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# Recent developments in international taxation – Japan

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## Introduction

With respect to the policy proposals presented in the BEPS 2015 Final Reports published by the OECD/G20, the Japanese government has already implemented all of the minimum standards, and some of the common approaches/best practices. Most recently, the annual tax reform in 2019 aligned the transfer pricing rules and interest deduction limitation rules with the 2017 OECD Transfer Pricing Guidelines and BEPS 2015 Final Report (Action 4), respectively. The government is considering introducing a mechanism to require taxpayers to disclose information on certain aggressive tax planning arrangements, such as mandatory disclosure rules proposed by the BEPS 2015 Final Report (Action 12) but has not yet determined a particular direction. Further, the 2020 annual tax reform overhauled the entire consolidated taxation system, and significant resources had to be allocated thereto.

Against this background, the volume of legislative actions taken in the 2020 annual tax reform in the area of international taxation is modest as compared to those in the preceding several years. However, there are a number of important developments which taxpayers and tax professionals should be aware of, and this report explains them below.

## Preventing tax avoidance effected through a combination of dividends received from subsidiaries and transfer of subsidiary shares

Under Japanese corporate tax law, 95 per cent of dividends received from foreign subsidiaries are exempt from Japanese corporation tax, while capital gains/losses from transfer of shares of such subsidiaries are fully taxable. Due to this asymmetrical treatment, before the 2020 annual tax reform, it was possible for a Japanese corporate taxpayer: 1. first to receive a large amount of dividends from its foreign subsidiary and pay corporation tax on only 5 per cent of such dividends; and 2. then to transfer shares of such subsidiary and realise a capital loss, which could be offset against its other income. The second step is likely to generate a capital loss because of the cash out from the

subsidiary in the form of dividends, and the government viewed this scheme as tax avoidance.

In order to address this scheme, a new rule has been introduced through the 2020 annual tax reform. Under the new rule, if 1. the total amount of dividends a corporate taxpayer receives from a subsidiary in a fiscal year exceeds 2. an amount equivalent to 10 per cent of the tax book value of shares of such subsidiary held by such corporate taxpayer, then the tax book value of such shares will be reduced by an amount equivalent to the dividend amount that is exempt from Japanese corporate tax. Where this rule applies, then, because of the reduction in the tax book value of the shares of the subsidiary, the corporate shareholder is no longer able to realise a capital loss for the amount of decrease in value of such shares as a result of dividends paid out.

This new rule is intended to be an anti-abuse rule, and as such, there are also several exceptions for situations where concerns in relation to tax avoidance are limited. For example, the new rule does not apply if a taxpayer is able to establish by documentary evidence that dividends are paid out of the profit surplus accumulated after the corporate shareholder has become the parent company of such shareholder.

This new rule will be effective with respect to dividends received in a fiscal year commencing on or after 1 April 2020.

**Disallowing offsetting of depreciation expenses with respect to overseas used real property against other income**

Over the past several years, the government had considered as problematic a scheme under which 1. individual taxpayers reduced their taxable income that was subject to progressive tax rates (55 per cent at a maximum), by taking a deduction for depreciation expenses with respect to their overseas used real property; and 2. realised a capital gain that is subject to a 20 per cent flat tax rate at the time of disposal of such real property. This scheme was attractive since depreciation expenses for used real property can be

calculated by using the 'simplified method', under which, depending on the type of real property, the depreciation period can be as short as four years, and therefore, individual taxpayers can claim large amounts of depreciation expenses in the early stages of their investment.

To prevent erosion of the tax base using this scheme, a new provision has been enacted to disallow offsetting of net loss from overseas used real property against other income, to the extent of depreciation expenses with respect to such overseas real property. This amendment will be effective with respect to individual income tax for the calendar year 2021 and thereafter, regardless of whether overseas real property is acquired before 1 April 2020 or not.

**Tax treaty network**

As of 1 August 2020, Japan has 76 tax treaties in force, including 11 tax information exchange agreements (TIEA) and the Convention on Mutual Administrative Assistance in Tax Matters.

The government is very active in trying to expand its tax treaty network further. Since June 2019, Japan has signed a new tax treaty with seven countries (Argentina, Jamaica, Morocco, Peru, Serbia, Uruguay and Uzbekistan), and the government is negotiating with four countries (Finland, Greece, Nigeria and Tunisia) for a new tax treaty or amendment to the existing treaty. Further, since June 2019, new tax treaties with Croatia and Ecuador, as well as an amendment to the existing tax treaty with the United States, have entered into force.

**Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)**

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which was proposed by the BEPS 2015 Final

Report (Action 15) and amends existing tax treaties, entered into force for Japan as of 1 January 2019.

Japan elected that tax treaties with 41 jurisdictions be treated as covered by the MLI. Among such 41 jurisdictions, 26 jurisdictions have deposited the instruments of ratification as of 22 July 2020. The jurisdictions that have deposited the instruments of ratification since June 2019 are Canada, the Czech Republic, India, Indonesia, Kazakhstan, Norway, Oman, Portugal, Qatar, Saudi Arabia, South Korea and Ukraine.

**Common Reporting Standards (CRS)**

The 2020 annual tax reform includes amendment to the domestic legislation implementing the Common Reporting Standard (CRS) so that such legislation will be further aligned with the CRS.

Among others, the amendment has introduced a new provision, under which any act (or omission) by financial institutions, persons or intermediaries shall be ignored for the purpose of application of the CRS legislation, where one of the principal purposes of such act (or omission) is to circumvent reporting of information on financial accounts to tax authorities under the CRS legislation. This is noteworthy in that it is the second domestic piece of tax legislation that has introduced a test similar to the principal purposes test (PPT) proposed by the BEPS 2015 Final Report (Action 6) to prevent treaty abuse, following the introduction, in the 2018 annual tax reform, of a similar test to prevent avoidance of constructing a permanent establishment.

This amendment is effective with respect to an act (or omission) on or after 1 April 2020.

**Extending statute of limitations in case of taxpayer's non-cooperation**

The 2020 annual tax reform introduced a mechanism to extend the statute of limitations, where taxpayers are not cooperative in providing information to tax

authorities, and the authorities have to rely on an exchange of information framework under applicable tax treaties.

That is, if a taxpayer does not provide information on cross-border transactions or overseas assets in a timely fashion in response to a request by a tax official, and tax authorities make a request to another jurisdiction for exchange of information on such transactions or assets pursuant to an applicable tax treaty, the statute of limitations for a tax assessment with respect to such transactions or assets will be extended until three years after the date of such request by tax authorities to such another jurisdiction.

This amendment will be effective with respect to taxes in relation to which the statutory due date for the tax return or tax payment is on or after 1 April 2020.

**Conclusion**

While the Japanese government has already implemented many outcomes of the OECD/G20 BEPS Project, the government is yet to be fully reassured. The government will continue to take any legislative or enforcement measures to address international tax avoidance, and taxpayers and tax professionals need to keep their eyes on such developments.