Japan Tax Bulletin

Foreign Tax Credit System in Japan

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The Foreign tax credit system is designed to avoid international double taxation. It allows a corporation to deduct, within certain limits, the amount of foreign corporate income tax paid or withheld abroad from its corporate tax liability. A domestic corporation and a foreign corporation which has a permanent establishment in Japan are allowed to take advantage of the foreign tax credit. The following explanations are for a domestic corporation. A foreign corporation is able to take foreign tax credit for eligible foreign taxes on income attributable to a permanent establishment in Japan.

1. Definition of Foreign taxes to be eligible for the tax credit

The following types of foreign corporate taxes are considered eligible for the foreign tax credit under Japanese tax law:

(a) Taxes imposed under foreign legislation where the corporation's income serves as the basis for taxation

(b) Taxes imposed based on gross revenue instead of income, such as withholding taxes on dividends, royalties, interest, and professional service fees

On the other hand, the following types of taxes are not eligible for the foreign tax credit:

(c) Taxes that are not income based, such as value-added tax

(d) Taxes which are imposed at a rate higher than the reduced rate stipulated on a relevant tax treaty.

(e) Taxes for which the taxpayer is entitled to request a full or partial refund at their discretion after payment

(f) Surcharges, such as penalties and interest

2. The foreign tax credit limitation

2-1. Formula to calculate the foreign tax credit limitation

The foreign tax credit limitation is calculated below:

Japan corporate income tax for the year x Adjusted foreign source income for the year / Worldwide income for the year

The above formula represents the corporate tax credit limit. As for the credit limit for inhabitant tax, which is a part of local taxes, it is generally calculated by multiplying the corporate tax credit limit by the inhabitant tax rate.

2-2. Adjusted foreign source income

(a) Adjusted foreign source income is calculated as foreign source income minus non-taxable foreign source income.

(b) Foreign source income includes income attributable to foreign permanent establishments, as well as the other foreign source income such as dividends, interest, royalties, and service fees excluding those attributable to foreign permanent establishments.

(c) Non-taxable foreign source income refers to foreign source income that is not taxed due to local or tax treaty rules.

(d) Adjusted foreign source income for the year is capped at 90% of worldwide income for the year.

(e) Direct expenses that are directly attributable to foreign-source income must be deducted from foreign source income.

(f) Common expenses incurred in relation to both foreign-source income and domestic-source income, the portion attributable to foreign-source income must be reasonably allocated using an appropriate allocation method in accordance with the Corporation tax law and deducted accordingly.

2-3. Carried forward system

Foreign taxes in excess of the credit limitation can be carried

forward for up to three years. Unused portion of foreign tax credit limitation can be carried forward for up to three years.

3. Tax sparing credit

Tax sparing credit enables certain tax incentives granted by developing countries such as tax exemptions or reductions to be treated as if tax had actually been paid. Under this system, taxpayers can claim a foreign tax credit for amounts that would have been payable if such incentives had not been granted. This preserves the benefit of the local tax relief while avoiding double taxation in Japan. The application of tax sparing credits is based on specific provisions included in Japan's bilateral tax treaties. As of now, the tax sparing credit is effective under Japan's tax treaties with six countries: Zambia, Sri Lanka, Thailand, China, Bangladesh, and Brazil. Among these, China is notable for its frequent application, particularly with respect to royalty payments. For example, in case where China imposes a 10% withholding tax on royalties, the Japan-China tax treaty allows for a deemed credit of 20% under the article 23③(c).

4. Timing of applying the foreign tax credit

In principle, the foreign tax credit is applied in the fiscal year that includes the date on which the foreign tax is paid. In the case of a self-assessment system, the date on which the foreign tax is paid refers to the date of filing the tax return. In the case of a withholding tax system, it refers to the date of payment of interest, dividends, or royalties subject to withholding tax.

5. Filing requirement

In order to claim a foreign tax credit, taxpayers must submit a detailed schedule with the final corporate tax return and to retain supporting documentation evidencing the imposition of the relevant foreign income tax. This documentation may include, but is not limited to, copies of foreign tax returns, certificates of tax payment, official tax assessment notices, and withholding tax certificates.

6. Treatment of Foreign tax credits on withholding tax imposed on Service provision

When a company provides services to an overseas client, withholding tax may be imposed under the domestic laws of source countries. However, under Japan's tax treaties (excluding certain jurisdictions, such as India), income derived from the provision of services is generally classified as business income. These incomes are only taxable in the source country if the Japanese company has a permanent establishment (hereinafter referred to as a PE) there. Accordingly, withholding tax should not be levied in the absence of a PE. Nevertheless, in practice, some countries may impose withholding tax even where no PE exists. In such cases, the portion of tax withheld that exceeds the maximum rate permitted under the applicable tax treaty is not eligible for foreign tax credit relief in Japan. To recover the excess tax, the taxpayer must apply a refund claim with the relevant foreign tax authority. If a refund is not obtained, the excess amount, although not creditable under Japan's foreign tax credit system, is treated as a deductible expense in the fiscal year that includes the payment date.

7. Tax planning of choosing between tax credit and tax deduction

Taxpayers may elect to treat foreign taxes either as a tax credit or as a deductible expense. This election must be made consistently for all foreign taxes incurred during the fiscal year. As a general rule, applying the foreign tax credit is more beneficial, as it directly reduces Japanese corporate tax liability. However, in cases where continued tax losses are anticipated, or under certain other circumstances, it may be more beneficial to treat the foreign tax as a deductible expense. In such cases, the amount can be carried forward as part of taxable losses for up to ten years. Please note that once the deduction method is elected, any previously carried forward unused portion of foreign tax credits limitation or excess credit limitation will lapse at that time. Therefore, we recommend carefully considering which method is more beneficial based on company's future plans.

Should you have any questions regarding this topic or wish to discuss potential tax planning strategies, please do not hesitate to contact us.