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Japan's CFC rules tightened in line with BEPS action 3

The 2017 tax reform enacted by Japan's National Diet on 27 March 2017 makes fundamental changes to the country's controlled foreign company (CFC) rules (for prior coverage of the reform, see *World Tax Advisor*, 28 April 2017). The changes generally were made in light of the OECD's final report on action 3 of the BEPS project and to address aspects of the existing rules that potentially lead to the under- or over-inclusion of income. The new rules will become effective for accounting years of a foreign related company that begin on or after 1 April 2018.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170428_2.html

The key measures that may have potential tax implications for Japanese-owned groups are discussed below.

Current rules and background

Under Japan's CFC regime, income derived by certain foreign subsidiaries is taxed currently at the level of the Japanese parent. A foreign subsidiary of a Japanese company is considered a CFC if both of the following tests are met:

- The foreign company is more than 50% controlled, directly or indirectly, by Japanese shareholders. A foreign company is considered "controlled" for these purposes if Japanese shareholders own, directly or indirectly, more than 50% of the outstanding shares, the voting shares or the dividend rights of the foreign company; and
- The country in which the foreign company is resident does not impose income tax, or the effective tax rate (ETR) of the foreign company is "less than 20%." (The ETR is calculated by making certain adjustments to the local tax rate and is computed for each fiscal year.)

If a foreign subsidiary qualifies as a CFC, each Japanese shareholder that holds directly or indirectly 10% or more of the outstanding shares (or voting shares or dividend rights, if any) of the CFC is required to report its pro rata share of the taxable profits of the CFC, unless an exception under the rules applies (*e.g.* the active business exemption). All income of the CFC is apportioned – no distinction is made between active and passive income.

There has been considerable discussion about the need to update the CFC rules because they are both under-inclusive and over-inclusive. For example, if the ETR of a foreign subsidiary is 20% or more, the CFC rules do not apply (*i.e.* none of the foreign subsidiary's income is subject to taxation at the level of the Japanese parent company), even if the subsidiary lacks actual economic substance. This leads to the potential "under-inclusion" of income. On the other hand, where the ETR of the foreign subsidiary is less than 20%, income earned by the company may be subject to Japanese taxation in certain circumstances, even where the subsidiary has actual economic substance. This leads to the potential "over-inclusion" of income.

In line with the basic premise of the OECD BEPS project that tax should be imposed based on where the actual economic activities of foreign subsidiaries occur, the changes to the CFC rules aim to ensure that passive income arising in a foreign subsidiary without sufficient economic substance will be aggregated with the income of the Japanese parent company. Active income earned by businesses with sufficient economic substance, however, will not be included in the total income of the Japanese parent, regardless of the subsidiary's ETR.

Overview of new rules

The new rules make the following changes:

- The definition of a controlled foreign subsidiary is revised.
- Both an "entity approach" and an "income approach" will be used.
- The CFC regime generally will apply where a foreign subsidiary is considered a "paper company," a "cash box" or a "blacklist company" (collectively, a "specified foreign subsidiary"), even if the ETR of the foreign subsidiary is 20% or more (but less than 30%).
- Changes are made to the active business exemption.
- The scope of passive income is expanded.

Definition of controlled foreign subsidiary: The revised rules appear to focus on the purpose of the CFC rules as an anti-tax avoidance measure. They will introduce an additional substantive control test, under which a foreign company will be treated as a controlled foreign related company where certain conditions are fulfilled (*e.g.* where the Japanese company has a residual claim for "almost all" the assets of the foreign company), even if Japanese shareholders own 50% or less of the outstanding shares, the voting shares and the dividend rights of the foreign company.

Entity approach / income approach: The application of the revised CFC rules will be based on both an entity approach and an income approach. The entity approach is similar to the main framework under the current rules, and will look at certain characteristics of the company (*e.g.* the ETR of the subsidiary or the overall extent of active business undertaken in the subsidiary, etc.). Under the income approach, a determination will be made based on the details of income earned by the foreign subsidiary. The "less than 20%" tax rate test will be replaced by the following three ETR rules:

- A company that has an ETR of 30% or more will fall outside the scope of the CFC rules.
- The income of a company that is a "specified foreign subsidiary" will be subject to CFC taxation on an entity basis in the hands of the Japanese shareholder unless the specified foreign subsidiary's ETR is 30% or more.
- The income of a company that is not a specified foreign subsidiary and that has an ETR of less than 20% will be subject to CFC taxation on an entity basis in the hands of the Japanese shareholder unless the foreign subsidiary satisfies the "economic activity test," in which case only its passive income will be subject to CFC taxation.

Specified foreign subsidiaries: Under the current CFC rules, where the ETR of a foreign subsidiary is 20% or more, the income of the company is not subject to Japanese taxation in the hands of the Japanese shareholder. Under the new rules, the income of specified foreign subsidiaries that are considered a "paper company," a "cash box" or a "blacklist company" will be subject to Japanese taxation on an entity basis, even if the subsidiary's ETR is 20% or more (unless the ETR of the specified foreign subsidiary is 30% or more).

- A foreign related company will be considered a paper company if it fails to pass the following substance and management and control tests:
  - Substance test: The specified foreign company maintains an office or other fixed place of business necessary to conduct its main business; and
  - Management and control test: The specified foreign company functions with its own administration, management and control in the country where its head office is located.
- A foreign related company will be considered a cash box company if the total amount of certain types of passive income derived by the company during the year exceeds 30% of its total assets; and the sum of the company's securities, loan receivables, intangible assets, etc. exceeds 50% of its total assets. The types of passive income considered and the calculation mechanism will differ depending on whether the company is a financial subsidiary (*i.e.* a foreign subsidiary whose business is banking, financial services or insurance and that meets certain requirements) or a company other than a financial subsidiary.
- A foreign related company will be considered a blacklist company if its head office is located in a jurisdiction designated by Japan's finance minister as a noncooperative jurisdiction with respect to the exchange of tax information (a list of such jurisdictions has yet to be issued). In this case, the foreign company will automatically be considered a CFC, even if it has substance.

The changes relating to specified foreign subsidiaries may have major implications for minority investments, intellectual property management, group finance, etc. performed from countries where the subsidiary's ETR is 20% or more, but under 30%, which are not within the scope of the current CFC rules.

Economic activity test: Where the ETR of a foreign related company is less than 20%, its passive income will be subject to the Japanese CFC rules, even if the foreign subsidiary meets the "economic activity test" and does not fall within the definition of a paper company, cash box or blacklist company. If a foreign subsidiary with an ETR of less than 20% fails the economic activity test, its income will be subject to CFC taxation on an entity basis.

Economic substance currently is determined based on whether the company qualifies for the active business exemption by satisfying certain tests (the business purpose test; the substance test/administration and control test; and the country of location test or the unrelated party test). Under the revised rules, the active business exemption will be changed and renamed the economic activity test, with updates to each of the current tests that apply for purposes of the active business exemption. The main aim of the changes is to grant an exemption from the CFC rules only for certain business activities.

Among other changes, a foreign related company whose major business is aircraft leasing could be treated as satisfying the business purpose test if certain conditions are fulfilled. The current CFC rules clearly state that aircraft leasing does not satisfy the business purpose test. Under similar rules in other major countries, aircraft leasing businesses with sufficient business substance typically are excluded from equivalent CFC rules and, therefore, the tax reforms responded to complaints that Japan's aircraft leasing businesses are unfairly disadvantaged against their international competitors.

Passive income: The scope of income that is subject to the passive income inclusion rules will be expanded under the new CFC rules. The changes include the following:

- Dividends generally will be considered passive income unless they are paid by a company owned 25% or more by the foreign related company (increased from 10% or more under the current rules), except for dividends from certain oil and gas businesses in a country with which Japan has concluded a tax treaty, which will be subject to a 10% ownership requirement. Similarly, capital gains/losses on the disposal of securities generally will be considered passive income unless the foreign related company owns 25% or more of the company whose shares are sold (increased from 10% or more under the current rules) and certain conditions are fulfilled; the current provision under which capital gains are considered passive income only if the shares are disposed of through the open market will be eliminated.
- Interest, including interest received from loans to related companies, generally will be considered passive income unless certain conditions are fulfilled.
- The scope of certain other types of passive income, including royalties and income from leasing, will be expanded.
- New types of passive income will be added, including income from securities lending, profit and losses from derivative transactions, foreign exchange gains and losses, capital gains or losses on intangible assets and certain "irregular amount" income.
- Special rules will apply for financial subsidiaries, under which certain types of income that otherwise would be considered passive may be exempt from the CFC's taxable income in Japan if certain conditions are satisfied.
- Losses arising from certain types of passive income subject to CFC taxation may be carried forward to offset future passive income.

In practice, the extent to which a CFC taxation charge may arise on income from foreign subsidiaries that currently satisfy the active business exemption rule or the economic activity test under the new rules will be likely to increase. For example, Japanese-owned groups that have established regional headquarters in countries with lower tax rates, such as Hong Kong and Singapore, and that are investing in Asian countries through those regional headquarters, should review the nature of income received by such headquarters. In particular, dividend income and gains on disposals derived from shares where there is less than 25% ownership, interest income from group financing, gains and losses on derivative transactions and foreign exchange gains and losses, etc. often arise in the headquarters company from joint venture investment, fund management and similar activities.

Considerations for Japanese-owned groups

Given that the new rules are expected to potentially cause additional CFC income pickup with respect to the new "specified foreign subsidiary" rule and expanded passive income definition, for example, Japanese-owned groups should consider taking the following actions in view of the new CFC rules:

- Review/prepare relevant documentation and establish an ongoing reporting system to the Japanese headquarters for those companies not currently monitored for potential CFC treatment due to having an ETR of 20% or more, but that potentially may be categorized as a paper company, etc. under the new rules;
- For companies whose ETR is less than 20% but that pass the active business exemption test and that have no passive income under the current CFC rules, consider whether passive income will be deemed to exist under the expanded definition and establish a reporting system to the Japanese headquarters;
- Review the organizational structure based on potential risks identified from the steps above (*e.g.* consider the integration of companies where there is sufficient economic substance with a paper company in the same country, or consider reallocation of passive income to a subsidiary located in a country where the effective income tax rate is 20% or more, etc.); and

- Review business models based on potential risks identified from the steps above (*e.g.* for those businesses that are due to generate passive income on an ongoing basis or for businesses that are predicted to have a large amount of passive income in the future, consider reorganizing the business model so that it is more tax efficient, etc.).

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