Taxation of Foreign Passive Income for Group Companies

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In Japan, CFC rule was adopted in 1978. In principle, Japanese corporations are subject to corporate tax in Japan only with respect to its own income. Until CFC rule was adopted, foreign passive income obtained in low tax jurisdiction was not subject to tax in Japan under the corporate tax rule as long as it was obtained by another company in the same corporate group. But, since CFC rule was adopted, passive income obtained by foreign group companies are imputed to the Japanese parent company and subject to corporate tax in Japan.

Although anti-avoidance rule exists in Japan, such anti-avoidance rules have not been applied to foreign passive income except transfer pricing rule.

This report details how CFC rule in Japan tax the foreign income obtained by group companies, and outlines the anti-avoidance rules adopted in Japan.

1. General Corporate Tax System in Japan

(1) General Corporate Tax System in Japan

(a) Income Subject to Corporate Tax

In Japan, Japanese corporation is subject to corporate tax in Japan for its worldwide income. Japanese corporation is defined as the corporation that has head office or main office in Japan. Practically, these corporations are the corporations incorporated under the laws of Japan. Even when effective management of a corporation is in Japan, such corporation will not be treated as Japanese corporation unless it is not incorporated under the laws of Japan.

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.
The exception is corporations filing consolidated tax return. This system was adopted in tax reform of Japan in 2002. If the parent company elects to file the consolidated corporate tax return, the profit and loss of wholly owned subsidiaries in the corporate group will be aggregated. However, this system only applies to the Japanese corporations in the same corporate group.

(b) Income of the Foreign Subsidiaries

In principle, the income of foreign subsidiaries of a Japanese corporation will not be subject to corporate tax in Japan. The income will be subject to corporate tax in Japan only after the profit is distributed as dividend. Until 2011, all the amount of dividend distributed by foreign corporation was counted as income. If the dividend was subject to withholding tax, the recipient corporation may use foreign tax credit, and the amount of foreign tax may be credited against the corporate tax imposed. Further, if the recipient corporation held 25% or more of the shares of the foreign corporation, the recipient corporation was eligible to receive benefit under indirect foreign tax credit. Although the recipient corporation had to impute the amount of corporate tax paid by the payer corporation, the amount of corporate tax could be credited against the corporate tax to be paid in Japan if the corporation elected to apply indirect foreign tax credit.

However, after tax reform in 2011, this system was amended. After tax reform in 2011, if the recipient Japanese corporation holds 25% of the shares of the foreign payer corporation for 6 months or more, most of the amount of dividend paid by such foreign corporation will not be subject to corporate tax in Japan: only 5% of the amount of dividend received will be counted as its corporate income. Because foreign tax credit is the system to avoid double tax, foreign tax credit will not apply to the dividend under this income exclusion rule. That is, even when the dividend was subject to withholding tax, the recipient may not be able to enjoy benefit foreign tax credit as the dividend will not be subject to corporate tax in Japan. Further, indirect foreign tax system was abolished at the same time.

(2) Definition of Passive Income

In Japan, we did not have definition of passive income. However, when CFC rule was amended in the tax reform in 2010, definition of passive income appeared. The
income listed as passive income is as follows: (a) dividend, (b) interest from bonds or notes, (c) profit from the redemption of bonds or notes, (d) capital gain, (e) royalty and (f) lease fee from the lease of ship and aircraft. This passive income list will only work in CFC rule, and will not work in domestic tax context. This list works as an exception to the exemption of CFC taxation and detailed explanation will be provided later.

2. CFC Rule in Japan

We have a CFC rule in Japan. CFC rule was adopted in the tax reform of 1978. Basic purpose of this CFC rule was to prevent the corporate group from accumulating the income in the subsidiaries that does not engage in business with substance situated in a low tax jurisdiction. As indicated above, income of foreign subsidiaries is not subject to corporate tax in Japan until it is distributed as dividend. If income of a corporate group obtained outside Japan is accumulated in a subsidiary in low tax jurisdiction, and such income is used for reinvestment, such income of the group corporations will not be subject to corporate tax in Japan. On the other hand, if the Japanese corporation obtains income outside Japan, such income will be subject to corporate tax in Japan.

CFC rule was adopted to prevent this kind of tax avoidance. Under CFC rule of Japan, all the income of the subsidiaries in low tax jurisdiction will be imputed to the corporate income of Japanese parent corporation. The CFC rule in Japan applies to the corporation in a low tax jurisdiction. In this respect, Japanese CFC rule adopts jurisdictional approach. In principle, Japanese CFC rule does not tax income of foreign subsidiaries based on a kind of income, and thus, Japanese CFC rule does not adopt transactional approach.

Below, detailed explanation of CFC rule will be provided.

(1) Definition of CFC

(a) Definition of Foreign Affiliate

CFC rule applies to a controlled foreign corporation. In Japan, CFC is called Foreign Affiliate and in order to qualify as Foreign Affiliate, more than 50% of the total
number of shares or total amount of capital must be directly or indirectly held in aggregate by Japanese corporations and/or resident individuals of Japan.\(^1\)

If the foreign corporation issues classes of shares that are different with respect to voting rights, the foreign corporation will be a Foreign Affiliate if more than 50% of the voting rights are in aggregate held by Japanese corporations and/or resident individuals of Japan.

If the foreign corporation issues classes of shares that are different with respect to dividend distribution, the foreign corporation will be a Foreign Affiliate if Japanese corporations and/or resident individuals of Japan in aggregate hold rights to receive more than 50% of the amount of dividend distribution.

That is, a foreign corporation is a Foreign Affiliate if (i) more than 50% of the number of shares, (ii) more than 50% of the voting rights, (iii) rights to receive more than 50% of the dividend is held by Japanese corporation and/or Japanese resident individuals.

By the way, the shares of a foreign corporation are sometimes indirectly held by a Japanese corporation. In such a case, the shareholding ratio of a Japanese corporation will be calculated by multiplying the shareholding ratio held by the intermediary corporations. For example, a Japanese corporation A holds 80% of the shares of a foreign corporation B, and the foreign corporation B holds 80% of the shares of a foreign corporation C. For the purpose of deciding whether C is a Foreign Affiliate of A, the shareholding ratio of A in B and the shareholding ratio of B in C will be multiplied. Therefore, A will be considered to hold \(0.8 \times 0.8 = 64\%\) of the shares in C.

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\(^1\) In deciding whether a foreign corporation falls within the Foreign Affiliate, the shares held by non-residents who are in a special relationship with the resident shareholder or the Japanese corporation will be taken into account. Non-residents who are in a special relationship are (i) family members of the resident shareholder, (ii) persons who are in the situation of almost equivalent to marriage with the resident shareholder, (iii) employees of the resident shareholder, (iv) persons other than listed from (i) to (iii) and who earn living from the money given by the resident shareholder, (v) the family member of the persons listed from (ii) to (iv) who lives by the support of them, (vi) executives of the Japanese corporation and its family member, the person in the situation of almost equivalent to marriage with the executive, other persons who lives by the support of the executive.
and thus, C will be a Foreign Affiliate of A for the purpose of CFC rule in Japan.

**(b) Designated Foreign Subsidiary**

CFC rule in Japan applies to the Foreign Affiliate situated in low tax jurisdiction. CFC rule applies to the Foreign Affiliates only when either of the below is satisfied:

(i) The country of head office does not have any tax on corporate income; or

(ii) The country of head office has tax on corporate income, but the effective tax rate of the Foreign Affiliate is 20% or lower.

A Foreign Affiliate that satisfies either of the above is defined a Designated Foreign Subsidiary. Unless a Designated Foreign Subsidiary satisfy the condition for the exemption, the income of the Designated Foreign Subsidiary will be imputed to the income of the Japanese parent corporation or the Japanese resident shareholder.

When the CFC rule was originally adopted, the Japan adopted black list; that is, the foreign subsidiaries which is subject to CFC rule was decided based on whether the head office of CFC was situated in the black list countries. But, now, it is decided based on the effective tax rate of the Foreign Affiliate.

**(2) Shareholders**

Under CFC rule in Japan, income of a Foreign Affiliate which is located in a low tax jurisdiction (i.e. a Designated Foreign Subsidiary) is imputed to the shareholders in Japan. The shareholders that have to impute the income of a Designated Foreign Subsidiary are Japanese corporations or Japanese residents who hold directly or indirectly 10% or more of the shares of the Designated Foreign Subsidiary.

More precisely, Japanese corporations or Japanese residents will have to impute corporate income of the Designated Foreign Subsidiary if the Japanese corporations or the Japanese residents hold 10% or more of the total number of shares.

If the Designated Foreign Subsidiary issues classes of shares which are different with respect to voting rights, the Japanese corporations and the Japanese residents who
holds 10% or more of the voting rights have to impute the income of the Designated Foreign Subsidiary.

If the Designated Foreign Subsidiary issues classes of shares which are different with respect to dividend distribution, the Japanese corporations and the Japanese residents who hold rights to receive 10% or more of the dividend have to impute the income of the Designated Foreign Subsidiary.

That is, Japanese corporations, or Japanese residents who hold 10% or more of the number of shares, voting rights, rights to receive dividends will be subject to CFC taxation in Japan.

By the way, if the shares of a foreign corporation are indirectly held by a Japanese corporation, the shareholding ratio of a Japanese corporation will be calculated by multiplying the shareholding ratio held by the intermediary corporations. For example, a Japanese corporation A holds 80% of the shares of a foreign corporation B, and the foreign corporation B holds 80% of the shares of a foreign corporation C. For the purpose of deciding whether A has to impute the income of C, the shareholding ratio of A in B and the shareholding ratio of B in C will be multiplied. Therefore, A will be considered to hold 0.8 x 0.8 = 64% of the shares in C, and thus, A will be considered to hold 10% or more of the shares of C.

(3) Low Tax Jurisdiction Defined

CFC rule in Japan applies to the Foreign Affiliate situated in low tax jurisdiction. CFC rule applies to the Foreign Affiliates only when either of the below is satisfied:

(i) The country of head office does not have any tax on corporate income; or

(ii) The country of head office has tax on corporate income, but the effective tax rate of the Foreign Affiliate is 20% or lower.

With respect to (ii) above, effective tax rate shall be calculated as below;

\[
\text{The amount of tax imposed on the income of the Foreign Affiliate in the fiscal year} \quad \frac{\text{The amount of income of the Foreign Affiliate in the fiscal year}}{1 - \text{Effective tax rate}}
\]
(a) The Amount of Income of the Foreign Affiliate

With respect to denominator, in principle, the income will be calculated based on the tax law of the country where the head office of the Foreign Affiliate is situated. However, the following items shall be added to the amount of income: (a) amount of income which was not included in the tax base under the tax law of the foreign country, (b) the amount of dividend paid by the Foreign Affiliate and deducted from the income, (c) the amount of corporate tax deducted from the income, (d) the amount of insurance reserve that is maintained or added in excess of the amount granted for Japanese insurance corporations under the tax laws of Japan. On the other hand, if the amount of corporate tax refunded is included in the income, such amount will be deducted from the denominator.

With respect to (a) above, the “income” is classified based on the concept of income under the tax laws of Japan. However, the amount of dividend is excluded as the income that must be added. Therefore, for example, for the purpose of deciding whether the Dutch subsidiary is a Foreign Affiliate in a low tax jurisdiction, the amount of dividend that is excluded from the income under participation exemption is still disregarded.

With respect to (b) above, in Japan, REITs or other designated special kinds of real property investment vehicle are allowed to deduct the amount of dividend from the income. But, in deciding whether the Foreign Affiliate is situated in a low tax jurisdiction or not, the amount of dividend deducted from the income must be added.

With respect to (d), Japanese government found that some countries allow insurance companies to include significantly high amount of insurance reserve. In the light of this situation, the treatment indicated above is required.

(b) The Amount of Tax Paid by the Foreign Affiliate

With respect to numerator, the amount of tax includes all the amount of tax paid in the country of head office and outside the country of head office. However, the tax which may be refunded at the request of the tax payer, or the tax the deadline of payment may be extended at the request of the taxpayer will be excluded.
To illustrate, assume that a Foreign Affiliate invest outside the country of head office, and obtained income. Even when the amount of tax paid with respect to the income is low in the country of head office, the tax paid outside that country is taken into account for the purpose of CFC rule in Japan.

With respect to “tax”, there is a case where the issue was whether the tax in Guernsey would be considered as tax for the purpose of the CFC rule in Japan\(^2\).

In Guernsey, certain tax payers are eligible to choose to be subject to tax at the tax rate agreed with the government of Guernsey. Under this system, a wholly-owned subsidiary of a Japanese corporation negotiated with the government of Guernsey, and paid tax at the rate of 26% of the income\(^3\). Although the parent company of the Guernsey corporation did not impute the income of the Guernsey subsidiary, the National Tax Agency (the “NTA”) of Japan made tax assessment claiming that the “tax” paid by the Guernsey subsidiary did not qualify as foreign tax under the CFC rule in Japan.

In this case, the Tokyo District Court and the Tokyo High Court ruled in favor of the Japanese government. But, the Supreme Court of Japan reversed the decisions. The Supreme Court ruled that the money paid by the Guernsey subsidiary to Guernsey government is the money paid under the tax obligation generally applied to all the corporations which satisfy certain requirements, and that the money paid is not the consideration for the specific services made by the government. In this way, the Supreme Court decided that the “tax” in Guernsey shall qualify as foreign tax for the purpose of CFC rule in Japan.

However, under the tax reform 2011, the tax the rate of which was agreed between the tax payer and the government was specifically excluded from the foreign tax for the purpose of the CFC rule\(^4\).

\(^{2}\) Supreme Court of Japan, December 3, 2009.

\(^{3}\) At the time when the rate was agreed, a Foreign Affiliate was considered in a low tax jurisdiction (i.e. a Designated Foreign Affiliate) if the effective tax rate was 25% or lower.

\(^{4}\) The foreign tax defined for the purpose of the foreign tax credit is referred to for the purpose of the CFC rule in Japan. Therefore, if the tax rate is agreed, such tax is also
(4) Exemption

If the Foreign Affiliate is considered to be the Designated Foreign Subsidiary, the parent is subject to the CFC rule in Japan, and the income of the Foreign Affiliate must be imputed to the income of the Japanese corporation or Japanese resident who holds 10% or more of the shares. However, the CFC rules are provided in order to prevent the accumulation of income to the corporate group without substantial business. Even when the effective tax rate of the Foreign Affiliate is low, the CFC rule will not be applied if the Foreign Affiliate engages in substantial business.

Whether the Foreign Affiliate engages in substantial business will be decided based on the following criteria: (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).

(a) Business Standard

In order to be exempt from the CFC rule in Japan, the main business of the Foreign Affiliate must not be any of the following:

(a) holding shares;
(b) holding bonds or notes;
(c) providing intellectual properties or copyrights; or
(d) lease of ships or aircrafts.

With respect to (a) above, sometimes, a Japanese parent corporation has holding companies in order to control business of certain region, and have the holding company control the subsidiaries of such region. For example, Japanese corporation has holding company in the Netherlands to control the business in Europe. While the holding company controls business with substance, it can be subject the CFC rule if the effective tax rate is 20% or less. In order to avoid it, exception is granted to Controlling Companies which satisfy following requirements.

excluded from the foreign tax credited.
(i) all of the shares of the Controlling Company must be directly or indirectly held by one Japanese company;
(ii) the Controlling Company engages in the control (decision of basic business plan) of two or more Controlled Companies
(iii) the Controlling Company must have a fixed place of business to engage in the business control in the country of the head office;
(iv) the Controlling Company must have a person (other than the executive of the Controlling Company) to engage in the control of Controlled Companies on a permanent basis; and
(v) more than 50% of the book value of the asset of the Controlling Company must consist of the shares of the Controlled Companies.

When a Japanese corporation holds the shares of the Controlling Companies through another intermediary foreign corporation, whether the Japanese corporation holds all the shares of the Controlling Corporation or not shall be decided based on the same calculation method applied in deciding whether a foreign corporation is a Foreign Affiliate. Assume that a Japanese corporation A holds the shares of a foreign corporation B, and B holds shares of a Controlling Corporation B, whether the Japanese corporation holds 100% of the shares is decided by multiplying the shareholding ratio of A in B and B’s shareholding ratio of the Japanese company in C.

The Controlled Companies referred to above are foreign companies which satisfy the following conditions;

(i) 25% or more of the shares of the foreign company must be held by the Controlling Company;
(ii) the foreign company must have a person to engage in the business of the company on a permanent basis; and
(iii) the foreign corporation must be subject to control\(^5\) by a Controlling Company or its parent\(^6\);

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\(^5\) “Control” in this item means that a corporation holds more than 50% of the voting power of another corporation.

\(^6\) More precisely, any of the following; a Controlling Company, b. a Japanese corporation which holds 10% or more of the shares of the Controlling Company,
(b) Substance Standard

In order to be exempt from the CFC rule in Japan, a Foreign Affiliate must have the fixed place of business (such as office, stores, and factories) for its main business in the country of head office.

(c) Effective Management Standard

In order to be exempt from the CFC rule in Japan, the Foreign Affiliate must control the main business of the corporation in the country of head office. In deciding whether this condition is satisfied or not, the place of the general meeting or the board of directors meeting, the place where the executives engage in the business, the place where the accounting books are created will be taken into account.

(d) Affiliate Transaction Standard or Head Office Country Standard

In order to exempt from the CFC rule in Japan, in addition to the standards (a) through (c), a Foreign Affiliate must satisfy Affiliate Transaction Standards or Head Office Country Standard.

(i) Affiliate Transaction Standard

If the business engaged by the Foreign Affiliate is wholesale trade, banking, trust, transaction of financial instrument, insurance, water transportation business or aircraft transportation business, Affiliate Transaction Standard will apply. In order to satisfy this standard, the main business of the Foreign Affiliate must be the transaction with the
c. a foreign corporation whose share is held by the Japanese corporation indicated in b above, and holds the shares of the Controlling Company and such foreign corporation,
d. the foreign corporation indicated in c. above, and the foreign corporation whose shares are held by the foreign corporation indicated in c. above and holds the shares of the Controlling Company,
e. a Japanese corporation or the foreign corporations indicated from a. through d. above and the foreign corporation controlled by corporations a. through d. above; and
f. corporations indicated in a. through d. above.
parties who are not Affiliated Parties. Whether the main business of the Foreign Affiliate is the transaction with the parties who are not Affiliated Parties are decided based on the following formula;

1. Whole Sale Business

\[
\frac{\text{The amount of sales to non-Affiliated Parties}}{\text{The total amount of sales}} > \frac{50}{100}
\]

or

\[
\frac{\text{The amount of purchase of inventories from non-Affiliated Parties}}{\text{The total amount of purchase of inventories}} > \frac{50}{100}
\]

2. Banking Business

\[
\frac{\text{The amount received from non-Affiliated Parties}}{\text{The total amount of interest received}} > \frac{50}{100}
\]

or

\[
\frac{\text{The amount of interest paid to non-Affiliated Parties}}{\text{The total amount of interest paid}} > \frac{50}{100}
\]

3. Trust Business

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\text{The amount of trust fee received from} > \frac{50}{100}
\]

The Affiliated Parties are the following parties;

a. Japanese resident individual or Japanese corporation who holds 10% or more of the shares of the Foreign Affiliate,
b. a corporation which holds more than 50% of the shares of a Japanese corporation a. above;
c. a foreign corporation which holds the shares of the Foreign Affiliate, and all the shares of which are held by the Japanese residents or the Japanese corporations in a. above;
4. Financial Instrument Exchange Business

The amount of fee received from non-Affiliated Parties and capital gain arising from the transaction with non-Affiliated Parties > 50%

5. Insurance Business

The amount of insurance premiums from non-Affiliated Parties > 50%

6. Water Transportation Business or Aircraft Transportation Business

The amount of transportation fee or lease fee received from non-Affiliated Parties > 50%

(ii) Head Office Country Standard

For Foreign Affiliates engaging in business other than the business listed in (i) above, this Head Office Country Standard will apply. In order to be exempt from the CFC rule in Japan, the Foreign Affiliate must mainly engage in the business in the head office country. If the Foreign Affiliate engages in the business of sales or lease of real property, the Foreign Affiliate must engage in (a) the sales or lease, (b) agency of sales or lease, or (c) intermediary of the sales or lease mainly in the country of head office. If the Foreign Affiliate engages in the lease of movable properties, the Foreign Affiliate must engage in lease of the properties to be used mainly in the country of head office. The Foreign Affiliate engaging in other business must engage in its business mainly in the country of head office.
With respect to these standards, there is a court case where the classification of the business was an issue. In this case, a wholly owned subsidiary of a Japanese company was located in Hong Kong. Since the effective tax rate of companies in Hong Kong was less than 20%, the Hong Kong company was subject to the CFC rule in Japan unless the exemption standards are satisfied.

The Hong Kong company consigned manufacturing to a Chinese company, under the condition that the Hong Kong company provides manufacturing equipment and ingredients for free, and dispatched engineers for providing technical advice. On the other hand, the Chinese company shipped out all the products, and claimed to the Hong Kong company manufacturing cost, factory lease fee, and administration cost.

The issue in this case was whether the business engaged by the Hong Kong company (a Foreign Affiliate) is manufacturing or wholesale trade. If the business engaged by the Hong Kong company was considered wholesale trade, then it was exempt from the CFC rule in Japan as long as more than 50% of the sales is to non-Affiliated Parties. If the business engaged by the Hong Kong company was considered manufacturing, the Hong Kong company must engage in manufacturing in Hong Kong, and this condition is not satisfied. While the Japanese parent company filed tax return without imputing the income of the Hong Kong subsidiary, the NTA made tax assessment claiming that the business engaged by the Hong Kong subsidiary was manufacturing, and was subject to the CFC rule.

Tokyo High Court\(^8\) took into account of the fact that (i) the Hong Kong company proactively engaged in the planning of allocation of manufacturing facility, allocation of human resource, purchase of ingredients and management of the manufacture in the factory of the Chinese corporation, (ii) the Hong Kong company engaged in the control of the manufacturing, and controlled personnel in the factory of the Chinese corporation, (iii) the Hong Kong company made annual business plan as if the factory of the China corporation was a part of the Hong Kong company, (iv) the Hong Kong company filed tax return to the Chinese government notifying that it engage in wholesale trade in Hong Kong, and manufacturing in China, and that the Hong Kong company controls all the manufacturing process, and received favorable tax treatment (50% of the income from manufacturing in China was tax exempt). Tokyo High Court ruled that the Hong

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\(^8\) Tokyo High Court decision August 30, 2011.
Kong company engaged in manufacturing, rather than wholesale trade.

In the case above, it seems that the Japanese parent company incorporated a Hong Kong company in order to conduct manufacturing in China. In conducting manufacturing in China, it tried to make use of the favorable tax treatment in China\(^9\), and it does not seem to have intention of accumulation of income in the Hong Kong company. However, because of the structure, it was subject to the CFC rule in Japan.

(5) Income Imputation

If the effective tax rate of the Foreign Affiliate is 20% or less, and the Foreign Affiliate does not satisfy conditions for the exemption, it will be subject to the CFC rule in Japan. The Japanese corporation or the Japanese resident individual must impute income of the Foreign Affiliate in accordance with the ratio of dividend which the shareholders are entitled to receive.

Basically, all the amount of income of the Foreign Affiliate will be imputed. The total amount of income to be imputed is calculated under the following formula;

\[
\text{The total amount of income} - \text{The amount of dividend paid out of the amount subject to the CFC rule} - \text{The amount of corporate income tax to be paid by the Foreign Affiliate} - \text{The amount of losses to be carried over}
\]

(a) The Total Income

The amount of total income of the Foreign Affiliate is calculated 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.

1. Method under the Corporate Tax Act of Japan

When the income is calculated in accordance with the Japanese corporate tax act,

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\(^9\) As recognized by Tokyo High Court, if this manufacturing consignment structure was adopted, 50% of the income from manufacturing in China was tax exempt.
the total income will be calculated under the following:

The amount of income calculated pursuant to Corporate Tax Act of Japan + The amount of corporate tax to be paid by the Foreign Affiliate - The amount of corporate tax to be refunded - The amount of dividend received from subsidiaries

With respect to the amount of income calculated pursuant to Corporate Tax Act, the calculation method is adjusted. Among these items, what should be specifically noted is the inclusion of the amount of dividend received. In Japan, a part or all the amount of dividend received by a Japanese corporation will not be included in the amount of income. However, for the purpose of calculation of income of a Foreign Affiliate to be imputed to the parent, the provisions regarding the exclusion of dividend from corporate income will not apply. Instead, as in the last column of the formula above, the dividend received from subsidiaries (corporations in which the Foreign Affiliate holds 25% or more of the shares for 6 months or more) will be deducted.

2. Method under the Corporate Tax Act of the Country of Head Office

When the income is calculated in accordance with the corporate tax act of the country of head office, the amount of income is adjusted in order to avoid the result being significantly different from the amount calculated pursuant to the Corporate Tax Act of Japan. The adjustment is conducted for 17 items. The items to be added to the income of the Foreign Affiliate include (i) the income which is excluded from the income subject to tax, (ii) the amount of dividend which is deducted from the corporate income, and (iii) the amount of loss carried over from the past fiscal years. The items to be deducted include the amount of dividend received from subsidiaries (corporations in which the Foreign Affiliate holds 25% or more of the shares for 6 months or more).

(b) The Amount of Dividend Paid Out of the Income Imputed to Parents

The amount of dividend paid out of the income which was subject to the CFC rule will be excluded from the income to be imputed, as long as the dividend is paid out of
the distributable profit\textsuperscript{10}, and paid in accordance with the rights to receive dividends pre-determined. However, if the Foreign Affiliate holds 25% or more of the shares of the Foreign Affiliate paying the dividend for 6 months or more, the amount of dividend is already deducted in the calculation of total income in (a) above, and therefore, the dividend paid by such Foreign Affiliate will not be excluded here.

(c) The Amount of Losses Carried Over

There can be an amount of losses if the income is calculated pursuant to the method indicated in (5) (a) 1. and 2. The amount of losses generated in the past 7 fiscal years may be carried over.

(d) The Amount Allocated to Japanese Companies or Japanese Residents

The actual allocation of the amount of income to be imputed to Japanese parent is decided based on the ratio of dividend which each Japanese shareholder entitled to receive. Even if a Japanese corporation holds 10% or more of the shares of a Foreign Affiliate, if the Japanese corporation is not entitled to receive dividends, the amount of income allocated to the Japanese corporation is zero.

If the shares of a Foreign Affiliate are held through another foreign company, the ratio of dividend which each Japanese shareholder entitled to receive is calculated by multiplying the ratio of rights to receive dividend held by the Japanese company in another foreign company, and the ratio of rights held by the foreign company in the Foreign Affiliates.

(6) Exception for Passive Income

In principle, if the condition for exemption is satisfied, the income of Foreign

\textsuperscript{10} In this case, the amount of the distributable profit is the distributable profit of the Foreign Affiliates which are subject to the CFC rule in Japan. The distributable profit will be the aggregate of (i) the amount of income which should be imputed to the parent, (ii) the amount of dividend received from subsidiaries, (iii) the amount of income added to the Foreign Affiliate under the transfer pricing rule, but not actually paid to the Foreign Affiliate, less (iii) the amount distributed as dividend, and the amount of expense that were not included because of the adjustment indicated (5) (a) 1, and 2.
Affiliates will not be imputed to the Japanese corporations or Japanese resident individuals. However, if the Foreign Affiliate has passive income generating from certain types of assets, then the Japanese corporations or Japanese residents will have to impute a part of the income of the Foreign Affiliate.

(a) Items of Passive Income

The passive income listed in the law is as follows;

(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%.

As this exception is trying to tax the passive income which are not relevant to the business, if the income (i) through (v) are inevitable to the business of the Foreign Affiliate, these items will be excluded from the passive income to be taken into account.

With respect to (vi), royalties arising from the following intellectual properties are excluded from the amount taken into account for the purpose of this exception; (i) the intellectual properties developed by the Foreign Affiliate, (ii) the intellectual properties acquired by the Foreign Affiliate and used for its own business, (iii) the intellectual properties developed by the Foreign Affiliate, (iv) the intellectual properties acquired by the Foreign Affiliate and used for its own business.

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11 The business may not be the business which is listed in (4) (a) (Business Standard).
12 The business may not be the business which is listed in (4) (a) (Business Standard).
properties licensed to the Foreign Affiliate and used for its own business. 

(b) The Amount Imputed

The amount imputed is the amount of income indicated above. If the withholding tax is imposed, such amount will be deducted. Further, with respect to (i) through (iii), following amount will be deducted:

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\text{The amount of interest to be paid by the Foreign Affiliate} \times \frac{\text{The book value of the shares or notes at the end of fiscal year}}{\text{Total amount of asset of the Foreign Affiliate at the end of fiscal year}}
\]

The aggregate amount of the items of income (i) through (vii) will be imputed to Japanese corporation or Japanese resident in accordance with the ratio indicated in (5) (d) (ratio of rights to receive dividends).

(7) Avoidance of Double Taxation

For the purpose of the avoidance of double taxation, several items will be taken into account.

(a) Foreign Tax

If the Foreign Affiliate pays tax at the country of head office, and such tax is not taken into account for the purpose of the CFC rule, there can be an economic double taxation for the same income. In order to avoid double taxation, if income of the Foreign Affiliate is imputed to the Japanese corporation or Japanese resident, foreign tax credit will apply and the amount of tax paid by the Foreign Affiliate will be deemed foreign tax paid by the Japanese corporation or Japanese resident to whom the income will be imputed.

The amount of foreign tax which is deemed to be foreign tax paid by the Japanese corporation is calculated as follows;

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13 The business may not be the business which is listed in (4) (a) (Business Standard).
The amount of tax imposed on the income of the Foreign Affiliate x The amount of income to be imputed to the Japanese company or the Japanese resident

Total amount of income to be imputed to Japanese corporations and Japanese residents

If the income imputed is the amount of passive income, the amount of foreign tax which is deemed to be paid by the Japanese corporation is as follows;

The amount of tax imposed on the passive income of the Foreign Affiliate x The amount of income to be imputed to the Japanese company or the Japanese resident

Total amount of income to be imputed to Japanese corporations and Japanese residents

If the foreign tax credit applies, the amount which is deemed to be paid by the Japanese corporations or Japanese residents is credited against corporate tax or income tax.

(b) Dividend

If a Japanese corporation[^14] receives dividends from a foreign corporation, the amount to be included in the corporate income different depending on the shareholding ratio as indicated in 1. (1) (b). If a Japanese corporation holds less than 25% or less of the shares of a foreign corporation which pays the dividend, all the amount of dividend must be included in the income. However, if a Japanese corporation holds 25% or more of the shares of a foreign corporation, only 5% of the amount of dividend shall be included in the corporate income.

1. The Amount of Dividend out of the Income of the Foreign Affiliate Directly Held

If the dividend is paid by a directly held Foreign Affiliate out of the income which is subject to income imputation, all the amount of dividend will not be included in the corporate income of the Japanese corporation (if the shareholding ratio is less than

[^14]: The issues of Japanese resident individuals are not discussed here.
25%. to the extent of the amount imputed in the past 10 fiscal years.

If the shareholding ratio is 25% or more for 6 months, in principle, Japanese corporation have to include 5% of the amount of dividend. However, in this case, the Japanese corporation does not have to include this 5% of dividend until the amount of dividend reaches the amount imputed to the Japanese company in the past 10 fiscal years.

2. The Amount of Dividend out of the Income of the Foreign Affiliate Indirectly Held

If a Japanese corporation is subject to income imputation with respect to the Foreign Affiliate held through another foreign corporation, the amount of dividend paid by the direct holding foreign corporation will be excluded from the income to the extent of the amount of income imputed.

More precisely, the amount of dividend received from the direct shareholding company will be excluded from income to the extent of the lessor of (i) and (ii);

(i)

\[
\text{The dividend received by the foreign corporation during the Relevant Period} \times \frac{\text{The ratio of dividend which the Japanese corporation entitled to receive from the foreign corporation}}{\text{aggregate amount of the below;}}
\]

# Relevant Period is the fiscal years of the Japanese corporation receiving dividend which started within 2 years before the first day of the fiscal year receiving dividend (same in below).

(ii) aggregate amount of the below;

\[
\frac{\text{The amount to be imputed from the Foreign Affiliate in the fiscal year}}{\text{The number of shares indirectly held by the Japanese corporation}} \times \frac{\text{Total number of shares of the Foreign Affiliate}}{\text{The number of shares indirectly held by the Japanese corporation}}
\]
The amount to be imputed from the Foreign Affiliate in the Relevant Period \( \times \) The number of shares indirectly held by the Japanese corporation \( \text{Total number of shares of the Foreign Affiliate} \)

As in the above, the dividend by the Foreign Affiliate must be paid within 2 fiscal years after the income is imputed in order to avoid double taxation at the time when it is received by the Japanese corporation.

(c) Capital Gain

Although the amount imputed to income in the past may be taken into account when the Japanese corporation receives dividend, it will not be taken into account in calculating capital gain from the sales of the shares of the Foreign Affiliate or the foreign corporation holding the shares of the Foreign Affiliate. There is no increase in the base amount of the shares even when the income is imputed. Capital gain is fully taxable under the Corporate Tax Act of Japan.

(d) Case Study – Double Tax

Assume that the Japanese corporation A holds 40% of the shares of a foreign corporation B in country X, and A also holds all the shares of a foreign corporation C in country Y. C holds 60% of the shares of B. Effective tax rate of A is 40%, and B is zero, and C is 20%. C is subject to CFC tax with respect to the income of B, and the CFC rule in country Y is the same as in Japan. In Year 1, B obtains income of 100 and in Year 2, B distributes all of this 100 income in accordance with the shareholding ratio, and C distributes all the amount of dividend remaining after tax. Also assume that there is no withholding tax for dividend.
In this case, income of B in Year 1 (100) is fully imputed to income of A. A have to pay tax of 40. A part of B’s income (60) will be imputed to C’s income under the CFC rule in country Y. C has to pay 60 x 20% = 12 as corporate tax.

When B distributes all of its income 100 as dividend in accordance with the shareholding ratio, the dividend paid to A (40) shall not be included in A’s income. C receives dividend of 60, and all of this amount will not be included in corporate income of C. Although A is subject to CFC taxation on C’s income, the dividend received by C will be disregarded as it is paid out of the amount already imputed. If C pays to A all the income as dividend less the tax imposed on the income imputed (60 – 12 = 48) in Year 2, all the amount of dividend will not be included in the corporate income.

As a result, A received 40+48=88. The amount of tax paid by A is 40. So after tax income of A is 48. The CFC rule of Japan does not tax the dividend received by C. So, there is no double taxation for this respect. However, the source of income is B’s income, and as the tax in C will not be taken into account for the purpose of corporate tax of A in Japan, there is an economic double taxation with respect to the income imputed to C, and there is an increase of tax amount of 12. This economic double taxation will not be cured through tax treaty procedure.

(7) Tax Treaty Issues
(a) Argument concerning CFC Taxation and Tax Treaty

In Japan, there has been an argument as to whether CFC taxation is a breach of tax treaty. The argument arose from CFC taxation of a Singapore subsidiary of a certain Japanese company. The outline of the argument of commentators who advocate that the CFC rule in Japan is a breach of Japan Singapore Tax Treaty is as follows;

1. Under the CFC rule in Japan, accumulated income of Foreign Affiliates are calculated by the aggregate of the operating profit and loss, and non-operating profit and loss. This is the profits of an enterprise of the Foreign Affiliate of Japanese company.

2. Taxation of a profit of the Singapore company is not allowed under Article 7 of Japan Singapore unless the Foreign Affiliate has permanent establishment in Japan.

3. Whether the entity to which the tax is levied is the Japanese parent or the Singapore subsidiary is not relevant. The profit of Singapore entity is object of tax.

4. Although the OECD commentary to model tax treaty indicates that the paragraph does not limit the right of a Contracting State to tax its own residents under CFC provisions, it is clear that the OECD commentary does not have legally binding effect. Further, since Singapore is not an OECD country, the commentary is not relevant for the interpretation of Japan Singapore Tax Treaty.

These are the outline of the argument that the CFC rule is in breach of tax treaty. In Japan, as indicated in the rulings of the Supreme Court below, it is commonly understood that the OECD commentary is not legally binding, although it is commonly admitted that it is used as a reference for the interpretation of tax treaties.

(b) Case Law

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\(^\text{15}\) in 2009. The

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\(^\text{15}\) Supreme Court, October 29, 2009 *Hanrei Times No. 1311 Page 77.*
outline of the ruling of the Supreme Court is as follows;

1. The Article 7 Paragraph 1 of Japan Singapore Tax Treaty only provides “profit of an enterprise” and the provision does not specify the person who is subject to tax. But, it is clear the second sentence of the Article 7 Paragraph 1 provides regarding the taxation of an enterprise of a Contracting State having a permanent establishment in the other Contracting State. Since the second sentence is based on the first sentence, and it is logical to consider the first sentence is regarding the taxation of enterprise of a Contracting State. Therefore, Article 7 Paragraph 1 only limits the taxation by the other Contracting State of an enterprise of a Contracting State.

2. 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. While OECD Commentary may be considered as “supplementary means of interpretation” under Article 32 of Vienna Convention of the Law of Treaties, OECD Commentary clearly states that Article 7 Paragraph 1 does not limit the right of a Contracting State to tax its own residents. It shows that this interpretation is an interpretation widely accepted in many countries.

4. Having mentioned above, considering that the purpose of the tax treaty is to allocate the taxation right of the countries, and to prevent the double taxation, the tax system which infringes this purpose of tax treaty could be considered a breach of the tax treaty. However, under the CFC rule in Japan, Foreign Affiliates with a substantial business shall be excluded from the Foreign Affiliates subject to the CFC taxation. Further, the CFC rule adopts measures to avoid double taxation. Thus, the CFC rule in Japan does not unduly interfere with the international transaction between Japan and Singapore.

5. Therefore, CFC taxation in Japan shall not be considered a breach of Japan Singapore Treaty.

3. Anti-Avoidance Rule in Japan

(1) General Anti-Avoidance Rule
In Japan, we do not have provision in tax code providing for anti-avoidance rule. Tax avoidance is generally referred to as the act of taxpayers trying to avoid or reduce tax burden by electing unusual legal form in pursuing certain economic transactions under which the condition of tax will not be satisfied.

The NTA was trying to deny the legal form of transactions under which the condition to tax will not be satisfied. The NTA conducted tax assessment by deeming the transaction being conducted under the legal form which the NTA considered usual. However, in most cases, the court denied the denial of legal form adopted by the taxpayers.

The outline of the rulings by the court is as follows:\(^{16}\);

1. In principle, the party to the transaction may choose any legal form and there are no legal grounds to restrict the parties from adopting legal form in order to reduce tax burden.

2. In Japan, the conditions for triggering tax must be provided by law. The conditions for tax are provided based on the legal form adopted by the parties under the tax laws on income of Japan. Unless there are grounds under the law, the tax authority is not allowed to deny the legal form adopted by the parties and to deem the transaction being conducted under the form triggering the tax.

Having said the above, in some cases, the court denied the form adopted by the parties. After examining the terms and conditions of the agreement of the parties, if the parties actually agreed is not consistent with the legal form that was claimed by the taxpayers, the court recognized the legal form and tax consequences in accordance with the actual terms and conditions.

One of the examples of the cases in which the legal form was denied was the film lease case\(^ {17}\). A taxpayer X invested in a partnership A, which purchased ownership of the film of the movie created by B (a US corporation). The partnership A entered into an agreement with C, and provided C with the right to select the title of the movie, to

\(^{16}\) E.g. Tokyo High Court decision June 21, 1999

\(^{17}\) Supreme Court decision, January 24, 2006.
distribute the movie worldwide, to edit, to conduct advertisement etc., and such rights are further sold from C to B. According to the agreement, the right provided to C should not be affected by the termination of the agreement, and A was not entitled to limit the right of C. As a partner of A, X filed its tax return deducting depreciation amount corresponding to the interest in the film. But, the NTA made tax assessment, denying the depreciation of the film, claiming that A does not have substantial title to the film.

In the case above, the Supreme Court ruled that the most of the rights regarding the film was transferred to C, and substantially, A does not have right to use and profit making, and to dispose. The film in this case cannot be considered as depreciable asset of A, and of X.

As in above, there is no statutory general anti-avoidance rule in Japan. Generally, the court does not deny the legal form adopted by taxpayers as a means to avoid tax avoidance. However, there are some cases in which the court denied the legal form adopted by the taxpayers depending on the actual title the parties have.

(2) Special Anti-avoidance Rules

Although there are no statutory general anti-avoidance rules, there are some special anti-avoidance rules in Japan. There are three statutory anti-avoidance rule, (i) anti-avoidance rule for family corporations, (ii) anti-avoidance rule for corporations filing consolidated tax return, and (iii) anti-avoidance rule for corporate reorganization. Another international tax rule for anti-avoidance is transfer pricing rule.

(a) Anti-Avoidance Rule for Family Corporations

In the case of family owned corporation, it tends to conduct act of tax avoidance. In order to prevent the tax avoidance, anti-tax avoidance rule is provided.

A corporation is a Family Corporations if three or less shareholders (including a person or corporation in a special relationship) holds more than 50% of the total number of shares or equity interests.

As indicated in (1), generally the court is hesitant to deny the legal form of
transactions adopted by the taxpayers. However, under anti-avoidance rule for family corporations, the NTA is allowed to deny the legal form of the transactions adopted by the taxpayers.

The denial of the legal form of the transactions is allowed if the act of the family corporation “unduly reduce the tax burden of the Family Corporation”. There are many court cases with respect to this rule, and whether the act “unduly reduce the tax burden” or not is generally based on the criteria of whether the act is reasonable or not from the viewpoint of its economics.

Generally, if the transaction is not reasonable from the economics, and the reasons for the transaction are only to obtain tax benefit, the legal form of the transaction may be denied.

Theoretically, this rule may be applied to the transaction between a Japanese parent company and its foreign subsidiaries. However, to date, no cases were found where this special anti-avoidance rule was applied.

(b) Anti-Avoidance Rule for Corporate Reorganization

This special anti-avoidance rule for corporate reorganization was adopted when the rule for corporate reorganization was adopted. In the tax reform of 2001, corporate reorganization rule was adopted in Japan, and as long as the reorganization falls within the tax qualified corporate reorganization, it could be conducted tax free. However, the Ministry of Finance was afraid that this system of tax qualified reorganization may be abused, and special anti-avoidance rule was adopted.

This anti-avoidance rule is recently used by the NTA, and some of these cases are brought to the court.

Under the Companies Act of Japan, Japanese corporation may not be able to conduct merger, corporate split, share exchange or other kinds of statutory reorganization with foreign companies. Therefore, most of the tax qualified reorganization will not be relevant with respect to the relationship between Japanese parent and the foreign subsidiaries.
However, among the tax qualified reorganization, tax qualified contribution in kind can be conducted between Japanese corporation and the foreign subsidiaries. Even so, in order for the contribution in kind to be tax qualified, the contributing company may not contribute the asset in Japan to foreign companies, and the foreign contributing companies may not contribute the asset outside Japan to Japanese companies. The scope of this special anti-avoidance rule will be limited.

(c) Anti-Avoidance Rule for Corporate Group Filing Consolidated Tax Return

This special anti-avoidance rule for corporate groups filing consolidated tax return was adopted when the consolidated tax return system was adopted under 2002 tax reform. Under consolidated tax return system of Japan, a corporate group in a 100% shareholding relationship can file consolidated tax return. However, the Ministry of Finance was afraid that this system may also be abused, and special anti-avoidance rule was adopted.

This anti-avoidance rule may be applied to international context. But, no example of application of this rule was found.

(d) Transfer Pricing

Transfer pricing rule may be counted as one of the special anti-avoidance rule. Recently, transfer pricing rule was revised. Main revision includes;

- In the past, traditional transaction method had a priority over other calculation methods. In the 2011 tax reform, best method rule was adopted, any method which is appropriate can be adopted for the arm’s length price.
- Idea of range of transfer pricing was admitted. In the past, court\(^{18}\) ruled that there is no range in arm’s length price in Japanese transfer pricing rule.
- Provisions regarding documentation requirement was provided.
- In the administration guideline regarding transfer pricing, it was made clear that the negotiation process of the pricing will be taken into account. In Japan, transfer pricing rule may be applied to the transaction between a foreign company and the Japanese corporate shareholder holding 50% and or more of the shares of the

\(^{18}\) Takamatsu High Court decision October 13, 2006.
foreign company. However, in the case of 50-50 joint venture, the price are often heavily negotiated, and the conditions often reflect arm’s length price. The administration guideline made clear that such negotiation process will be taken into account.

There is not special transfer pricing rules for the transaction between Japanese companies and the group companies in a low tax jurisdiction. There are no reversed burden of proof rules for the payments to low tax jurisdictions.

(e) Thin Cap Rule or Similar Interest Deduction Limitation Rule

Thin cap rule in Japan mainly applies to the borrowings from the Foreign Major Shareholder. The Foreign Major Shareholder is (i) a non-resident or a foreign company which directly or indirectly holds 50% or more of the Japanese company, and (ii) a foreign company which is under the common control by the same shareholder.

Thin cap rule applies if both of the following conditions are satisfied;

1. The amount of the average amount of debt in the fiscal year is more than three times of the amount in the capital account of the Japanese company, and
2. The amount of the average amount of debt in the debt provided by the Major Foreign Shareholder is more than three times of the amount in the amount of capital corresponding to the shareholding ratio of the Foreign Major Shareholder.

If both of the above are satisfied, the interest corresponding to the amount of debt indicated in 2 above will not be deductible. As this rule applies to the borrowing from the foreign companies under the same control, this rule may apply to the borrowings of a Japanese company from the foreign finance company in the same group. For example if a Japanese holding company A holds all the shares of a Japanese company B and a foreign finance company C, and if B borrows money from C, the interest paid to C may be subject to thin cap rule, and the shareholding ratio of C for the purpose of thin cap rule is decided based on the ratio held by A.

In the tax reform of 2012, additional anti-avoidance rule was adopted. From the

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19 The control here means holding, directly or indirectly, 50% or more of the shares
fiscal year starting on or after April 1, 2013, if the amount of interest paid to affiliated foreign companies (less certain interest received) by a Japanese company exceeds 50% of the corporate income of the Japanese company, the excess portion of such interest may not be deductible. Practically, the possibility that the Japanese company in a Japanese group will be subject to this rule is not high, but, this system may work as anti-avoidance rule.

4. Conclusion

Although there are special anti-avoidance rules in Japan, these rules were not provided to target the taxation of foreign passive income of Japanese group companies. On the other hand, CFC rule has a provision for taxation of foreign passive income. As CFC rule is clearer, CFC rule will be used more for the purpose of taxation of foreign group companies in Japan.

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