Chapter 19

JAPAN

Michito Kitamura and Tsuyoshi Ito[1]

I INTRODUCTION

After the Liberal Democratic Party of Japan regained government in 2012, the Prime Minister, Shinzō Abe, advocated a series of economic policy proposals collectively referred to as 'Abenomics'. Abenomics consists of three principal measures (also referred to as the 'three arrows') encompassing aggressive and expansive monetary policy, flexible fiscal policy to stimulate demand, and deregulation and certain structural reforms intended to stimulate sustainable growth. The measures are aimed at expanding the Japanese economy, which is still facing challenges related to the global economic recession. While Abenomics was moving ahead, there were widespread discussions regarding whether the consumption tax rate should be increased due to its potential impact on the Japanese economy. In October 2013, the government formally decided to increase the consumption tax rate from 5 to 8 per cent as of 1 April 2014, and also considered further increasing the consumption tax rate from 8 to 10 per cent. In November 2014, Prime Minister Abe announced that the next consumption tax hike would be delayed until 2017 and called a snap election for the House of Representatives to seek further public endorsement of Abenomics. The government also released the new 'Economic Policy Package', which details an economic stimulus package intended to mitigate the adverse economic effects of the increase in the consumption tax rate and the risk of a short-term business downturn, while at the same time encouraging future sustainable growth for the Japanese economy. The stimulus package includes a reduction in the effective corporate tax rate, special measures intended to promote certain investments and tax incentives for certain investments. The economy and tax system will certainly react to Abenomics; as such, foreign companies interested in investing in Japan will need to pay careful attention to recent and future policy movements in Japan.

1 Michito Kitamura and Tsuyoshi Ito are partners at Nishimura & Asahi.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

In Japan, businesses are generally operated through a corporate entity. The following four types of corporate entities are available under the Companies Act of Japan:

a a joint-stock company (KK);
b a limited liability company (GK);
c a general partnership-type company (*gomei kaisha*); and
d a limited partnership-type company (*goshi kaisha*).

Of the above types of corporate entity, the KK is the most common when operating a business in Japan. Historically, it has been perceived as the most prestigious and stable entity through which to operate a business, as the liability of all shareholders of a KK is limited to the amount of their contribution. In contrast, all equity holders in a *gomei kaisha* have unlimited liability to creditors of the company, and a *goshi kaisha* consists of both unlimited and limited liability members. Both types of company are rarely used in practice. The GK was introduced in 2006 for the purpose of allowing the establishment of a company with only limited liability equity holders, and affording such equity holders an opportunity to determine the company's internal governance rules with more flexibility. The GK is relatively popular with US parent companies. While it is taxed in Japan on its income as a non-pass through corporation, it may be regarded as a pass-through (transparent) entity for US tax purposes under the check-the-box regulations in the United States.

These four types of corporation are treated identically as taxable entities under Japanese tax law.

ii Non-corporate

Some types of non-corporate forms are legally available in Japan, including general partnerships (NKs), limited liability partnerships (LLPs), limited partnerships for investment business purposes (LPSs), silent partnerships (TKs) and trusts. NKs, LLPs, LPSs and certain type of trusts are fiscally transparent for Japanese tax purposes. A TK is technically not an entity, but rather a bilateral agreement between an operator and a silent partner whereby a silent partner (usually an investor) contributes (or agrees to contribute) cash or other assets into the operator in exchange for participating in profits and losses of the business of the operator. The operator is liable to pay income tax on the business, but the profits of the business allocated to the silent partner are deductible from the taxable income of the business operator, while the losses of the business allocated to the silent partner must be added to the taxable income of the business operator.

Non-corporate entities are not common for Japanese business generally, but LPSs and TKs are used as vehicles for private equity funds and private equity investments. Additionally, TKs are often used in securitisation transactions.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Under the Japanese Corporate Tax Act, a Japanese corporation is liable, in principle, to pay corporate tax on its worldwide income. In order to eliminate double taxation on income, the foreign taxes levied on a Japanese corporation may be credited against Japanese corporate tax and local inhabitant tax, subject to certain limitations. Further, dividends received from certain foreign subsidiaries are exempt in the calculation of a Japanese company's taxable income under the foreign dividend exemption system (if the shareholding threshold and holding period requirements are satisfied).

A foreign corporation, which is not classified as a domestic corporation for Japanese tax purposes, is only liable to pay certain types of corporate tax and income tax on domestic-sourced income. The scope of a foreign corporation's taxable income varies depending upon whether it has a permanent establishment (PE) in Japan and, if it does, the type of PE.

A corporation's taxable income for each accounting period is generally calculated on the basis of a corporation's final settlement of its annual accounts as prepared in accordance with Japanese generally accepted accounting principles (GAAP). Under the Japanese Corporate Tax Act, the taxable net income is calculated by subtracting deductible expenses from gross revenues, beginning with the annual Japanese GAAP accounts and then adjusting those accounts using specified statutory tax accounting methods. Adjustments provided for under the Japanese Corporate Tax Act include limitations on the deductibility of donations and entertainment expenses, the treatment of valuation losses or gains, and the deferral of capital gains under certain conditions for corporate tax purposes.

Capital and income

Under the Japanese Corporate Tax Act, all of the income generated by a corporation is aggregated, regardless of the type of income (such as ordinary income or income from capital gains).

Losses

Where a company that consecutively files a blue return (see 'Administration', *infra*) incurs tax losses in any given tax year, it may carry forward such losses for deduction from taxable profits for the next seven years (for tax losses incurred in fiscal years before 1 April 2008) or for the next nine years (for tax losses incurred in fiscal years ending on or after 1 April 2008). As part of the 2011 tax reforms, the period during which losses can be carried forward was extended from seven to nine years for tax losses incurred in fiscal years ending on or after 1 April 2008. It should be noted that for companies other than small or medium-sized companies (small or medium-sized companies are those with a stated capital of ¥100 million or less), the limit of the deductible amount has been reduced from 100 to 80 per cent of the taxable income for the tax year for fiscal years commencing on or after 1 April 2012.

Corporations, including parent companies, are not able to utilise tax losses of other corporations carried forward unless a consolidated taxation system is selected.

When a company with tax losses carried forward merges with another company, the tax losses generally cannot be utilised by the surviving company; if, however, the merger is a tax-qualified merger and certain conditions are met, the tax losses of the merged company can be utilised by the surviving company.

Tax losses incurred in any given tax year may be carried back for one year, subject to certain requirements being satisfied. It should be noted that, for corporations with stated capital of more than ¥100 million, the ability to carry back a tax loss has been suspended since 1 April 2009.

Rates

The main corporate taxes that a corporation is potentially subject to are:

a national corporation tax;
b local (prefectural and municipal) inhabitant tax;
c local enterprise tax;
d local special corporation tax; and
e special reconstruction tax.

Local inhabitant tax and local enterprise tax are imposed by each local government in accordance with the Local Tax Act and its ordinances established by each local government, and therefore the tax rates vary to some extent. In 2008, the government created a new local special corporation tax as an interim step-in exchange for reducing the local enterprise tax. In addition, due to tax reforms in 2012 and 2014, a special reconstruction corporate tax was imposed to deal with the aftermath of the earthquake of 11 March 2011, which will be levied for a two-year period beginning from the first fiscal year commencing on or after 1 April 2012.

The national corporation tax rate is 25.5 per cent for a fiscal year commencing on or after 1 April 2012. A reduced rate of 15 per cent applies to the first ¥8 million of taxable income earned by small or medium-sized companies. The effective tax rate on taxable income for a Japanese corporation is generally 35.64 per cent (the rate is a little different depending on local tax rates in some prefectures). The government is also currently discussing lowering the effective corporate tax rate further.

Administration

A Japanese corporation is required to file a final tax return within two months of the end of its business year. In practice, however, this two-month period can be extended by one month (in the case of a Japanese corporation) by filing an application with the competent tax authority. Nevertheless, the final tax liability for the tax year must be paid within the two months after the end of the relevant fiscal year, and thereafter interest tax accrues during any such extended period. A company that files a blue return with the approval of the tax office is granted some privileges in the calculation of taxable income (e.g., losses carried forward as described above). The main authority responsible for assessing and collecting national taxes is the National Tax Agency (NTA), which is an external body of the Ministry of Finance.

The NTA has one head office, 11 regional taxation bureaux, one Okinawa regional taxation office and 524 tax offices. For local taxes, the main authority responsible is the governor of the respective local government. The responsibilities of each governor are

delegated to the tax department of the local government, which enforces local taxes in practice.

Tax authorities may apply assessments against the taxpayer if the taxpayer's tax return does not comply with the applicable tax laws and the authorities believe that the taxpayer should pay higher taxes. The statute of limitation periods are generally five years for underreporting of taxable income, six years for transfer pricing, and seven years for excessive tax losses and fraud.

Japanese tax laws do not provide an advance tax ruling system, but the tax authority provides written answers upon taxpayers' requests. The written answers of the tax authority, together with the original queries, are publicly disclosed. In reality, the tax authority's system of written answers is not commonly used, especially when the relevant parties contemplate sophisticated and complex transactions, as it often takes a substantial period of time to receive an answer from the tax authority. Instead, parties may sometimes informally ask the relevant tax authority for its expected treatment of the issues they encounter. Although the tax authority does not respond to such informal queries in writing, it may provide an oral, non-binding answer, which does not take long. Such discussions with the tax authority are therefore useful to improve a tax analysis.

Tax grouping

Under the Japanese Corporation Tax Act, group relief is available for groups of Japanese corporations by filing consolidated tax returns at the groups' election. A group of Japanese corporations consists of a Japanese parent and its wholly owned Japanese subsidiaries. Consolidated taxable income is calculated by combining the separate taxable income of each member corporation of a tax-consolidated group (i.e., taxable profits and losses within a tax-consolidated group are offset) and various consolidating adjustments are applicable.

Where one of the consolidated group corporations transfers certain assets, including fixed assets, land, marketable securities (other than securities for a trading purpose), monetary receivables and deferred charges (excluding those whose tax book value just before the transfer is lower than ¥10 million) to another consolidated group corporation, capital gains or losses arising from the transfer should be deferred until the relevant asset is transferred to an entity outside of the group. When one of the consolidated group corporations receives dividends from another in the group, such dividends should be fully excluded from taxable income without deducting interest expenses attributable to such dividends.

The '100 per cent group taxation regime' was introduced in 2010 to bring the Japanese taxation system in line with business environments in which operations are managed on a unified basis across a corporate group. Although the consolidated tax return system described above applies to Japanese companies on an elective basis, the 100 per cent group taxation regime mandatorily applies to certain transactions carried out by companies belonging to what is termed a '100 per cent corporate group'. A 100 per cent corporate group consists of a group of only domestic companies with a 100 per cent control relationship, which is a relationship:

a between a person and a company where 100 per cent of the company's shares are directly or indirectly held by such person; or

b a relationship between companies, whereby 100 per cent of certain companies' shares are held directly or indirectly by another company in the same group.

The 100 per cent group taxation regime includes particular tax treatment for items such as the deferral of gains or losses arising from the transfer of certain assets.

ii Other relevant taxes

Japan has a consumption tax, which is similar to a value-added tax, which is calculated by offsetting the amount of consumption tax on taxable purchases from the amount of consumption tax on taxable sales. Both domestic companies and foreign companies are subject to consumption tax if relevant transactions are carried out that transfer or lease goods or other assets within Japan, or that provide services within Japan. Export transactions are generally exempt from consumption tax. The rate of consumption tax until 31 March 2014 was 5 per cent, which consisted of a 4 per cent national tax and a 1 per cent local tax. Under the revised Consumption Tax Act, the consumption tax rate was raised from 5 to 8 per cent from 1 April 2014, and the government has been discussing whether to raise the consumption tax from 8 to 10 per cent.

Japan also has a stamp tax, which is imposed on certain documents including real estate transfer agreements, business transfer agreements, share certificates, and merger agreements and demerger agreements.

In Japan, a registration and licence tax is imposed on companies that register certain transactions or changes, including in relation to real estate, ships, aircraft and intellectual property, as well as the licensing of businesses such as banking and liquor-related businesses.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

The Japanese corporate income tax statute defines a domestic corporation as a corporation having its head office or main office within Japan. A foreign corporation is defined as a corporation other than a domestic corporation. Thus, whether a corporation is classified as a domestic corporation or a foreign corporation for Japanese tax purposes depends on the location of the head or main office. Currently, Japanese corporate income tax does not adopt management and control criteria for corporate tax residency. A domestic corporation is subject to taxation on its worldwide income, while a foreign corporation is subject to taxation on Japanese-sourced income.

ii Branch or PE

Business profits earned by a foreign corporation through a PE in Japan is considered Japanese-sourced income and is subject to Japanese corporate income taxation. The scope of the definition of a PE contained in the domestic tax statute is generally similar to (but a little broader than) that provided for in the OECD Model Tax Treaty. The main factors used to recognise the existence of a branch PE or an agent PE in Japan are generally the same under domestic tax rules and in tax treaties executed by Japan. The Japanese domestic tax statute provides certain rules as to what extent business profits of a foreign

corporation should be included in a business profit allocated to a PE in Japan. These rules are generally consistent with the arm's-length principle, but are not the same in all respects. A PE will calculate its taxable income in Japan based on similar rules as would be applicable to a domestic corporation, subject to certain exceptions, although only reasonably allocated expenses and losses of properties located in Japan are deductible.

Currently, the scope and method of assessing a foreign company's income (other than business profits) varies depending upon whether it has a PE in Japan and, if it does, the type of the PE. For example, under the domestic tax rules, for a foreign company that has branch offices, factories or any other fixed locations for conducting business in Japan, the foreign corporation must declare all Japanese-sourced income in its corporate tax filing, even if such income is not attributable to a PE in Japan. However, many tax treaties executed by Japan override this principle so that only income attributable to a PE in Japan is subject to a corporate income tax filing. Further, the recent tax reform statute, which is scheduled to be effective from 1 April 2016, will amend the domestic tax rules so as to adapt the attributable income principle of PE income.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

While it is legally permissible to establish a holding company in Japan, Japanese tax laws generally do not entitle a holding company to special treatment for tax purposes. However, under the Act on Special Measures for Promotion of Research and Development et al. by Certified Multinational Enterprises, which was promulgated and came into force in November 2012, global enterprises establishing their Asian regional headquarters or R&D centres within a special zone in Japan are eligible for national and local tax breaks if certain conditions are met. In order to promote Japan as a base for high-value adding companies, such as R&D bases and Asian headquarters of global enterprises, the Act provides tax incentives for global enterprises, such as a reduction of corporation tax (20 per cent income deduction for five years) and an exemption from local corporate enterprise tax.

ii IP regimes

Japan does not currently have an IP regime equivalent to the innovation box regime in Holland or the patent box regime in Luxembourg. Although the Ministry of Economy, Trade and Industry, as well as several other organisations (such as the Japan Business Federation), have submitted requests for the introduction of an innovation box or patent box regime, these requests have not yet been incorporated into any tax reforms.

iii State aid

State aid is available in various sectors (agriculture, information technology, medical, etc.) and in various forms.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)

Dividends and any other forms of distributions (including capital repayments or a portion of the consideration for a share buy-back) paid by a domestic company to non-residents and foreign corporations are subject to withholding tax. The standard rate is 20.42 per cent, which has been reduced to 15.315 per cent, if shares in the corporation making distribution payments are listed on a stock exchange.

Interest payable to non-residents or foreign corporations is subject to Japanese withholding tax when the source of interest is from Japan. Japanese tax law provides different source rules for interest depending on the type of debt from which the interest arises. For example, interest under a loan is generally deemed to be from Japan when the borrower conducts its business in Japan and uses funds provided under the loan for business in Japan. Interest on debt securities such as bonds and debentures is generally a Japanese source of income when an issuer is a national or local government or a domestic corporation in Japan. In addition, Japanese-sourced income includes interest on debt securities issued by a foreign corporation and attributable to its business in Japan.

The rate of withholding tax on interest under a loan is 20.42 per cent, while interest on bond securities and bank deposits paid to a non-resident or a foreign corporation is subject to withholding tax at a rate of 15.315 per cent if it is Japan-sourced income. Original issue discount, which is normally created when a bond is issued at discount, is not included as 'interest' for domestic tax law purposes, but is subject to withholding tax at a rate of 18.378 per cent or 16.366 per cent.

Royalties paid to non-residents of foreign corporations are subject to withholding tax at a rate of 20.42 per cent if it is Japan-sourced income. Under domestic tax law, royalties are sourced from Japan when the royalties are paid by a person engaged in business in Japan and are paid in connection with its business in Japan.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Subject to certain requirements set out in the Act on Special Measures Concerning Taxation (ASMCT), non-residents and foreign corporations are entitled to be exempted from income tax and corporation tax on interest on Japanese government bonds or local government bonds issued via the book-entry system in Japan, corporate bonds that were issued outside Japan and for which the interest is paid outside Japan, and corporate bonds issued via the book-entry system in Japan. The exemptions do not apply to corporate bonds for which interest is linked to profits of the issuer or its related party. Further, certain specified parties related to the issuer (which includes a person having more than 50 per cent shares in the issuer) may not claim these exemptions.

No withholding tax is imposed on interest under a loan payable to a non-resident or a foreign corporation that has a PE in Japan if the non-resident or foreign corporation obtains a certificate from the relevant tax office and presents the certificate to the borrower before payment of interest; this interest is, however, subject to Japanese income tax or corporation income tax imposed on the non-resident or the foreign corporation.

In addition, no withholding tax is imposed on interest paid by a financial institution on a deposit or a loan recorded in a special international financial transactions account (as set out in the Foreign Exchange and Foreign Trade Act) to a foreign corporation.

iii Double taxation treaties

As of the end of November 2014, the government has entered into 63 tax treaties covering 88 countries, which includes 52 tax treaties for avoiding double taxation on income. Most income tax treaties entered into by the government generally follow the OECD Model Tax Treaty. In 2004, the government changed its tax treaty policy, and it currently places more emphasis on promoting genuine cross-border economic activities and bilateral investments. Thus, some recent tax treaties amended or entered into by the government provide more generous tax rates or exemptions for dividends, interests and royalties, while at the same time they contain limitation-on-benefits clauses and anti-treaty abuse clauses.

The following table provides a general summary of Japanese withholding tax rates on dividends, interests and royalties:

	Dividend		*Interest*		*Royalty*
	General	*Parent-subsidiary*	*General*	*Banks*	
Domestic standard tax rate	20.42%	20.42%	15.315% or 20.42%	15.315% or 20.42%	20.42%
Japanese treaty rate	15%	5%	10%	10%	10%
US	10%	5% or 0%	10% (0% if the proposed amendment is ratified)	0%	0%
UK	10%	5% or 0% (0% if the proposed amendment is ratified)	10% (0% if the proposed amendment is ratified)	0%	0%
France, Netherlands, Switzerland	10%	5% or 0%	10%	0%	0%
Australia	10%	5% or 0%	10%	0%	5%
Germany, Italy	15%	10%	10%	10%	10%
Canada	15%	5%	10%	10%	10%
China	10%	10%	10%	10%	10%

iv Taxation on receipt

Dividends received by a domestic corporation from other domestic corporations are subject to withholding tax at a standard rate of 20.42 per cent, which has been reduced to 15.315 per cent if shares in the corporation making distribution payments are listed on a stock exchange. The withholding tax will work as a credit for a corporate income tax liability of the domestic company receiving dividends (and will be refunded if there is any excess). Fifty per cent of the amount of dividends from other domestic corporations

(less interest payment amounts allocable to the shares from which dividends derive) is excluded from taxable income of the recipient corporation. One hundred per cent of the amount of dividends (less interest payment amount allocable to the shares from which dividends derive) is excluded from the taxable income of the recipient corporation if the recipient corporation holds 25 per cent or more shares in the domestic corporation paying dividends, subject to certain holding period requirements.

Dividends received by a domestic corporation from foreign corporations are generally included in the taxable income of the domestic corporation, but 95 per cent of the amount of dividends from a foreign corporation in which the domestic corporation holds 25 per cent or more shares is excluded from the taxable income of the domestic corporation, with certain exceptions.

A domestic corporation is able to claim foreign tax credit, subject to certain limitations and requirements under domestic tax law, if foreign withholding tax is imposed on dividends, interest and royalties that the domestic corporation receives. The Japanese tax statute abolished the indirect foreign tax credit system in 2009, and domestic corporations can no longer claim an indirect foreign tax credit.

VII TAXATION OF FUNDING STRUCTURES

Business entities in Japan are generally funded by equity and debt. Typically, a foreign parent company extends a loan to a Japanese corporation.

i Thin capitalisation

Japanese corporations (and Japanese branches of foreign corporations) are subject to the thin capitalisation rule. Generally, under this rule, if the average balance amount of loans and other credits and debts that a foreign controlling shareholder provides (by itself and through third parties) exceeds three times the amount of equity share of the foreign controlling shareholder, interest and other debt costs payable to it relating to the excess debt are not deductible from the taxable income for Japanese corporate income tax purposes, unless the average balance amount of all debt-bearing interest does not exceed three times the amount of the shareholders' equity. Instead of this three-times-multiple standard, a taxpayer can use other debt-to-equity ratios found to be appropriate compared with similar companies of the same size that conduct the same business as long as the taxpayer demonstrates to the tax authority that the debt-to-equity ratio of its foreign controlling shareholder is appropriate.

ii Deduction of finance costs

Finance costs, including interest and other fees payable to financial institutions, are generally deductible expenses. A borrower can deduct these costs from the gross income when calculating the taxable income for the accounting period. If the interest rate on a loan is higher than the fair market rate, however, the borrower can only deduct the amount of interest at a fair market rate. As previously mentioned, there is also a thin capitalisation rule in cross-border transactions, which can limit the amount that a Japanese corporate borrower can deduct as interest and other amounts from its gross income for tax purposes.

In addition, since recent tax treaties between developed countries tend to provide exemptions from taxation on interest in the source country, the government was concerned that Japanese companies would increase their interest payments to foreign related parties that were eligible for tax treaty benefits. Therefore, the 2012 tax reform introduced new earnings-stripping rules, similar to those in the United States and some European jurisdictions, to prevent tax avoidance through interest payments inappropriate for actual income. The Japanese earnings-stripping rule applies for fiscal years commencing on or after 1 April 2013. Under this rule, if interest and other debt costs payable to certain controlling persons (and not subject to Japanese income tax or corporation tax) exceed 50 per cent of the statutory base income amount, such excess is generally not deductible; however any non-deductible excess may be carried forward for seven fiscal years and deducted until the 50 per cent threshold has been reached.

iii Restrictions on payments

There are statutory limitations on the amount available for dividends or distributions of profits under the Japanese Companies Act. The limitation amount is calculated differently depending on the types of corporate forms. In the case of a KK, the distributable amount is the aggregate amount of 'other capital surplus' and 'other retained earnings surplus' at the end of the previous fiscal year with an adjustment made by deducting a certain amount such as the book value of the treasury stock. If the net assets are lower than ¥3 million, the KK cannot pay dividends.

iv Return of capital

A corporation has several ways to return its capital to shareholders in accordance with requirements set out in the Japanese Companies Act, which vary depending on the type of corporation and methods of return of capital. In a KK, a return of capital involving a reduction of its stated capital or the statutory reserve generally requires an approval of the shareholders' meeting and a series of procedures for the purpose of protecting the interests of creditors. The KK is required to notify its creditors of its intent to reduce its stated capital or statutory reserve in accordance with the Japanese Companies Act and, if a creditor objects to the reduction of the stated capital or the statutory reserve, the corporation must either pay off the debt of the objecting creditor, post adequate security for such debt, create a trust to secure the debt or prove that the reduction will not likely have an adverse effect on the objecting creditor.

For Japanese tax purposes, the amount of capital paid by a corporation to its shareholders is generally treated as a combination of a return of capital and a deemed dividend as long as the corporation has retained earnings. The amount of a deemed dividend is calculated by subtracting the amount of capital attributable to the shares from the amount of the market value of assets provided to its shareholders. The amount of a deemed dividend is subject to withholding tax, in the same way as for ordinary dividends. A shareholder recognises as capital gain or loss the difference between the amount characterised as a return of capital and the tax basis of the share held by the shareholder.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

When a foreign corporation acquires a business in Japan, generally the legal structure of either a share deal (i.e., acquisition of shares issued by the target Japanese corporation) or an asset deal (i.e., acquisition of assets and liabilities as well as employees of the target Japanese corporation) is used. In both cases, it is possible for a foreign corporation to acquire the shares or assets directly from the target Japanese corporation. The prevailing interpretation of the Japanese Companies Act is, however, that a Japanese corporation may only engage in corporate reorganisation transactions, such as mergers, demergers, share exchanges or share transfers, with other Japanese corporations, but not with foreign corporations. Thus, where a foreign corporation wishes to utilise a corporate reorganisation transaction, it will generally set up a wholly owned subsidiary in Japan (Newco) and then use the Newco to acquire the shares or assets through a corporate reorganisation. Both equity and debt finance is permitted for an acquisition of the target Japanese corporation by way of either a share deal or an asset deal.

The consideration given by a foreign corporation for an acquisition of shares issued by a target Japanese corporation or its assets is generally in cash; however, a triangular mechanism, such as a triangular merger or a triangular share exchange, has been available since 2007. Under a triangular mechanism, the shares issued by the parent company (which could be a foreign corporation) of the Newco are transferred to shareholders of the target Japanese corporation as consideration for the corporate reorganisation transaction.

ii Reorganisation

Under Japanese tax law, in the case of mergers, demergers, share exchanges and share transfers, the contributions-in-kind and dividends-in-kind are, if certain conditions provided under the Corporation Tax Act are met, classified as tax-qualified corporate reorganisations. As described above, where a foreign corporation wishes to utilise a corporate reorganisation transaction, it is necessary to set up a Newco in Japan or purchase shares of an existing Japanese corporation that will be a party to the corporate reorganisation transaction. Each of the said corporate reorganisation transactions under the Companies Act, as well as the contributions-in-kind and dividends-in-kind, are, in principle, treated as taxable events. In the case of a tax-qualified corporate reorganisation, however, transfers of assets and liabilities are made at their book value, which means that capital gains or losses from the transfer of assets are deferred at the corporate level, and capital gains or losses from the transfer of shares by shareholders of the target Japanese corporation should also be deferred at shareholder level.

One important requirement for tax-qualified corporate reorganisations is the consideration requirement, which requires that the consideration from the acquirer consists solely of shares of the acquirer or shares in the acquirer's parent company (which directly owns all the acquirer's shares).

Other qualification requirements differ depending upon the shareholding relationship that the relevant companies have. Such shareholding relationship can be

classified into three categories: a 100 per cent control relationship, a less than 100 per cent but more than 50 per cent control relationship, and a 50 per cent or less control relationship. The requirements generally become more stringent the lower the level of the shareholding relationship is.

iii Exit

The sale of shares issued by a Japanese subsidiary of a foreign company is a common way for a business to exit Japan. Capital gains arising from the sale of shares of a Japanese corporation held by a foreign company are subject to Japanese corporate tax (even if the foreign company does not have a PE in Japan) if the foreign corporation (combined with the holdings of related persons as defined under Japanese tax law) owns 25 per cent or more (or has owned 25 per cent or more at any time during the fiscal year of the sale or the previous two fiscal years) and has sold 5 per cent or more of the shares in the Japanese corporation in the fiscal year in which the foreign corporation sells the shares ('25 per cent–5 per cent rule'). However, the tax on capital gains may be exempt if a tax treaty is applicable under which the capital gains from the transfer of shares are exempt from taxation in the source country.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Japanese tax law does not provide comprehensive general anti-avoidance rules, although some specific anti-avoidance rules apply to specific persons and situations under certain conditions. The Corporate Tax Act provides specific anti-avoidance rules that cover the principle of taxation of the actual beneficiary and disallowance of an act and computation with respect to:

a family corporations with three or fewer individual shareholders (counting among them individuals with whom they have a special relationship) or companies that hold more than 50 per cent of the number or amount of issued shares or invested capital of the company concerned;

b corporate reorganisations; and

c consolidated corporations.

Other tax laws, including the Income Tax Act, the Inheritance Tax Act and the Local Tax Act, also provide similar rules to those described in (a) and (b). In addition, the ASMCT provides a set of anti-avoidance rules regarding cross-border transactions, including transfer pricing rules, anti-tax haven (CFC) rules, thin capitalisation rules and earnings-stripping rules.

ii Controlled foreign corporations

The CFC rules were introduced to prevent tax avoidance through the use of related subsidiaries in low-tax jurisdictions, and have been revised several times over the past 30 years.

The CFC rules only apply to the income of a specified foreign subsidiary (SFS), which is defined as a company of which more than 50 per cent of the shareholders

are Japanese residents, Japanese legal entities or related parties thereto; and that is incorporated in a country in which the effective tax rate calculated pursuant to the CFC Rules is 20 per cent or lower. If a Japanese company owns, either directly, indirectly, or together with other companies within a group of companies, at least a 10 per cent interest in a SFS, it is in principle required to report as taxable income its proportionate share of the taxable income of the SFS; however, the income of an SFS (except for its passive income) will not be included in the taxable income of its Japanese shareholders if the SFS meets all of the following requirements:

a a business purpose test;
b a substance test;
c a management and control test; and
d either an unrelated party test or a country of location test (referred to as the 'exclusion rule').

Even if an SFS satisfies the foregoing exemption requirements, its proportionate passive income (income arising out of certain assets held by it) will be combined with the income of the aforementioned Japanese shareholders.

The exclusion rule has repeatedly been the subject of tax lawsuits. For instance, cases have arisen as to whether Hong Kong subsidiaries of Japanese manufacturers can satisfy the exclusion rule where the subsidiaries are using Chinese companies (factories) for contract manufacturing. Most courts dealing with these tax lawsuits have found in favour of the tax authorities on the ground that the exclusion requirements were not satisfied.

iii Transfer pricing

Under the transfer pricing rules, when a Japanese corporation conducts transactions with a foreign entity that has a special relationship with the corporation, and the consideration received or paid is not calculated on an arm's-length basis, these foreign related transactions will be deemed conducted at arm's-length prices. Recent major revisions in 2010 and 2011 to the rules included the adoption of using 'the most appropriate method' to determine the arm's-length price and abolishing the priority over using one of three traditional basic methods, and clearly listing the documents required to apply the transfer pricing rules. Where a taxpayer does not promptly submit the necessary documents pursuant to a request by the tax authority, the authority is able to calculate an arm's-length price based on its presumptions. This requirement appears to have indirectly introduced the documentation rule in Japan.

There have been relatively few transfer pricing lawsuits in Japan, probably because disputes have been resolved through mutual agreement procedures (MAPs) (one exception is the *Takeda Pharmaceutical Co* case where, in 2012, the MAP between Japan and the United States broke down and all of the additional taxes assessed by the tax authority were repealed by the administrative tax appeal procedures). The number of transfer pricing lawsuits will, however, likely increase in the near future because of transfer pricing issues increasing in transactions with companies in developing countries such as Brazil, China, India and south-east Asian countries, as well as the difficulty of resolving these issues by way of MAPs. In addition, Honda has disputed the legality of

the tax assessment of approximately ¥7.5 billion issued by the Japanese tax authorities in 2004, in which the tax authority applied the transfer pricing rule on transactions including an intangible transaction between Honda and its Brazilian subsidiary. In the *Honda* case, the Tokyo District Court endorsed Honda's argument in 2014, stating that the tax authorities' calculation of underpayment based on the transfer pricing system was inappropriate in using another automaker without considering the tax benefits of the free trade zone as a reference.

iv Tax clearances and rulings

See Section III.i, *supra*.

X YEAR IN REVIEW

The rate of the consumption tax (the Japanese version of value added tax) was increased from 5 to 8 per cent on 1 April 2014. Although the statute increasing the rate further to 10 per cent on 1 October 2015 was passed, in November 2014, the Prime Minister announced that he intends to postpone this further increase in the consumption tax rate until 1 April 2017, and to call a snap election for the House of Representatives to seek further public endorsement of Abenomics. If the Liberal Democratic Party win a national election in December 2014, it is likely that the further increase in the consumption tax rate will be postponed.

The special corporate income tax, which was introduced in reaction to the 11 March 2011 earthquake and imposed an additional 10 per cent in the amount of the corporate income tax on corporations, was abolished in the 2014 tax reform, which reduces the standard effective corporate income tax rate to 35.64 per cent. In the area of income taxation on non-residents and foreign corporations, the tax reform statute amends the domestic tax rules relating a PE and its income, including the adoption of the attributable income rules, which will be effective from 1 April 2016.

XI OUTLOOK AND CONCLUSIONS

From the domestic perspective, the government is currently discussing corporate income tax reforms aimed at reducing the effective corporate income tax rate and expanding the tax base, thereby strengthening Japan's competitiveness in the global economy in terms of attracting business enterprises.

In the international taxation area, the tax reforms based on the OECD BEPS Project are currently under discussion, including consumption tax reforms on cross-border e-commerce transactions, restrictions on foreign dividend exemptions to neutralise hybrid mismatch arrangements and exit taxes. Some of the reforms are likely to be proposed in the 2015 tax reform statute.

Appendix 1

ABOUT THE AUTHORS

MICHITO KITAMURA

Nishimura & Asahi

Michito Kitamura has been a partner with Nishimura & Asahi since 2011, working primarily in the firm's tax group. As a lawyer focusing on tax matters, Mr Kitamura has had extensive experience dealing with tax planning, tax advice and tax disputes, including tax litigation. In particular, he has won judgments in the Nagoya High Court on behalf of individual investors in a tax litigation case involving an important legal issue regarding entity classification of Delaware limited partnerships, and is representing these clients in appellate courts. Mr Kitamura is also currently representing companies in a large-scale tax litigation case involving corporate restructuring matters, as well as counselling on tax planning regarding mergers and acquisitions and other international taxation matters. Prior to joining Nishimura & Asahi in 2000, he worked as a certified public accountant (CPA) at one of the Big Four audit firms in Japan. Mr Kitamura has contributed to influential tax-related publications. He is a graduate of Keio University (1994), Georgetown University Law Center (LLM, 2006) and New York University School of Law (LLM in international taxation, 2007), is admitted to the bar and is a CPA in Japan.

TSUYOSHI ITO

Nishimura & Asahi

Tsuyoshi Ito is a partner of Nishimura & Asahi LPC, an affiliated entity of Nishimura & Asahi, and is a head of the Nishimura & Asahi Nagoya office. Mr Ito is a member of the tax group and the finance practice group of the firm. Mr Ito joined the firm in 2000, and has since been practising law for 14 years in a wide variety of practice areas. He has, in addition to general experience providing routine corporate legal advice, significant experience in tax counselling and tax controversies, and has represented major corporations in many tax disputes and tax lawsuits. Mr Ito teaches tax law at a

Japanese law school. He has significant experience in financing transactions, especially banking transactions, and also asset management and investment fund transactions. He is a graduate of the University of Tokyo (1999) and New York University School of Law (LLM in corporation, 2007).

NISHIMURA & ASAHI
Ark Mori Building
1-12-32, Akasaka, Minato-ku
Tokyo 107-6029
Japan
Tel: +81 3 5562 9853
Fax: +81 3 5561 9711
m_kitamura@jurists.co.jp

JR Central Towers, 41st floor
1-1-4 Meieki, Nakamura-ku
Nagoya, Aichi 450-6041
Japan
Tel: +81 52 533 2591
Fax: +81 52 581 0327
t_ito@jurists.co.jp

www.jurists.co.jp/en