividend income and gains on disposals deriving from shares with less than 25% ownership, interest income from group finance, gains and losses on derivative transactions and foreign exchange gains and losses etc. often arise in the headquarters company from Joint Venture investment, fund management and similar activities, and therefore it is necessary to monitor the details of the CFC rules which are due to be amended based on the proposed Tax Reforms.

(Deloitte comment) The UK is a popular location for establishing a regional headquarter function for Europe and beyond, but where its consecutive corporation tax rate reductions in recent years have attracted attention. The UK’s corporation tax rate will be reduced to 19% from April 2017 and therefore will give rise to issues similar to those described above.

5 Changes in scope of Foreign Related Company definition

(1) Overview

A substantive control test is introduced to define control of the foreign related company. The foreign company will be treated as a controlled foreign related company, where certain conditions are met (e.g. the Japanese company has a residual claim for almost all the assets of the foreign company).

(2) Practical impact

Although it is possible to be related to a foreign company not only on the basis of share ownership, but also in the form of loans, dispatching executives etc., it is extremely difficult to put in place a precise provision which comprehensively and accurately covers such a relationship. As such, when the CFC rules were first introduced, this consideration was taken into account and the control test was limited to one based on the capital relationship only[5]. This limitation will be eliminated as a result of the amendments proposed by the Tax Reforms, which appear to give more focus on the purpose of the CFC rules as an anti-tax avoidance measure.

6 Economic Activity Test – Reform of the Active Business Exemption

(1) Overview

The Active Business Exemption under the current CFC rules will be reformed and renamed the Economic Activity Test, with each condition of the Active Business Exemption updated as below. The main aim of this change is to take into consideration an exemption only for certain business activities.

① Business Purpose Test

A foreign related company whose major business is aircraft leasing will be treated as satisfying the Business Purpose Test, where the foreign related company meets certain conditions (e.g. the directors or employees of the foreign related company engage in all the work which is generally required to manage the aircraft leasing business.)

② Substance Test/ Administration and Control Test

A foreign related company which is an insurance consignor will be treated as satisfying the Substance Test/ Administration and Control Test, where the foreign related company meets certain conditions when obtaining the licence as an insurance consignor.

③ Country of Location Test

There will be some necessary updates for a foreign related company whose major business is manufacturing with regard to the Country of Location Test, where the foreign related company is considered to be independently engaged in the important part of the manufacturing business in the country where its head office is located.

(Deloitte comment) From this announcement, it is presumed that some relief measures will be provided for cases where the manufacturing principal and the manufacturer itself are located in different locations, for example, for specific contract processing arrangements in China, which resulted in a large number of precedent court cases about the application of the CFC rules.

④ Unrelated Party Test

- Where the transaction with an unrelated party is determined in advance as if the goods or services are to be transferred or provided to a related party, the transaction is treated as a related party transaction when the Unrelated Party Test is considered.
- Where a foreign related company whose major business is to act as an insurance consignee has a transaction with an insurance consignor, the transaction of the foreign related company is treated as a transaction between unrelated parties when the Unrelated Party Test is considered.
- The Unrelated Party Test will be applied to a foreign related company whose main business is aircraft leasing.

5 "Commentary on Anti-Tax Haven Rules" (Seibunsha, January 10, 1979) Supervised by Gen Takahashi, Ministry of Finance Tax Div. Director

(2) Practical impact

Although the aircraft leasing business is expected to grow with demand for LCCs (Low Cost Carriers) rapidly increasing, the Japanese tax rules were considered to be holding up the growth of Japanese groups in this industry. This is because the current CFC rules clearly state that aircraft leasing does not satisfy the Business Purpose Test. For example, subsidiaries that conduct aircraft leasing business in Ireland are subject to the CFC rules. Under similar rules in other major countries, aircraft leasing businesses with sufficient business substance are typically excluded from equivalent CFC rules, and therefore the proposed Tax Reforms are responding to protests that Japan's aircraft leasing businesses are unfairly disadvantaged against their international competitors.

7 Other major amendments

(1) Document required for submission in relation to the foreign related company

Where the national tax officers ask the Japanese parent company to submit supporting documents that provide proof that the foreign related company satisfies the Economic Activity Test or meets the conditions to be exempted as a Paper Company but the Japanese parent company does not submit them by the due date, the foreign related company will be assumed not to have satisfied the requirements of the Economic Activity Test nor the conditions to be exempted as a Paper Company.

(2) Changes to indirect holding ratio calculation of the foreign related company

The calculation method for testing the indirect holding ratio of the foreign related company will be amended from the multiplication method to testing the shareholding ratio owned by the intermediate foreign holding company which is more than 50% owned by the Japanese parent company.

(Deloitte comment) It will be necessary to review the scope of application, since the indirect holding ratio calculation will be amended from a conventional multiplication method to looking at the shareholding chain relationship that determines control under the corporate reorganisation taxation regime.

(3) Special treatment for dividends from mining fossil fuel business

Where the major business of the dividend paying company is mining of fossil fuels (including businesses that are closely related to the mining of fossil fuels), and the company has a place to mine the fossil fuel located in a country with which Japan has concluded a tax treaty, the minimum 25% ownership requirement for the exclusion of relevant dividend income from the CFC taxable income calculation, would be reduced to 10% or more.

(Deloitte comment) For fossil fuel mining businesses, there are many cases where investment in countries with natural resources is made through an investment SPC based on operational reasons such as ringfencing various risks or reflecting the intention of investment partners. In such cases, there is an increased risk of being subjected to the CFC rules due to the Paper Company criteria (see above section 3 ①), but at the same time, the risk is also reduced to a certain extent by the special treatment of dividends under the CFC rules for mining of fossil fuel businesses. However, since these special rules are limited to fossil fuels mining businesses in countries with which Japan has a tax treaty, such investments in countries (e.g. Peru) with which Japan does not have a tax treaty will need more attention under the new rules.

(4) Requirement to attach the foreign related company’s financials to the Japanese company’s tax return

A Japanese company who holds a foreign related company that is subject to CFC taxation has to attach the financials of the following foreign related company to its corporate tax return.

- A foreign related company whose effective tax rate is less than 20%
- A foreign related company whose effective tax rate is less than 30% (limited to a foreign related company that is considered a paper company etc.)

(5) Effective date

The new rules will become effective for accounting years beginning on or after 1 April 2018 of the foreign related company.

8 Areas that should be considered by Japanese owned groups now

Examples of areas that Japanese owned groups should consider in view of the proposed new CFC rules can be summarised as below. In many cases, it is necessary to manage, analyse, instruct and monitor risks on a global basis, which we envisage will be mainly driven by the Japanese headquarters in a wide range of areas.

- Reviewing, preparing individual documents, and establishing a reporting system to the Japanese headquarters on a continuous basis for those companies not currently monitored due to having an effective tax rate of 20% or more but which may potentially be categorised as a paper company etc. under the new rules;
- For companies whose effective tax rate is less than 20% but pass the Active Business Exemption test and has no passive income under the current CFC rules, to consider the existence of passive income under the proposed expanded definition (e.g. dividends from shares where there is less than 25% ownership, interest income in companies conducting group finance, gains and losses on derivative transactions, foreign exchange gains and losses, etc.), and establish a reporting system to the Japanese headquarters;
- Review the organisational structure based on potential risks identified from the above (e.g. consider the integration of companies where there is sufficient economic substance with a paper company in the same country, or consider reallocation of passive income to a subsidiary located in a country where the effective income tax rate is 20% or more, etc.)
- Review business models based on potential risks identified from the above (e.g. for those businesses that is due to generate passive income on an ongoing basis or for businesses that are predicted to have a large amount of passive income in the future, consider reorganising the business model so that it is more tax efficient etc.)

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