Recent Developments in International Taxation

Japan

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Overview

Japan actively participates in the ongoing discussion at the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework to address the tax challenges arising from the digitalisation of the economy. In its annual outline of tax reform for fiscal year 2022, the Japanese Government expressed its commitment to continue to proactively contribute to this discussion and to prepare for implementation of the international agreement on two pillar solutions. Although the Pillar two solution will be classified as a common approach (which is not mandatory for the participating countries to implement), officials of the Japanese Ministry of Finance have stated that they plan to implement both the Pillar one and two solutions. Separately, in relation to international taxation, the Government is also considering a major reform of Japan's gift/inheritance tax regime so that the overall tax burden will be largely the same regardless of whether the estate is transferred as a gift while the owner is still alive or through inheritance at his/her death.

Against this background, the volume of legislative activity taken in the 2022 annual tax reform in the area of international taxation was limited. Among the legislative actions taken in 2022, however, it is noteworthy that, while the Government continues to take measures to address base erosion and profit shifting (BEPS) concerns, the Government is also taking action to amend the anti-BEPS rules that were implemented in the past several years so that those rules will not unduly interfere with legitimate business activities (see below).

Expanding the scope of earning stripping rules to cover income not attributable to a PE in Japan

Under the earning-stripping rules of Japan, interest is not deductible in calculating taxable income of the payer, if, and to the extent that, the total amount of interest that is paid to (both related and third-party) lenders and not subject to Japanese taxation at the level of the recipients of the interest payments exceeds 20 per cent of earnings before interest, taxes, depreciation, and amortization (EBITDA) of the payer as calculated for this purpose.

Before the 2022 annual tax reform, however, where a foreign company was the payer of interest, the earning stripping rules had been applicable only to the extent of Japan-

sourced income that was attributable to a permanent establishment (PE) in Japan. In contrast, while a foreign company is still required to file a corporation tax return with respect to certain types of Japan-sourced income that is not attributable to a PE in Japan (eg, income from real estate in Japan), such income had been outside the scope of the earning stripping rules.

Due to concerns that certain foreign companies may be reducing their taxable income that is not derived through a PE in Japan by recording an excessive amount of interest expenses, the 2022 annual tax reform expanded the scope of earning-stripping rules so that Japan-sourced income not attributable to a PE in Japan will also be covered by the earning-stripping rules.

Expanding the scope of assets and liabilities report to cover wealthy individuals with relatively small income

In order to collect information on the assets held by taxpayers and thereby ensure proper tax reporting, Japan has the following information reporting requirements:

Reporting on assets and liabilities

A person having an obligation to file a Japanese income tax return is required to file a report on his/her assets and liabilities, if, as of 31 December each year:

1. his/her total income exceeds JPY 20m; and

2. either (i) the total value of his/her assets is JPY 300m or more, or (ii) the total value of his/her securities, unsettled derivative transactions and certain financial products, is JPY 100m.

Reporting on foreign assets

A permanent resident of Japan is required to file a report on his/her assets held outside Japan, if such assets have a total net fair market value exceeding JPY 50m as of 31 December each year.

Since wealthy individuals having relatively small taxable income fell outside the scope

of this reporting on assets and liabilities under category (1) above, the 2022 annual tax reform expanded the scope of reporting for category (1) so that a resident of Japan is required to report his/her assets if the total value of his/her assets is JPY 1bn or more as of 31 December each year, regardless of the amount of his/her taxable income in that year. At the same time, in order to mitigate the administrative burden on taxpayers, the filing due date of reports under either category (1) or category (2) was extended from 15 May to 30 June of the following year of each calendar year.

Amending the anti-abuse rule to reduce tax book value of subsidiary shares after receiving dividends to mitigate taxpayers' concerns

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 the 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) to first to receive a large amount of dividends from its foreign subsidiary and pay corporate tax on only five per cent of such dividends; and (2) then transfer the shares of such subsidiary and realise a capital loss, which could be offset against the Japanese corporate taxpayer's 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.

In order to address this two-step scheme which allowed Japanese corporate taxpayers to pay less tax, the 2020 annual tax reform introduced a new rule, under which, if (1) the total amount of dividends a corporate taxpayer receives from a subsidiary in a fiscal year exceeds (2) an amount equivalent to ten per cent of the tax book value of the 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. Therefore, where this rule applies, 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 the dividend paid out.

This new rule is intended to be an anti-abuse rule, and as such, a corporate taxpayer will be exempt from this rule in the following circumstances where BEPS concerns are considered limited:

1. where the relevant subsidiary is a Japanese company if Japanese companies and residents have owned 90 per cent or more of the shares of such Japanese subsidiary since its incorporation;[1]

2. (i) the amount of profit surplus of the subsidiary after dividend distribution is not less than: (ii) the amount of profit surplus at the time when the corporate shareholder that receives such dividends acquired more than 50 per cent control over such subsidiary;

3. the total amount of dividends received by the corporate shareholder in a fiscal year is JPY 20m or less; or

4. the corporate shareholder receives dividends after ten years from when the corporate shareholder acquired more than 50 per cent control over the subsidiary.

After introduction of this rule, however, corporate taxpayers expressed concern that certain aspects of this rule are too stringent and can unduly interfere with legitimate business activities. For example, calculation of amount (i) under exemption (2) above did not take into account any increase in profit surplus during the fiscal year in which the dividend distribution was made, and this made it difficult for a corporate taxpayer to satisfy exemption (2) above if it received interim dividends from its subsidiary.

In response to such concerns, the 2022 annual tax reform made certain amendments to this rule.[2] For example, with respect to exemption (2) above, a corporate taxpayer can now elect to take into account an increase in profit surplus during the fiscal year in which a dividend distribution is made when calculating amount (i), on the condition that the corporate taxpayer is also required to take into account an increase in profit surplus during the fiscal year in which it acquired more than 50 per cent control over the subsidiary when calculating amount (ii).

Tax treaty network

The Japanese government continues to be active in expanding or updating its tax treaty network. Since 1 January 2021, new tax treaties between Japan and seven different countries (Colombia, Georgia, Morocco, Peru, Serbia, Spain and Uruguay) have come into effect. In addition, during the same period, Japan signed a protocol amending the

existing tax treaty with Switzerland and has initiated negotiations for tax treaties to be signed with three other countries (Algeria, Azerbaijan, and Ukraine). All new or amended treaties are designed to be consistent with the minimum standards recommended by the BEPS 2015 Final Report (Action 6).

As of 1 September 2022, Japan has 83 tax treaties in force, including 11 tax information exchange agreements (TIEA), the Convention on Mutual Administrative Assistance in Tax Matters and a private-sector tax arrangement with Taiwan.

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

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, took effect for Japan as of 1 January 2019.

Japan elected that tax treaties with 42 jurisdictions be considered as covered by the MLI. Among such 42 jurisdictions, 35 jurisdictions have deposited instruments of ratification as of 28 July 2022. The jurisdictions that have deposited instruments of ratification since 1 January 2021 are China, Hong Kong, Hungary, Malaysia, Romania and Thailand.

Japan made, in its instrument of ratification, an election to apply the following provisions of the MLI, and thus, Japan's tax treaties have been or will be amended by these provisions, where the other contracting state also chooses to apply these provisions:

- provisions for application of the MLI to income derived through fiscally transparent entities (Article 3);
- provisions for determination of the resident state of a dual resident entity (Article 4);
- provisions regarding the wording of the preamble of tax treaties referring to the purposes of the tax treaties (Article 6);
- provisions for denial of treaty benefits based on the principal purpose of a transaction (Article 7);
- provisions for taxation on capital gains from the alienation of shares or comparable rights deriving their value principally from immovable property (Article 9);

- provisions for limitation of benefits for profits attributable to permanent establishments situated in third jurisdictions (Article 10);
- provisions regarding artificial avoidance of the permanent establishment status through commissionaire arrangements (Article 12);
- provisions regarding artificial avoidance of the permanent establishment status through the specific activity exemptions (Article 13);
- provisions for improving mutual agreement procedures (Article 16);
- provisions for corresponding adjustments to transfer pricing taxation (Article 17); and
- provisions for mandatory binding arbitration (Part VI).

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[1] The rule includes this exemption because the rule can apply to both domestic and foreign subsidiaries, while dividends from domestic subsidiaries raise fewer BEPS concerns.

[2] The 2022 annual tax reform contains an amendment to the Japanese controlled foreign corporation (CFC) rule so that certain specified insurance companies that are required to operate their businesses in a certain specified manner due to applicable insurance business regulations will not be subject to CFC taxation.