Taxation of Foreign Passive Income for Group Companies
Summary and Conclusion

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1. General Corporate Tax System in Japan

Japanese corporations are subject to corporate tax in Japan for its worldwide income. In principle, Japanese corporations are subject to corporate tax in Japan only for its worldwide income, and will not be subject to tax for the income of other companies in the same corporate group.

2. CFC Rule in Japan

CFC rule is the exception for this general rule. If a Japanese corporation is subject to CFC rule in Japan, the parent corporation must impute the income of the CFC.

(1) Subject Companies

Under the CFC rule in Japan, CFC is called Foreign Affiliate and in order to qualify as Foreign Affiliate, more than 50% of the shares must be directly or indirectly held by Japanese corporations and/or resident individuals of Japan.

If (i) the country of head office of the Foreign Affiliate does not have any tax on corporate income, or (ii) the effective tax rate of the Foreign Affiliate is 20% or less even when the head office country has system of corporate income tax, the Foreign Affiliate is called Designated Foreign Subsidiary. Unless the Designated Foreign Subsidiary satisfies the conditions for the exemption, it will be subject to CFC rule in Japan.

Effective tax rate is calculated under the following formula;

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\text{Effective tax rate} = \frac{\text{Amount of tax imposed on the income of the Foreign Affiliate in the fiscal year}}{\text{Amount of income of the Foreign Affiliate in the fiscal year}}
\]
In considering effective tax rate, the amount of income will be subject to adjustment. The income which was excluded from the taxable income under the tax law of the country of head office must be included. In calculating the amount of tax, tax paid out of the country of head office may be included.

(2) Shareholders

The income is attributed to the Japanese shareholders if the shareholder holds 10% or more of the shares of the Designated Foreign Subsidiary (“Japanese Shareholders”).

(3) Exemption

Even when the effective tax rate of the Foreign Affiliate falls within the Designated Foreign Subsidiary, if the Designated Foreign Subsidiary satisfies the conditions for exemption, CFC taxation does not apply.

That is, if the Foreign Affiliate engages in business with substance, it will not be subject to CFC taxation. The criteria will be (i) business standard, (ii) substance standard, (iii) effective management standard, and (iv) affiliate transaction standard or head office country standard. The Foreign Affiliate must satisfy all the requirements from (i) to (iv).

(4) Income Imputation

The income imputed to the Japanese Shareholders is the total amount of income of the Foreign Affiliate. The calculation is conducted in either of two ways; (i) the method in accordance with the Corporate Tax Act of Japan, (ii) the method in accordance with the corporate tax act of the country of head office. Whichever ways the Japanese shareholders adopted, there will be some adjustment.

(5) Exception for Passive Income

In principle, if the condition for exemption is satisfied, the income of Foreign Affiliates will not be imputed to the Japanese corporations or Japanese resident individuals in accordance with their shareholding ratio. However, if the Foreign Affiliate has passive income, then the Japanese shareholders have to impute the amount
of passive income.

The items of passive income which have to be imputed are;

(i) the dividends
(ii) the interest from bonds or notes
(iii) capital gain from the redemption of bonds or notes
(iv) capital gain from the sales of shares
(v) capital gain from the sales of bonds or notes
(vi) royalties from the intellectual properties,
(vii) lease fee of vessels or aircraft

With respect to (i), the dividends falls under this exception only in the case where the shareholding ratio of the Foreign Affiliate in the issuer of the shares is less than 10%.

Similar condition will apply to (iv). The capital gain from the sales of shares must be taken into account for the purpose of this exception only in the case where the shareholding ratio of the Foreign Affiliate in the issuer of the shares is less than 10%.

(6) Avoidance of Double Taxation

In order to avoid double tax, the Japanese Shareholders of the Foreign Affiliate are eligible for foreign tax credit with respect to foreign tax paid by the Foreign Affiliate if the Japanese Shareholders are subject to CFC taxation.

Further, the dividend paid out of the amount income imputed to the Japanese Shareholders will not be included in the income of the Japanese Shareholders.

However, in the calculation of the capital gain from the sales of the shares of the Foreign Affiliate, the amount which is subject to tax under CFC rule will not be taken into account. Therefore, there can be potential double taxation.

(7) Tax Treaty Issues

Regarding the issue of whether CFC taxation in Japan is a breach of Article 7 of Japan Singapore Tax Treaty or not, Supreme Court issued a decision in 2009. The ruling made by the Supreme Court was almost the same as in the argument in the OECD
Commentary. The outline of the ruling is that Article 7 Paragraph 1 only limits the taxation by the other Contracting State of an enterprise of a Contracting State. Taxation under the CFC rule in Japan is taxation by the Japanese government of a Japanese corporation, and is out of the scope of the limitation under Article 7 Paragraph 1.

3. Anti-Avoidance Rule

There are not general anti-avoidance rule in Japan although the NTA tried to develop anti-avoidance rule. Instead, there are some special anti-avoidance rules in Japan. However, except for transfer pricing, these rule were not applied to foreign passive income of group companies.

4. Conclusion

Although there are special anti-avoidance rules in Japan, these rules were not used for the taxation of foreign passive income of Japanese group companies. CFC rule has been and will be useful means of taxation of foreign group companies in Japan.