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Recent Developments in International Taxation

JAPAN

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1. Summary

In recent years, there have been many amendments to international tax rules in Japan based on the BEPS 2015 Final Reports published by the OECD. This trend can also be seen in the 2019 tax reform, which was passed by the National Diet of Japan (parliament) on 27 March 2019. The 2019 tax reform amends, among other matters, provisions regarding the transfer pricing rule, interest deduction limitation rule and CFC rule.

2. Transfer Pricing

Under the 2019 tax reform, based on Chapter 6 of the 2017 OECD transfer pricing guidelines, the discount cash flow method (the DCF method) is introduced as one of the calculation methods of an arm's length price. It is expected to be applied to transactions involving intangibles or corporate reorganisations, for which it is difficult to find proper comparables. However, since the new law does not provide details of the DCF method, it is likely that the National Tax Agency will publish administrative guidance explaining the DCF method in more detail. In addition, if taxpayers do not provide the tax authority with documents necessary for applying the DCF method in a tax audit, in order to calculate the arm's length price, the tax authority can apply the DCF method based on the information that they could know at the time of the transaction.

In addition, the Japanese transfer pricing rule introduces a price adjustment rule for transactions involving hard-to-value intangibles (HTVI), in accordance with paragraphs 6.186 to 6.195 of the 2017 OECD transfer pricing guidelines. The tax authority can calculate the arm's length price of transactions involving the HTVI by using the price adjustment rule in cases where there are differences between the projections and outcomes that serve as the basis of the calculation of the arm's length price of transactions involving the HTVI. However, if the difference between the amount calculated under the price adjustment rule and the consideration determined at the time of the transaction does not exceed 20%, the price adjustment rule is not applied. In addition, the price adjustment rule is not applied if the taxpayer submits certain documents within certain periods from the date when the tax authority required the taxpayer's submission thereof. HTVIs are defined as intangibles (i) that are unique and valuable, (ii) which arm's length price should be calculated based on future cash flow, etc., and (iii) which projections that serve as the basis of the calculation of the

arm's length price are highly uncertain.

3. Interest Deduction Limitation rule

As to the interest deduction limitation rules, there are two different rules under Japanese tax law. One is the thin capitalization rule, under which interest deductions are limited based on the debt-equity ratio, and the other is the earnings stripping rule, which limits interest deductions based on the ratio of net interest expenses to EBITDA. Under the 2019 tax reform, the earnings stripping rule is amended significantly based on the recommendation of the BEPS Action 4 2015 Final Report.

Under the new rule, the net interest expenses of a corporation (i.e., interest expenses minus the interest income corresponding to the interest expenses) are deductible from its taxable income up to 20% of its EBITDA. The interest expenses that are subject to the new rule include not only interest paid to related parties but also that paid to unrelated parties. On the other hand, interest expenses that are subject to Japanese taxation in the hands of the payee are excluded from the interest expenses that are targeted by the new rule.

The new rule is not applicable in cases where the net interest expenses of a corporation are 20 million JPY or less, or where the ratio of the net interest expenses of a corporate group to the EBITDA of the corporate group is 20% or less.

The new rule will enter into force from fiscal years beginning on or after 1 April 2020.

4. CFC rule

Following the 2017 and 2018 tax reforms, the 2019 tax reform also includes amendments to the Japanese CFC rule. The amendments under the 2019 tax reform cover a wide range of topics, and, among them, the treatment of transparent entities under the CFC rule is interesting both practically and theoretically. In cases where a legal entity is treated as transparent from the perspective of the local jurisdiction's tax law while it is treated as opaque from the perspective of Japanese tax law (a so-called hybrid entity), the effective tax rate of that entity for purposes of the Japanese CFC rule could be zero since it is not subject to corporate income tax under the tax law of the local jurisdiction. This issue has been discussed in the context of a US entity that is treated as a transparent entity for US tax purposes due to the application of the check-the-box rule. Under the 2019 tax reform, it is newly provided that the effective

tax rate of such an entity is calculated without taking into consideration the provision that treats the entity as transparent (such as the check-the-box rule).

5. Multilateral Instrument

Japan signed the Multilateral Instrument (MLI) on 7 June 2017, and it was approved by the National Diet of Japan on 17 May 2018. Accordingly, as of 24 May 2019, the MLI is applicable to the tax treaties with the following countries: Ireland, Israel, the UK, Austria, Singapore, Sweden, Slovakia, New Zealand, France and Poland. In addition, the MLI will be applicable to the tax treaties with the following countries in the near future: the Netherlands (from 1 July 2019), Finland (from 1 June 2019) and Luxemburg (from 1 August 2019).

6. Tax Treaties

As of 1 May 2019, Japan has concluded 74 tax treaties, 11 tax information exchange agreements and the Convention on Mutual Administrative Assistance in Tax Matters. Since June 2018, Japan has signed a new tax treaty with Spain in October 2018, with Croatia in October 2018, with Colombia in December 2018 and with Ecuador in January 2019. In addition, Japan agreed in principle on a new tax treaty with Argentina in December 2018, with Jamaica in December 2018 and with Uruguay in April 2019. All of these treaties have yet to enter into force.

7. Conclusion

Most of the recommendations of the BEPS 2015 final reports have been introduced in Japanese domestic tax law through the recent tax reforms, but some important matters remain unchanged, including the mandatory disclosure rules in BEPS Action 12. That subject will likely be taken up in the 2020 tax reform.

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