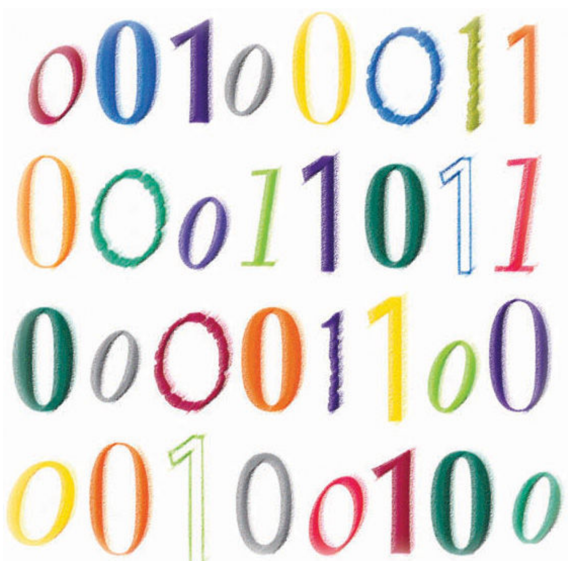
Japan tax bulletin

Quarterly newsletter on important tax and business developments in Japan

October 2009

In this issue

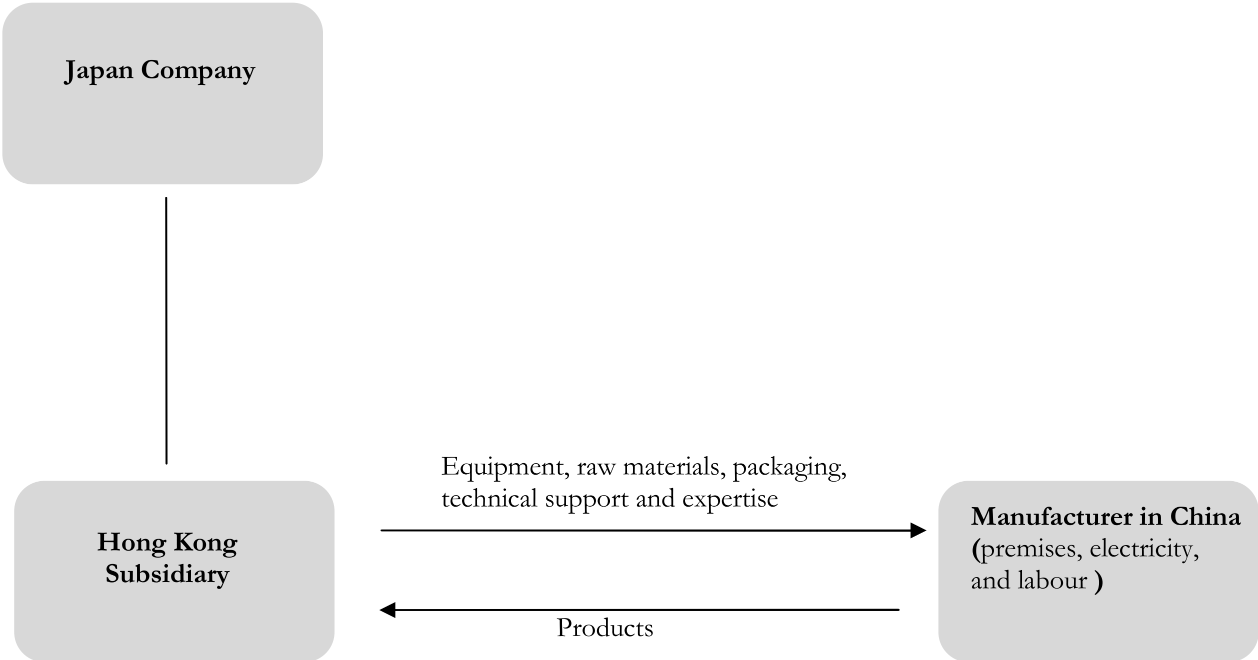


Consignment manufacturing and Japan's tax haven rules

Introduction

A recent decision by the Tokyo District Court[1] held that Japan's tax-haven rules apply to the Hong Kong subsidiaries typically used by Japanese firms in consignment manufacturer arrangements. The decision follows the long held position of Japan's National Tax Agency (NTA).

In a typical consignment manufacturer arrangement, a Japanese firm via a Hong Kong subsidiary will lease or provide equipment, raw materials, packaging, technical support and expertise to a consignment manufacturer located in mainland China. The manufacturer provides premises, electricity, and labour, to manufacture the Japanese company's products. The manufacturer sells the finished goods to the Hong Kong subsidiary, charging for the manufacturing process. Numerous Japanese firms receive tax benefits through use of such consignment manufacturers.



1 Tokyo District Court, Heisei 18, Gyo-U, 322, May 28th, 2009

Tax haven countermeasures

Japan's tax haven rules are designed to prevent Japanese taxpayers from using foreign corporations located in low tax jurisdictions to reduce the taxpayer's tax burden in Japan. The rules designate a tax haven subsidiary to be any foreign corporation located in a jurisdiction where corporate income tax is 25% or less that is more than 50% owned, directly or indirectly, by Japanese residents.

If a Japanese resident individual or corporation owns 5% of the stock of such a subsidiary, or is a member of a group of affiliates that collectively owns 5%, the taxpayer is required to include its prorated share of the taxable retained earnings of the subsidiary in its income for Japan tax purposes.[2]

The tax haven rules are not intended to apply to subsidiaries with legitimate business activities. Income of a subsidiary that meets each of the following conditions is exempt from the rules:

a. Active business requirement

The main business of the subsidiary must be other than holding debt or equity securities, licensing intellectual property rights, or leasing ships or aircraft.

b. Substance requirement

The subsidiary must have a fixed business facility in the jurisdiction where its head office is located, and the facility must be necessary for the subsidiary to conduct its main business.

c. Local management and control requirement

The subsidiary must itself manage and control its main business in the jurisdiction where its head office is located.

d. Requirement to deal with unrelated persons, or local business requirement

If the main business of the subsidiary is wholesale trade, banking, insurance, or a similar business, more than 50% of the business must be conducted with unrelated persons.

If the main business of the subsidiary is retail, manufacturing, services, real estate, leasing o f property, construction, agriculture, forestry, or a similar business, the subsidiary must conduct its main business within the jurisdiction where its head office is located.

The NTA's position has long been that the main business of a Hong Kong subsidiary in a consignment manufacturer arrangement is manufacturing, and that the main business is conducted in China rather than Hong Kong. Therefore, according to the NTA, such a subsidiary fails to meet the applicable local business requirement condition (d (2) above).

Decision

The taxpayer in the case argued that the main business of the subsidiary was wholesale trade, hence the applicable requirement is that 50% of the business must be conducted with unrelated persons.

The Tokyo court agreed with the NTA's position, holding that for the purpose of applying Japan's tax haven countermeasures, the main business of the HK subsidiary is manufacturing rather than wholesale.

The court listed the following reasons for its decision:

- The Hong Kong subsidiary controls the investment in the manufacturing facility, and has control over facility maintenance, labor management, material procurement, and financial control of the operation.
- The Hong Kong subsidiary declares to the Hong Kong tax authority that it operates a wholesale business in Hong Kong and a manufacturing business in China, in addition to it being registered as a manufacturing company in Hong Kong.
- The Hong Kong subsidiary contractually undertakes the management of the factory in China, has the associated management rights and control, and bears all costs of factory management.

The effect of the decision is to bring Hong Kong subsidiaries within the tax haven rules. As a result, income from Hong Kong subsidiaries with mainland consignment manufacturers must be included in the taxable income of the Japan parent company. According to the court report, the taxpayer intends to file an appeal.

2 When applying the 50% and 5% ownership tests, shareholdings of directors are included regardless of country of residence.

Tax agreement with Switzerland

Japan and Switzerland have reached an initial agreement on a revised Japan-Switzerland tax treaty. The current treaty has been in effect since 1971. Key revisions include reduction of withholding tax rates on dividends, interest, and royalties, and expanded information exchange between the two countries.

The revised treaty will be one of the first treaties (the other with the US) reflecting Switzerland's recent movement toward adoption of OECD standards, notably regarding banking secrecy and sharing of taxpayer information, via new tax agreements.

Switzerland's recent commitment to increase transparency is in response to pressure from the G-20. In April 2009, the G20 placed Switzerland and other tax havens on a 'grey list', and warned that failure to sign tax deals following OECD standards would result in sanctions.

Dividends

Under the current treaty, withholding rates on dividends are 10% for shareholders directly owning 25% or more of voting rights, and 15% for all other shareholders. Under the new agreement, there will be 3 rate classifications: exemption from withholding for shareholders with 50% or more share ownership, 5% for shareholders with 10% or more share ownership, and 10% for shareholders with less than 10% ownership.

Interest

The new treaty will expand the scope of the current withholding exemption to include interest received by banks. Under the current treaty the exemption only applies to interest received by governments.

Royalties

The new treaty will eliminate withholding tax on royalties.

Withholding rates on dividends

	Current treaty	Revised treaty
Shareholder with 50% or more ownership	-	Exempt
Shareholder with 25% or more ownership	10%	-
Shareholder with 10% or more ownership	-	5%
Shareholder with less than 10% ownership	15%	10%

Withholding rates on interest

	Current Treaty	Revised Treaty
Interest paid to governments	Exempt	Exempt
Interest paid to banks	10%	Exempt
Other interest	10%	10%

Withholding rates on royalties

	Current Treaty	Revised Treaty
All licensees	10%	0

Contact us for any enquiry on our service;

Yoichi Ishizuka
Managing Partner, Tax Services
Tel: 03-5770-8870 email: yishizuka@gtjapan.com

Naoji Sato
Partner, Transfer Pricing services
Tel: 03-5770-8848 email: nsato@gtjapan.com

Hideharu Tanaka
Partner, International tax services
Tel: 03-5770-8871 email: htanaka@gtjapan.com

Kumiko Miyajima
Partner, International tax services
Tel: 03-5770-8914 email: kmiyajima@gtjapan.com

Joseph Daniels
Director, International tax services
Tel: 03-5770-8765 email: jdaniels@gtjapan.com

Eric Keuling
Director, International tax services
Tel: 03-5770-8898 email: ekeuling@gtjapan.com

Yuka Iizumi
Manager, International tax services
Tel: 03-5770-8892 email: yiizumi@gtjapan.com

Stephan Forest
Assistant Manager, Corporate services
Tel: 03-5770-8839 email: sforest@gtjapan.com

Disclaimer

The information is general in nature and it is not to be taken as a substitute for professional consultation. ASG Tax Corporation accepts no responsibility for any loss that may occur to any party acting on information contained herein.

ASG税理士法人
ASG Tax Corporation