Japan Tax Bulletin

Navigating the New Horizons of Japan's Controlled Foreign Company Regime

April 2024

In the ever-evolving landscape of international taxation, the Controlled Foreign Company (CFC) regime has emerged as a critical tool for jurisdictions seeking to curb tax avoidance through the strategic allocation of profits to subsidiaries in low-tax jurisdictions. This article aims to unpack the complexities of the CFC regime, with a focus on the recent amendments in Japan, providing a comprehensive understanding for businesses and tax professionals navigating these changes.

1. *Introduction to the Controlled Foreign Company (CFC) Regime*

(1) Scope and Types of Foreign Related Corporations

Under Japan's CFC regime, a CFC is identified based on the percentage of shares owned by Japanese residents or corporations, either directly or indirectly. If a Japanese resident or corporation owns more than 50% of a foreign corporation, or has de facto control over it, that foreign corporation is considered a CRC and may be subject to Japan's CFC rules. CFC fall under the three categories, i.e. specified CFC, Full inclusion CFC and partial inclusion CFC. Specified CFC is a paper company which does not satisfy the business substance test and the management control test of the economic activity tests, a cash box company of which a certain passive income to total asset ratio is more than 30%, and a black list company which is headquartered in a country or a region designated by Minster of Finance as those significant insufficient with significantly inadequate cooperation in international efforts to exchange information. Full inclusion CFC is a CFC which does not satisfy one or more of business activity tests. A partial inclusion CFC is a CFC which satisfy all the economic activity tests.

The economic activity tests are the business purpose test, the substance test, the management and control test and either the unrelated party test or the country of location test.

(iv) Even if an SFS satisfies the above e

(2) Taxation Principles

The key principle behind CFC taxation is the inclusion of profits of CFC in the taxable income of the Japanese parent company under certain conditions.

A) Entity-Based Aggregation:

All income of a specified CFC and a full inclusion CFC is taxable to the Japanese shareholder if the burden ratio is below the 'trigger' rate.

B) Income-Based Aggregation:

Certain 'passive' income categories earned by a partial inclusion CFC are taxable to the Japanese shareholder if the burden ratio is below the 'trigger' rate.

(3) Tax Burden Ratio

The tax burden ratio, a critical factor in determining whether a CFC is subject to inclusion, is calculated based on the taxes paid by the foreign corporation relative to its taxable and non-taxable income. Where the tax burden ratio 20% or more, a full inclusion CFC and a patrial inclusion CFC is exempt from CFC. Where the tax burden ratio is 27% or more, a specified CFC is exempt from inclusion.

2. *Recent Amendments to Japan's CFC Regime*

Japan, aligning with global tax reform trends, has introduced significant amendments to its CFC regime as part of the fiscal year 2023 tax reforms. These changes are primarily aimed at simplifying the regime and adjusting it in response to the global minimum tax initiatives under Pillar Two of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

Key amendments as below:

(1) Lowering of the Tax Burden Ratio for Specified CFC:

The threshold for the tax burden ratio that exempts specified CFC from full inclusion has been reduced from 30% to 27% in 2023 tax reform. This adjustment is aimed at broadening the scope of foreign subsidiaries that fall under the CFC regime, ensuring that more profits are taxed at the parent company level in Japan.

(2) Timing of inclusion

Taxable inclusion amount is deemed to be taxable revenue for Japanese domestic company’s business year including the day 4 month later (currently 2 month) after the business year end of CFC in 2025 tax reform. The change is applicable from a business year starting on or after April 1, 2025 of Japanese domestic company.

(3) Relaxation of Documentation Requirements:

The following items shall be excluded from the scope of documents concerning affiliated foreign companies that are required to be attached to or preserved with the tax return in 2025 tax reform.

- Statement of changes in shareholders' equity and statement of appropriation of profit and loss
- Statement of account breakdown for balance sheets and statements of income

(4) Countermeasures to Global Minimum Taxation:

Where full inclusion income of CFC is calculated in accordance with local county's tax rules, it is made clear that the tax rules are not for those for IIR, UTPR, and QDMTT in 2024 tax reform.

(5) Tax burden ratio where QDMTT is applicable:

The taxable income and non-taxable income in denominator of tax burden ration calculation, it is made clear that they are not amounts for QDMTT calculation in 2024 tax reform.