



JAPAN

2009 TAX REFORM

This article is a summary of the significant amendments introduced by the fiscal year 2009 tax reform (FY2009 tax reform). The tax reform bill was passed by the Diet on 27 March 2009 and gazetted on 31 March 2009, and the new tax laws and enforcement orders were issued on 31 March 2009.

International taxation

Under the previous tax law, the taxation of foreign dividends and the application of the foreign tax credit (FTC) and anti-tax haven or controlled foreign corporation (CFC) rules are closely related and their interaction in many cases give rise to complex issues. The principal tax law amendment of the FY2009 tax reform in relation to international taxation is the introduction of a foreign dividend exemption to replace the taxation and credit system. This is arguably one of the most significant reforms of the Japanese tax system in recent years as it represents a fundamental shift in the taxation of foreign dividends.

The change from a taxation and credit system to an exemption system required corresponding amendments to both the FTC and CFC rules. Given the complexity of the interaction of these rules with the new foreign dividend exemption rules, the tax reform presents not only significant planning opportunities but also pitfalls for companies that do not fully understand the impact of the new laws on their global corporate structures.

In addition, as the companies most affected by the reform are likely to be multinational companies with subsidiaries located in various countries, the impact of the reform should also be assessed by taking into consideration any planned tax reforms in those countries. For example, the UK's proposed introduction of a foreign dividend exemption and the Netherlands' proposed reduction of its statutory tax rate to below 25% and simplification of its participation exemption will have a significant impact on the application of the CFC rules in Japan. Accordingly, the combined impact of the Japanese and global tax reforms on Japanese multinational companies will need to be carefully assessed.

1. Exemption of foreign dividends

Previous tax law

Under the previous tax law, a dividend received by a company from a foreign company was included in taxable income and subject to tax at normal rates of corporate tax, irrespective of the level of the shareholding. Double taxation was eliminated through the FTC system as discussed further below.

New tax law

Under the new tax law, 95% of the dividend received by a Japanese company from a foreign company in which it has held at least 25% of the outstanding shares for a continuous period of six months or more ending on the date on which the dividends are declared can be excluded from the company's taxable income. The 25% ownership threshold is limited to direct shareholdings i.e. shareholding of an individual group company that is less than 25% would not qualify for the exemption even if the aggregate shareholding held within a wholly-owned group is 25% or more.

If the foreign company is a resident in a country with which Japan has concluded a tax treaty for the avoidance of double taxation, and such treaty provides for the allowance of an indirect FTC for taxes paid by the foreign company on the profits out of which the dividend is paid where the company holds a certain percentage of the foreign company's outstanding shares, that percentage applies for the purpose of determining the availability of the exemption to the extent that the actual shareholding percentage is lower than 25%.

The new tax law applies to foreign dividends received in fiscal years commencing on or after 1 April 2009.

Comments

- (1) Although a dividend received by a company from another domestic company is included as taxable income if the company has held at least 25% of the outstanding shares of the dividend paying company for a continuous period of six months or more ending on the date on which the dividend is declared, a deduction can be claimed for the amount of the dividend received less any interest expense attributable to the dividend. In this regard, the conditions for the application of the foreign dividend exemption are similar to those for the domestic dividend exemption and the indirect FTC system discussed below. It appears that the taxation of 5% of the dividend received is intended as an arbitrary amount to cover the costs of holding the shares including financing costs.
- (2) Companies that have recognised a deferred tax liability for tax on foreign dividends that have not been repatriated to Japan may be able to write back the liability. Depending upon the company's accounting policies, this could result in a reduction of the company's effective tax rate in its consolidated financial statements. Companies should discuss the appropriate accounting treatment with their independent auditors.
- (3) The exemption of foreign dividends may result in the tax authorities increasing their scrutiny of other international tax-related areas such as transfer pricing and the application of the anti-tax haven rules, to avoid abusive tax practices to take advantage of the new exemption.

2. Foreign tax credit system

Previous tax law

As mentioned above, under the previous tax law, a dividend received by a company from a foreign company was included in the taxable income and subject to tax at normal rates of corporate tax. However, in order to eliminate double taxation, a FTC was allowed for (i) foreign taxes directly paid by the company on the dividend (e.g. withholding tax imposed by the country in which the dividend paying company is located) and (ii) taxes paid by the dividend paying company (1st tier subsidiary) and, if the 1st tier subsidiary has itself received dividends from its subsidiary (2nd tier subsidiary), taxes paid by the 2nd tier subsidiary. The latter was commonly referred to as the "indirect FTC system" and was available if, in the case of a 1st tier

subsidiary, the company had held 25% or more of the total number of shares, amount of investment in capital or voting shares in the 1st tier subsidiary for at least six months prior to the dividend declaration date and, in the case of a 2nd tier subsidiary, the company had an indirect interest of at least 25% in the 2nd tier subsidiary and the 1st tier subsidiary has held 25% or more of the total number of shares or voting capital of the 2nd tier subsidiary for at least six months prior to the declaration date of dividend from the 2nd tier subsidiary to the 1st tier subsidiary.

New tax law

The introduction of the foreign dividend exemption eliminates any potential double taxation and thus, the indirect FTC system has been repealed, although certain transitional measures are provided for. In addition, foreign tax directly paid on the exempt dividends (e.g. withholding tax) is no longer eligible for direct FTC claim or deduction from taxable income. Such tax should be added back to taxable income. Foreign taxes directly paid on foreign dividends received from shareholdings of less than 25% continue to be eligible for a direct FTC claim as the dividends continue to be taxable.

The new tax law applies to foreign dividends received in fiscal years commencing on or after 1 April 2009.

Comments

- (1) As the amendments only apply to exempt foreign dividends, foreign taxes directly paid on shareholdings of less than 25% will continue to be eligible for direct FTC claim or deduction from taxable income. The reform does not include any changes to the direct FTC system for other types of foreign source income (e.g. royalties, interest and profits of a foreign branch) and thus, foreign taxes paid on such income continue to be eligible for FTC relief within the FTC limitation. As the FTC rules do not quarantine different types of foreign source income or the countries from which such income is derived, it is possible for FTC relief in respect of one type of foreign source income from a high tax jurisdiction to reduce the Japanese tax liability on another type of foreign source income from a low tax jurisdiction (cross crediting). The repeal of the indirect and direct FTC for dividends reduces the ability to cross credit and could result in an increased Japanese tax liability on other types of foreign source income.

- (2) A company that has a branch in a foreign country is subject to tax on the profits of that branch (with FTC relief being available for foreign taxes paid). Whether the dividend exemption makes it more tax efficient to conduct a foreign business through a subsidiary rather than a branch needs to be analysed and if necessary, the branch may need to be converted into a subsidiary.
- (3) Whether the combined impact of the foreign dividend exemption, repeal of the indirect FTC system and disallowance of a direct FTC claim increases or decreases a company's overall global tax liability on foreign dividends and its effective tax rate varies from company to company depending upon its particular circumstances. Companies should prepare simulations to assess the combined impact of the new and transitional rules in Japan and the related tax reform in foreign countries and if necessary, reconsider their policies for the repatriation of profits from foreign subsidiaries. This would include the timing of declaring dividends i.e. before or after the effective date of the new rules. In some cases, it may be necessary for a company to undertake a reorganisation of its foreign subsidiaries in order to maximise its tax efficiency under the new rules.

3. Anti-tax haven rules

Previous tax law

Under the previous tax law, in general, when calculating the undistributed income of a CFC to be included in the taxable income of a Japanese shareholder: (i) a dividend received by the CFC was included in the undistributed income; and (ii) a dividend paid by the CFC to a shareholder that is subject to tax on the dividend at a rate greater than 25% could be deducted from the undistributed income.

For a company receiving a dividend from a foreign company where the dividend was paid from earnings that had previously been taxed to the company under the CFC rules (previously taxed earnings), double taxation was eliminated through the allowance of a deduction for previously taxed dividends, provided that such earnings had been included in the company's taxable income within the previous ten years up to the end of the fiscal year preceding the year in which the dividend was received. However, the company was still entitled to claim a FTC for direct and indirect taxes paid in respect of the dividend, with an adjustment for any FTC claimed at the time the earnings were taxed under the CFC rules.

New tax law

When calculating the undistributed income of a CFC, a dividend paid by the CFC is not deductible.

However, a dividend received by the CFC from a company in respect of which it has held a shareholding of at least 25% of the outstanding shares for a continuous period of six months or more ending on the date on which the dividend is declared can be deducted from the undistributed income. The new law does not make any distinction between dividends received by the CFC from another company in the same country (domestic dividends) or in a different country (foreign dividends). In addition, a dividend received by the CFC from another CFC can be excluded to the extent that such dividend can be attributed to previously taxed earnings.

If a company receives a dividend from a foreign company where the dividend is paid from previously taxed earnings and 95% of the dividend is exempt under the foreign dividend exemption, a deduction for previously taxed dividends is not available. However, a corresponding "expense" deduction will be allowed to the extent of the previously taxed earnings to achieve the full tax exemption.

The new tax law applies to the fiscal years of a CFC commencing on or after 1 April 2009. For example, if a CFC has a fiscal year end of March 31, the new tax law is applicable to the calculation of its undistributed income for the fiscal year 1 April 2009 to 31 March 2010.

Comments

The exclusion of dividends received by a CFC from the calculation of undistributed income results in an equitable treatment of foreign dividends received through a non-CFC and a CFC. As the underlying policy of the amendment is to exempt foreign dividends, it would be contrary to this policy if dividends received through a CFC were subject to Japanese tax through their inclusion in the undistributed income of the CFC. This treatment may also minimise the adverse CFC impact of the current tax reform proposals in the UK and the Netherlands that may affect Japanese multinational companies with holding companies located in these countries.

4. Investment into certain partnerships and the 25/5 Rule

Determination of permanent establishment in relation to foreign investment in certain Japanese partnerships

Previously, an investment in a Japanese investment business limited partnership (*toushi jigyou yugen sekinin kumiai*, or “IBLP”) created a Japanese permanent establishment (PE) risk for a foreign investor. Under the new tax law, a foreign individual or corporate partner (Foreign Partner) may invest in an IBLP without the risk of a direct PE arising as a result of such investment provided certain requirements are met, including:

- (1) the Foreign Partner has limited liability with respect to the IBLP;
- (2) the Foreign Partner is not involved in the management or operation of the IBLP;
- (3) the Foreign Partner’s investment ratio in the IBLP is less than 25%;
- (4) the Foreign Partner is not specially related to the general partner of the IBLP; and
- (5) the Foreign Partner does not otherwise have a PE in Japan.

The new tax law applies to determinations of whether a Foreign Partner has a direct PE in Japan in relation to an investment in an IBLP with regard to domestic sourced income on or after 1 April 2009.

Application of the 25/5 Rule to certain foreign partners

Previously, a Foreign Partner without a PE in Japan was taxable on a gain from the sale of shares in a Japanese corporation if the Foreign Partner (together with specially related persons) sold 5% or more of the shares of such corporation during a fiscal year and such Foreign Partner (together with specially related persons) owned 25% or more of the shares in such company for a specified holding period (the “25/5 Rule”).

Under the new tax law, the application of the 25/5 Rule for certain transactions where the sale is made by an IBLP or other foreign partnership funds similar to an IBLP, has been relaxed, provided certain conditions are satisfied. The new tax law is intended to apply to transactions where (i) a 1-year holding period criteria is met; and (ii) the transaction does not involve a shareholding in certain distressed financial institutions, and if applicable, the 25% ownership threshold may be tested at the Foreign Partner level where the following conditions are met:

- (1) the Foreign Partner meets the criteria provided in 4 above; or

- (2) the Foreign Partner is in a partnership similar to an IBLP where (i) the Foreign Partner does not have a PE in Japan; (ii) the Foreign Partner is a limited partner in the partnership; (iii) the Foreign Partner does not own 25% or more of the shares of the corporation sold; and (iv) the Foreign Partner is not involved in the management or operation of the partnership.

The new tax law is applicable to sale of shares on or after 1 April 2009.

Scope of Japan-sourced income with regard to redemption gain on discount bond received by a foreign corporation

The scope of Japan-sourced income in relation to redemption gains on discount bonds received by a foreign corporation has been revised so that the taxation of redemption gains on discount bonds received by a foreign corporation is now the same as interest on bonds received by a foreign corporation. The following changes have been made:

- (1) With regard to a redemption gain on a discount bond issued by a foreign corporation, the redemption gain attributable to any business conducted by the foreign corporation in Japan is deemed to be Japan-sourced income for corporation tax purposes; and
- (2) A redemption gain on a discount bond received by a foreign corporation without a PE in Japan is subject to withholding tax only, and the foreign corporation is not required to file a corporation tax return.

The above amendment is applicable to discount bonds issued on or after 1 April 2009.

Tax loss carryback for small-medium sized companies

Previous tax law

Although tax losses can be carried back for one year, the provision allowing such carryback has been suspended for tax losses arising in fiscal years ending between 1 April 1992 and 31 March 2010 except for (i) losses of a small or medium sized company (excluding a subsidiary of a large sized company with capital of more than JPY100 million, etc.) arising within five years of its establishment (until 31 March 2010) or (ii) in the case of liquidation.

New tax law

Tax losses recognised by a small or medium sized company (defined as a company with the stated capital of JPY100 million or less at the year end, regardless of its parent’s capital amount) for fiscal years ending on or after 1 February 2009 can be carried back for one year.

Finance industry related amendments

1. Corporate securities

Taxation related to dividend income and capital gains from listed stocks for individuals

The applicable period of the existing concessionary individual income tax rate of 10% (national 7%, local 3%) for dividend income paid from listed stocks and capital gains derived from the disposal of listed stocks has been extended to cover the period from 1 January 2009 to 31 December 2011.

Withholding tax rate for dividends from listed stocks

- (1) The applicable period of the existing concessionary withholding tax rate of 10% (national 7%, local 3%) for dividend income on listed stocks paid to Japanese resident individuals or non-resident individuals who have a PE in Japan has been extended for one year to 31 December 2011.
- (2) The applicable period of the existing concessionary withholding tax rate of 7% for dividend income on listed stocks paid to non-resident individuals without a PE in Japan, Japanese corporations or foreign corporations, has been extended to 31 December 2011 (currently 31 March 2009).

Withholding tax rate applicable to “Special Accounts” for individuals

The period in which the existing concessionary withholding tax rate of 10% (national 7%, local 3%) is applicable (which originally applies to dividend income from listed stocks kept in a Special Account for the period from 1 January 2009 to 31 December 2010) has been extended for one year to 31 December 2011.

Taxation of covered warrants for individuals

Capital gains derived from the sale of covered warrants listed on the financial instrument exchange (Listed Covered Warrants) and income arising from the net settlement of Listed Covered Warrants will be treated as other income derived from forward transactions which is subject to separate taxation for Japanese income tax purposes. This amendment is applicable to the disposal and net settlement of Listed Covered Warrants on or after 1 January 2010.

2. Tokutei Mokuteki Kaisya (TMK) and investment corporation

Revision of the scope of qualified institutional investors

Under the previous tax law, a TMK (i.e. a special purpose vehicle) was not included in the definition of “qualified institutional investor” (QII). Under the FY2009 tax reform, if a TMK securitises (i) specified bonds issued by another TMK, or (ii) a specified loan borrowed by another TMK collateralised by real property, the TMK conducting the securitisation would be considered as falling within the scope of a QII in determining whether the following conditions are satisfied for the purpose of applying the dividend deductibility rules:

- (1) specified bonds are entirely underwritten by QIIs; and
- (2) specified loans are entirely financed by QIIs.

Revision of the 90% test for dividend deductibility

Under the previous tax law, a TMK or a Japan-real estate investment trust (J-REIT) was required to pay dividends in excess of 90% of its “distributable taxable income” to meet the dividend deductibility test. Under the 2009 tax reform, “distributable taxable income” has been revised to “distributable profit” for accounting purposes. However, certain adjustment measures have been introduced. For example, where negative goodwill is recognised, such negative goodwill is excluded from the “distributable profit” of the fiscal year in which it is recognised.

Treatment of cash delivered due to merger corresponding to dividends

The treatment of cash delivered due to merger (*Gappei Kofu-kin*) between J-REITs has been clarified so that *Gappei Kofu-kin* corresponding to dividends is included in the scope of deductible dividends for J-REITs.

Extension of special taxation measures for transfer taxes

- (1) The scheduled increase of the reduced registration tax rates on the transfer of ownership of real property acquired by a TMK based on the Asset Liquidation Plan or acquired by a J-REIT on or after 1 April 2009 has been suspended for one year and the existing reduced registration tax rates of 0.8% applies for a further year.
- (2) The 1/3 tax-base exception on certain real property acquired by TMK based on the Asset Liquidation Plan or acquired by J-REIT with regard to real property acquisition tax has been extended for two years.