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Overview of Japan Tax System

Ernst & Young Tax Co.
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I. Corporate Income Taxes

Corporation income tax - overview

- Residence
  - A corporation that is incorporated or has its head office in Japan is treated as a resident corporation (no central management and control or effective management criteria is used to determine the tax residence of a corporation)
- Basis of taxation and worldwide taxation
  - Resident corporations are subject to Japanese corporate tax on their worldwide income with exemption for dividends received from certain foreign subsidiaries. A foreign tax credit is allowed for direct taxes (subject to limitations)
  - Nonresident corporations without a permanent establishment (PE) are subject to Japanese tax on their Japan sourced income. A foreign corporation that establishes a PE in Japan will be subject to Japan corporate income tax for the income attributable to the PE.
- Corporation tax rates
  - The national corporation tax rate is 23.49% (23.2% for fiscal years beginning on or after 1 April 2018) for standard corporations with stated capital of more than JPY100 million.
  - Local income taxes, which are local inhabitant tax and enterprise tax, are also imposed on corporate income. Inhabitants tax includes a corporation tax levy and a per capital levy (based on share capital and number of employees). The enterprise tax can include factor based taxes as well as income based.
  - The combined effective tax rate for a company with paid-in capital of over JPY100 million is approximately 30%.

Corporation income tax - overview

- Transfer pricing
  - In general, Japanese tax authorities refer to the OECD's Transfer pricing (TP) guidelines, including those recommended under the Base Erosion and Profit Shifting (BEPS) initiative
  - A taxpayer is required to provide to the tax authorities documentation relevant to the establishment of the arm's length price in a timely manner upon their request
  - A statement concerning detail of foreign affiliated persons and transactions with them (Schedule 17-4) has to be attached to the annual corporate tax returns
  - Advance Pricing Arrangement (APA) is available

- General anti-avoidance rules (GAARs)
  - Japan has no GAAR, but has specific anti-avoidance rules for

    (1) "family corporations" and related party transactions,

    (2) corporate reorganization, and

    (3) corporate tax consolidation.
  - Sometimes Japanese tax authorities use "substance over form" concept to deny tax motivated transactions
  - Japan also has controlled foreign company/anti-tax haven rules

- Tax rulings
  - Tax rulings are available to confirm a tax position in certain circumstances

Tax Losses

- Carryback: One year (only available for a small and medium-sized enterprise (“SME”), which is generally defined, for corporate income tax purposes, as a company with share capital of JPY100 million or less, which is not directly or indirectly 100% owned by a company or companies with share capital of JPY 500 million or more.)
- Carryforward:
  - Loss carry forward period is nine years
  - Ten years for tax losses incurred in tax years beginning on or after 1 April 2018
- Limit of utilization:
  - The deductible amount of any carried forward losses is limited to 60% (55% for fiscal years beginning on 1 April 2017 until 31 March 2018, and 50% for fiscal years beginning on or after 1 April 2018) of taxable income in a period.
  - 100% for SMEs
- Change in control rules: Applicable, in certain circumstances (e.g., terminate all business and start another business after the control change). Restrictions may apply.

Corporate income taxes – administrative elections

- Blue Tax Return
  - Qualifies corporations for special privileges, most importantly the ability to carry forward losses and certain protections in a tax audit
- To receive permission to file, a corporation must
  - Record transactions in books and maintain and preserve those books and records
  - Submit an application with the head tax office before the beginning of the year for which the Blue Tax Return is to be filed
- Approval to file Blue Return can be revoked for:
  - Not maintaining, recording or preserving books and other documents in accordance with tax laws
  - Concealing or disguising all or part of transactions in the books of the account
  - Failing to file tax return by the deadline for two or more consecutive years

II. Treaty relief from WHT and CIT

WHT and CIT on Japan source income

- Taxation of dividends, interest and capital gains
  - Interest income and capital gain/loss are included in ordinary taxable income
  - Domestic dividends, net of allocable interest expense, are generally excluded from taxable income (in case of less than 25% ownership, 50% of net dividend is taxable)
  - 95% of foreign dividends (with 25% or more ownership) are generally excluded from taxable income (no credit or deduction is available for foreign withholding tax)
  - Japan levies a nonresident withholding tax on dividend, interest and royalty payments and a nonresident capital gain tax (CGT)

Treaty relief

Capital gains taxation for nonresidents

Types of companies	Capital gains tax (CGT)	Other transaction taxes
Shares in a corporation owned directly or indirectly at least 25% (tested for past three years) and sold at least 5% in a given year	24.43%	Not applicable
Shares in real estate holding corporation	24.43%	Not applicable

Potential holding, financing or intellectual property (IP) company jurisdictions	Withholding tax to nonresidents				Branch remittance tax	Nonresident capital gains tax protection[7]
	Dividend[1]	Interest[2]	Royalties	Technical service fees[3]		
Domestic rates	20.42%	20.42%	20.42%	20.42%	Not applicable	——
United States [6]	0%[4]	0%[5]	0%	0%	Not applicable	Yes
United Kingdom [6]	0%	0%	0%	0%	Not applicable	Yes
Hong Kong	5%	10%	5%	0%	Not applicable	Yes
Singapore	5%	10%	10%	0%	Not applicable	No
Thailand	15%	20.42%	15%	0%	Not applicable	No

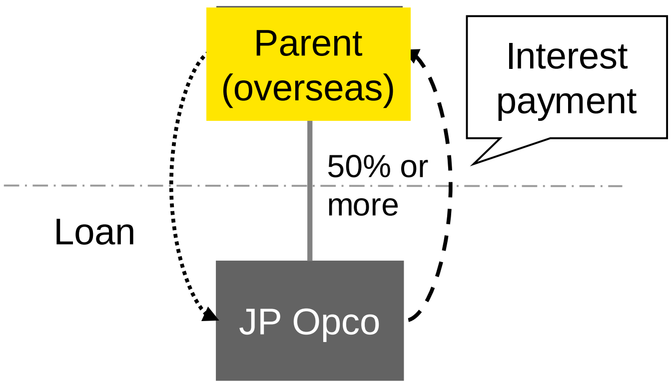
1. Certain shareholding percentages, holding period criteria may need to be satisfied to obtain these reduced rates.
2. Withholding tax on interest paid to governmental body, central bank or financial institution may be exempted or reduced under applicable tax treaty
3. Assuming that there is no permanent establishment (PE) in Japan.
4. The shareholder has to be a certain type of qualified person listed in the Limitation on Benefits (LOBs) clause (e.g., United States listed company or its subsidiary).
5. Current applicable rate is 10%. Upon the revised tax treaty entering into force the rate will be reduced to 0%.
6. There is an LOB clause in each of these tax treaties.
7. This column shows applicability of CGT protection on sale of shares in Japanese corporation s owned at least 25% and sold at least 5%. The CGT on shares in real estate holding corporations is not protected under the treaties listed here.

III. Interest limitation rules

Japanese thin capitalization rules (1)

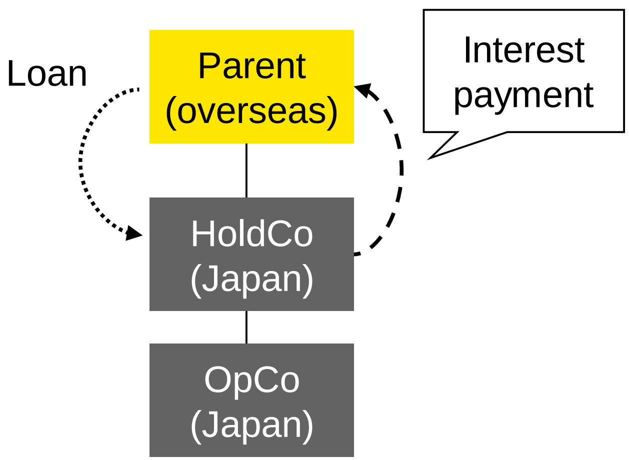
- Japanese tax laws contain a 3 to 1 debt to equity ratio. If taxpayer opts for it, different comparable ratio could be used – requires comparable study.
- The 3:1 debt to equity ratio is determined on a stand-alone basis, even if the Japanese company is a member of a tax consolidation group.
- Any excess interest expenses are permanently disallowed as a tax deduction for corporate income tax purposes.
- Furthermore, interest payments are generally subject to 20.42% withholding tax (10%/0% under certain treaties), regardless of whether or not the interest payments would be denied as a result of Japanese corporate income tax rules.

Japanese thin capitalization rules (2)



- Interest expenses paid to foreign related parties are non-deductible as far as the debt to equity ratio exceeds the safe haven of 3 to 1
  - Foreign related parties are defined as those directly or indirectly holding 50% or more of the Japanese corporation or otherwise exercising de facto control over JP Opco
- Pick-up of guarantee fees paid overseas
- Equity definition under thin capitalization rules
  - the average of net asset (accounting base)
  - the amount of share capital and capital surplus at the end of fiscal year (tax base)

Earnings stripping rules



HoldCo's interest payments would be entirely denied until HoldCo and OpCo form tax consolidation.

- Interest deduction derived from "net" interest payments to foreign related parties is capped at 50% of "adjusted taxable income."
- Interest costs subject to limitation would include overseas guarantee fees.
- Excess interest can be carried forward for up to 7 years.
- "Adjusted taxable income" calculation is as follows:
  - Taxable income

    \+ net interest payments to related parties

    \+ depreciation

    \+ exempt dividends, etc.
- In case of a tax consolidation the 50% threshold is determined on a consolidated basis.

IV. Tax consolidation, and 100% group rules

Tax consolidation, and 100% group rules

Tax consolidation

- Optional (applicable by election)
- Between 100% Japanese parent-sub companies
- Offset of taxable income and tax losses within a consolidation group
- Deferral of capital gains or losses realized on related party specified asset transfers (until the subsequent disposal), 100% dividends received deduction ("DRD" – in principle, dividends received by domestic company are subject to corporation tax) etc.
- Only for national corporation tax
- Upon formation, potential forfeiture of NOLs and capital gains taxation on built-in-gains held by subsidiaries

100% group taxation

- Mandatory application (not optional)
- Between 100% Japanese group companies
- Mainly limited to deferral of capital gains or losses and 100% DRD
- Both national CIT and local CIT

Tax consolidation - Pros & Cons

Advantages:

- Consolidation allows effective offset of current year taxable profits and losses of consolidation group members
- Pre-consolidation grouping NOLs of the parent company can generally be carried forward to offset consolidated taxable income
- Consolidated tax losses incurred can be carried forward for up to 9 years to offset future consolidated taxable income
- Could be effective for leveraging of Japan business by foreign inter-company loans

Disadvantages:

- Existing NOLs of subsidiary companies will effectively be extinguished upon joining a consolidation group, and
- Upon joining a consolidation group, generally, the assets of subsidiary companies must be revalued to market value so crystallizing unrealized gains or losses which can result in either additional taxation or extinguishment of losses realized as described above.
- Note that there are some exceptions to the above NOL forfeiture and built in gain taxation
- Obligation to join a consolidated tax group on the day the 100% holding relationship is formed

V. Tax administration system

Administration

- Japanese tax administration is based on self-assessment
  - Each taxpayer calculates and files his tax and tax return
  - No immediate assessment of the return and tax by the authorities
  - But regular audit cycle depending on undisclosed terms, e.g. size
  - Heavy penalties for late and incorrect filings
- Quick and efficient tax administration procedures
  - Filing period
  - Statute of limitation
  - Tax audit frequency

Tax compliance and filing deadlines (1)

- Annual Corporate Tax Returns
  - Within two months of the end of the corporation's fiscal year (even if there is no tax due), tax payment due at same time
  - Corporation can file for a one-month extension (return only, not payment)
  - Generally a corporation must file an interim return within two months of the end of the first six months and make an advance payment at the time of filing the interim return equal to either 50% of its prior year's tax liability or 100% of its estimated tax liability for the first six months of the current year
- Attached to the final return must be
  - Balance Sheet
  - P&L Statement
  - Detailed schedules supporting balance sheet & P&L statement
  - Detailed schedule of changes in shareholders equity

Tax compliance and filing deadlines (2)

- Annual Consumption Tax Returns
  - Within two months of the end of the corporations fiscal year, even if there is no tax due
  - No extension for Consumption Tax
- Annual Depreciable Assets Tax Returns
  - By end of January of every calendar year
- Annual Business Premises Tax Returns
  - Same as Consumption Tax Returns

VI. Consumption Tax

Consumption Tax

Basics

- Japanese consumption tax (JCT) rate is currently 8%, this is expected to increase to 10% from 1 October 2019 (reduced rates for certain necessities may be introduced)
- JCT is broadly similar to the European VAT system

JCT registration obligation

- A business entity or individual whose taxable supplies in the calculation period are over JPY10 million is a taxable person even if the taxable supplies in the "base period" are JPY10 million or less.
- Specific period rule: Even if an enterprise is not a JCT payer under the base period rule, it becomes a JCT payer for the current fiscal year, if either the amount of its JCT taxable sales during the first six months of the previous fiscal year exceed JPY 10 million; or the amount of salaries paid to residents of Japan during the same period exceeded JPY 10 million.
- Additional rules apply in respect to newly formed corporations.
- If not required to be a JCT payer, can elect to be one.
- No JCT Group registration.
- Reverse charge is applicable on B2B digital services

VII. Personal Income Tax

Personal Income Tax

Basics

- Permanent resident taxpayers are taxed on their worldwide income.
- Non-resident taxpayers are taxed only on their Japan-sourced income.
- Non-permanent resident taxpayers are taxed on their Japan-sourced income plus potentially part of their non-Japan-sourced income that is paid in or remitted to Japan.

Personal income tax rates

- National income tax rates: Progressive rate from 5% to 45%
- Surtaxes: 2.1% on individual's national income tax
- Local income taxes: Generally flat rate of 10%
- Non-resident taxpayers: 20.42% national income tax on gross compensation

Personal Income Tax

Residency

- A resident taxpayer is an individual taxpayer who has a domicile (base of living) in Japan or who has maintained a temporary place of abode in Japan for a period of one year or more.
- A resident taxpayer who is not a Japanese national and who has an aggregate stay in Japan of five years or less within the preceding ten years (60 months within the preceding 120 months) would be classified as a non-permanent resident taxpayer.
- If a resident taxpayer is a foreign national with an aggregate stay in Japan of more than five years within the preceding ten years, the taxpayer is considered a permanent resident taxpayer.

Speaker and contact info

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- Mark has over 15 years of experience in advising multinational groups on cross border tax issues and transactions.
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