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Japan: International Tax Highlights 2015

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2015 saw the impact of the OECD and G20's Base Erosion and Profit Shifting (BEPS) Project on international tax in Japan. Some of the tax reforms introduced were made in line with the BEPS Action Plan to ensure proper treatment of multi-jurisdictional taxation issues. This article discusses the reforms that were enacted to cross-border transactions and global mobility in Japan in 2015, as well as a transfer pricing court case where a multinational enterprise challenged a transfer pricing assessment made on it by the National Tax Agency and won.

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I. Consumption Tax Reform for Digital Transactions (BEPS Action 1)

The final BEPS Action 1 discussed a number of tax challenges that have been raised by the spread of the digital economy and noted potential options to collect income tax and VAT in the country where services are purchased and consumed. Following on from BEPS Action 1, the Japanese Government introduced a new VAT rule for distance selling, similar to those which have been already enacted and systemized in the EU. This rule is applicable from October 1, 2015.

Japanese VAT (known as consumption tax) is chargeable on services provided in Japan. Under the consumption tax law reform, books, music, advertising, etc., distributed through telecommunication lines will be deemed to be provided in the location of the purchaser (previously the supply was deemed to be provided in the location of the supplier). As a result of this reform, foreign enterprises that provide cross-border telecommunicated services to companies located in Japan will become subject to consumption tax in Japan.

Cross-border telecommunicated services provided by foreign enterprises fall into two categories, "B2B" transactions and "B2C" transactions. Whether or not transactions are B2B is determined with reference to the nature of services and the terms and conditions. B2C transactions are cross-border service transactions through telecommunication lines which do not fall under the definition of B2B transactions. Therefore, B2C transactions include the provision of electronic services generally provided for consumers and services intended for business use that are not effectively restricted to solely business customers. Japanese businesses receiving cross-border B2C electronic services are not allowed to claim input tax deductions for the purchase of these transactions. However, where foreign service providers are "registered foreign service providers", Japanese businesses are allowed to claim an input tax credit for the purchase. Foreign service providers may file an application to be a "registered foreign service provider" on or after July 1, 2015.

In the case of B2B transactions, the recipients of B2B services from foreign enterprises will need to pay consumption tax on behalf of the foreign enterprises through a reverse charge mechanism. For B2C transactions, the foreign enterprises will be required to file a consumption tax return and pay consumption tax to Japanese government.

The introduction of this rule has created confusion for many foreign enterprises due to the vague descriptions provided by the tax authority of what types of service are classified as cross-border telecommunicated services. Many enterprises struggle to identify

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whether the services they provide, which in many cases are highly specialized and niche in nature, are subject to this new rule or not. This confusion and uncertainty will likely continue well into 2016.

II. Restriction on Foreign Dividend Exclusion Rule

In 2015, the Foreign Dividend Exclusion rule was amended to incorporate a recommendation of BEPS Action 2 into domestic tax law. Action 2 recommended that domestic rules neutralize the effects of cross-border hybrid mismatch arrangements.

Under the current Foreign Dividend Exclusion rule, when a Japanese parent company receives dividends from a foreign subsidiary, 95% of the amount is excluded from taxable income if the payer is a foreign company and at least 25% of its shares have been held by the recipient company for a continuous period of at least six months. However in some cases the dividend could also be tax deductible in the payer company's country of residence. An example of this is a Redeemable Preference Share (RPS) in Australia. Although its legal form is a share, it is treated substantially as a loan for Australian tax purposes. Therefore, if certain conditions are met a dividend paid relating to an RPS can be tax deductible for the paying subsidiary in Australia. Under the old rule 95% of this dividend would be non-taxable income for a Japan parent company.

As a result of Action 2 the 2015 reforms amended the Foreign Dividend Exclusion rule so that where all or part of a dividend is tax deductible in the country where the foreign subsidiary is located, the dividend will be included in the taxable income of the domestic parent company.

III. Exit Tax on Individuals Leaving Japan

The tax reform in 2015 introduced an exit tax which entered into force on July 1, 2015. When Japan-resident individuals who meet certain conditions, cease to have domicile or place of residence in Japan, the tax is imposed on unrealized capital gains on some of their assets. The assets are treated as sold or disposed of and a tax of 15.315% levied on the gains.

Individual taxpayers who own the following assets that have a market value of 100 million yen ($812,300) or greater and have been in Japan for more than 5 of the past 10 years are subject to the tax on unrealized gains on the following assets:

- securities prescribed in individual income tax law;
- equity interests under Tokumei-Kumiai contracts;
- unsettled credit transactions; and
- unsettled derivative transactions.

The exit tax also applies when the assets are gifted to or inherited by non-Japanese residents.

The exit tax is an anti-avoidance measure aimed at preventing wealthy individuals from avoiding tax in Japan by crystallizing gains after they have left the country.

In Japan, capital gains arising from the sale of shares are subject to income tax of 20.315%, which includes 5% of inhabitant tax. However the sale of shares outside of Japan by non-residents is often exempted from individual income tax in Japan, if the individual's country of residence has a double tax treaty with Japan granting the other country taxing rights on the gain. Some countries, such as Singapore, Malaysia and Hong Kong do not tax capital gains and so residents in those countries that sell Japanese shares are not taxed in either Japan or their home country on the gains. As a result of this, many wealthy Japanese residents wishing to avoid tax in Japan on their gains emigrate to countries where capital gains are not taxed. The exit tax will apply in these situations in order to allow Japan to tax the unrealized gains on these assets when the individual leaves. BEPS Action 6 recommends that exit taxes established under domestic tax laws should not be prevented from applying by tax treaty provisions.

IV. Authorized OECD Approach

The Authorized OECD Approach ("AOA") rule for taxation of Permanent Establishments (PE) was introduced in the 2014 tax reform and will apply to fiscal years commencing after April 1, 2016. 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 Article 138(1)(i) of the Corporation Tax Law ("CTL"). According to the revised Article 138(1)(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 the PE with reference to functions performed by the PE and assets employed by the PE. Intra-company transactions are recognized 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.

- Interest expenses on equity attributable to a PE:
  In situations where (i) the equity (net assets) of a PE is lower than (ii) the equity of the foreign corporation which is attributable to that PE, any interest charged that corresponds to the difference between (i) and (ii) is non-deductible.
- 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 income.
- Intra-company transaction:
  Under the new rule, intra-company transactions are 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.
- Transfer pricing rule:
  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 in-

tercompany transactions. Article 66-4-3 of the Special Taxation Measures Law ("STML") was introduced as a set of transfer pricing rules to be applied to intra-company transactions. Article 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 include documents describing both intra-company transactions and the arm's length price for intra-company transactions.

- 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.

V. Assets and Liabilities Reporting Requirement for Individual Taxpayers

The scope of this reporting requirement was widened in the 2015 tax reform and will apply to the statement of assets and liabilities filed with personal income tax returns for the calendar year ended December 31, 2015 and thereafter. Individual taxpayers whose (i) total taxable income is more than 20 million yen ($162,500) and (ii) either total asset value as of the end of a calendar year is 300 million yen ($2.4 million) or more, or the total value of assets subject to exit tax (if the taxpayer has relinquished domicile or place of residence in Japan) is 100 million yen ($812,300) or more.

In the report, information about the location of the assets, names of securities, etc is required and the values of assets and liabilities need to be stated at fair market value or an estimated value must be disclosed.

If the report is filed on time, any under-reporting penalty levied in a future income tax or inheritance tax audit that relates to those assets and liabilities included in the report, is reduced by 5%. On the other hand, where a report is not filed or assets or liabilities are not stated, the penalty above is increased by 5%.

VI. Honda Transfer Pricing Court Case

The Tokyo High Court dismissed an appeal made by the National Tax Agency (NTA) relating to a transfer pricing case involving Honda.

The issue was with the comparability of comparable companies selected by the NTA in determining an appropriate return under the residual profit split method. Honda's Brazilian subsidiary was granted tax incentives in the Manaus Free Zone, but the NTA had selected comparables located outside of the Zone. The Manaus Free Zone is an area where enterprises can benefit from tax incentives for locating there, in particular with regard to import tax and a state tax called ICMS.

The High Court's decision upheld a previous ruling made by the Tokyo District Court in favor of Honda. The Tokyo District Court had highlighted that the "similarity of the market" is a factor when making comparisons and that the companies selected by the NTA were not comparable with the subsidiary unless adjustments for differences are made. The NTA did not file a final appeal with the Supreme Court.

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