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Japan tax bulletin

Newsletter on important tax and business developments in Japan

October 2014

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New rules for the taxation of Permanent Establishments and measures planned for consumption tax on electronic sales including the “reverse charge” mechanism.

This edition of our newsletter contains details of changes to the taxation of Permanent Establishments in Japan under the AOA (Authorised OECD Approach) and details of new measures being planned by the government to correct an imbalance in the consumption tax treatment on electronics sales for domestic and overseas companies.



Taxation of PEs

Taxation of a Permanent Establishment under the Authorised OECD Approach (AOA) approach

The AOA (Authorised OECD Approach) rule for taxation of Permanent Establishments (PEs) was introduced in the 2014 tax reform and will come into force for fiscal years beginning after March 31 2016. The new rule includes changes to the source rule, introduction of transfer pricing to intra-company transactions and the introduction of new documentation requirements for income attributable to PE.

Source rule

According to the current source rule, domestic source income for business income is different from income attributable to a PE. Currently, a foreign corporation operating in Japan through a PE is liable to corporate income tax on the domestic source income of the PE. Therefore, any foreign source income that is attributable to the PE is out of the scope of corporate income tax.

Under the new rule, domestic source income for business income will be the income attributable to the PE. A foreign corporation is subject to corporate income tax as long as the definition of its income follows Art 138(1)(i) of the Corporation Tax Law (“CTL”). According to the revised Art 138(i), domestic source income for business income will be defined as:

“Where a foreign corporation conducts business through a PE, domestic source income will be income attributable to PE with reference to functions performed by the PE, assets employed by the PE, intra-company transactions etc. assuming that the PE is a separate enterprise conducting business independently from the foreign corporation.”

In addition, new rules were introduced for calculating the income attributable to a PE.

Disallowance of interest expenses on equity attributable to a PE

In situations where the equity (net assets) of a PE is lower than the equity of the foreign corporation which is attributable to that PE, any interest charged that corresponds to the difference is non-deductible.¹

Disallowance of head office expense allocation

In order for a PE to take a tax deduction for allocated head office expenses, sufficient documentation on how the expense was allocated must be maintained. If the documentation is insufficient the expense will be disallowed for tax purposes.

Foreign tax credits

Where a PE pays foreign tax on foreign source income, the PE is allowed to take a foreign tax credit against its Japan corporation tax. The maximum credit available is capped at the amount of Japan corporation tax due on the foreign source income².

Intra-company transaction

Under the current rule, certain intra-company transactions such as intra-company licenses, intra-company loans etc, are not recognized³. After implementing the new rule, intra-company transactions will be recognized. Intra-company transactions are transactions with the head office or other offices in the same entity which would be made between independent enterprises, such as the transfer of assets, provision of services etc.⁴

Transfer pricing rule

The Japanese transfer pricing rule is applied to transactions between separate legal entities which are related in terms of ownership and other substantive control⁵. Although the arm's length

¹ Art 142-4 of CTL

² Art 144 of CTL.

³ Art 176(3)(ii) of Corporation Tax Law Enforcement Ordinance (“CTLEO”)

⁴ Art 138(2)

⁵ Art 66-4 of the Special Taxation Measures Law (“STML”)

principle is applicable to intra-company transactions, Art 66-4 of STML does not apply to them. From a transfer pricing perspective there are differences between intercompany transactions and intra-company transactions in terms of the statute of limitation, presumptive assessment and documentation requirements. In connection with the tax reform, the transfer pricing rule will be applied to intra-company transactions in the same way as it is applied to intercompany transactions.

Art 66-4-3 of STML was introduced as a set of transfer pricing rules to be applied to intra-company transactions. Art 66-4-3 is identical to STML 66-4 and has the same rules for the statute of limitation, presumptive assessment and documentation requirements as those that are applied to intercompany transactions.

Transfer pricing documents must be submitted without delay when requested. When the company fails to meet the deadline, the tax authorities are authorized to tax the company by presumptive assessment. Transfer pricing documents includes documents describing both intra-company transactions and the arm's length price for intra-company transactions.

Documents describing intra-company transactions⁶

- Documents describing details of assets and services in intra-company transactions.
- Documents describing functions performed and risks assumed by a PE and head office etc.
- Documents describing intangible assets and tangible assets utilized by a PE and head office etc.
- Contracts or equivalent documents that describe the transfer of assets, provision of services or other facts.
- Documents describing the method of determining the intra-company transaction price as well as the negotiation process on how the price was reached.
- Documents describing profit/loss on the intra-company transaction between the PE and head office etc.
- Documents describing the market analysis of the intra-company transaction.
- Documents describing the business policy of

⁶ Art 22-10-3(1) of Special Taxation Measures Law Enforcement Regulation("STMLER")

the foreign corporation, and the business activities of the PE and head office etc.

- Documents describing other transactions that are (including other intra-company transactions) closely connected to the intra-company transaction, along with the contents of the transaction.

Documentation requirements for the PE

A PE is required to prepare and maintain documents relating to both intra-company transactions and its transactions with third parties.⁷

Documentation for third party transactions⁸

A PE is required to prepare the following documents:

- Documents describing the contents of transactions attributable to the PE ("PE attributable intercompany transactions")
- Documents describing the details of assets and liabilities utilized by the PE and head offices etc for PE attributable intercompany transactions.
- Documents describing the functions and risks performed and controlled by the PE and head office etc in PE attributable intercompany transactions. The functions include labour functions and other functions in relation to assets attribution and risks involved.
- Documents describing the departments engaged in the functions performed in PE attributable intercompany transactions and the department's business description.

Documentation for intra-company transactions⁹

A PE is required to prepare the following documents:

- Orders, contracts, invoices, receipts, price estimates or equivalent documents describing intra-company transactions such as transfer of assets, provision of services etc and other facts.
- Documents describing the details of assets and liabilities utilized by the PE and head offices etc for intra-company transactions.
- Documents describing the functions and risks performed and controlled by the PE and head

⁷ Art 146-2 of CTL

⁸ Art 62-2 of Corporation Tax Law Enforcement Regulation("CTLER")

⁹ Art 62-3 of CTLE

office etc in intracompany transactions. The functions include labour functions and other functions in relation to assets attribution and risks involved.

- Documents describing the departments engaged in intra-company transactions, together with the department's business description.
- Documents that provides evidence of the facts related to intra-company transactions (these involve asset transfers, provision of services or other intra-company transactions).

Actions required

Under the new AOA rules, the compliance requirements for a PE of a foreign corporation have increased significantly. Therefore it is recommended that foreign corporations review how the new rules would affect their Japan PEs and that appropriate steps are taken in order to prepare for the requirements before they come into force.



Consumption tax proposals

On 26 June 2014 the international taxation discussion group of the Japanese government's Tax Commission released the current status of its discussions on consumption tax relating to cross-border services.

It is proposed to extend the scope of taxable transactions under the consumption tax law for cross-border services rendered by foreign enterprises.

Current law

Under the current law, purchases of digital services from domestic enterprises are subject to consumption tax, while those from foreign enterprises are not subject to consumption tax. This is because for cross-border services when the place of service provision is unclear the services are deemed to be rendered at the location of the supplier's office or address.

The government wants to achieve fair competition between domestic and overseas service providers by implementing its proposal.

Business to Business (B2B) transactions

The proposal introduces a reverse charge mechanism for B2B transactions. B2B transactions are cross-border service transactions established through telecommunication lines such as internet or telephone lines, where the recipients of the services are identified as enterprises with reference to the nature of service or trading terms etc.

Under the reverse charge mechanism, recipients of the service will be required to report a "reverse charge" output tax in their consumption tax return. The reverse charge means that the business will recognize an output tax credit for the service (as if it had provided the service to itself). For most enterprises this output tax will be equal to the input tax paid by the enterprise for the service provided.

Foreign enterprises that provide cross-border services that are subject to the reverse charge mechanism will need to notify the recipients of the service so that they can report the consumption tax

correctly. The timing of this notification has not yet been decided, although the reverse charge mechanism will apply regardless of whether the recipient has been notified or not.

Business to Consumer (B2C) transactions

B2C transactions are cross-border service transactions provided both inside and outside of the country through telecommunication lines such as internet or telephone lines, which **do not** fall under the definition of B2B transactions with reference to the nature of service or trading terms etc.

Foreign enterprises engaging in B2C transactions will be required to file a consumption tax return, which is also currently a requirement for domestic enterprises. The current exemption from tax filing will also be applicable to foreign enterprises engaged in B2C transactions, and so foreign enterprises whose taxable sales are JPY 10 million or lower will not be required to file a consumption tax return. For B2C services such as online music distribution or electronic books purchased by domestic enterprises, the input tax credit on the B2C services will be disallowed as there is a risk the foreign enterprise providing the B2C services may not file a tax return to pay over the sales tax. If tax returns are not duly filed, the Japanese government will take action in accordance with the information exchange clause or tax collection cooperation clause under the tax treaty established with the foreign enterprise's home country.

Other points

The proposed change will be applied to cross-border services (not limited to digital services) as long as services are provided through telecommunication lines. Therefore, intra-group services within multinational corporate groups may be subject to consumption tax unless it is clear that the services are rendered overseas. The following examples are given in the discussion paper as cross-border service transactions subject to consumption tax:

- In-house training services provided by a parent company to its subsidiaries
- Provision of common system infrastructure purchased by a parent company to subsidiaries.

Summary

The new proposal, if implemented, will ensure a level playing field for Japanese businesses engaged in providing cross-border digital services. A consequence of this is that foreign businesses will endure increased administrative burden when providing these types of service. The full extent of this burden will be known more clearly once the proposal has been debated further and the requirements and mechanism of the reverse charge are further refined.

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