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Japan Update: Delay of Long-Awaited Consumption Tax Increase from 8% to 10%, and Major Changes Implemented to Japanese PE Rules

Tax issues have been front and center recently in Japan as the Abe administration has called for snap elections in December 2014, at the same time as announcing that the long-debated hike in Japan's consumption tax rate from 8% to 10% would be delayed until 2017. The Abe administration clearly hopes that economic stimulus activities will have taken effect by that time, and that Japan's GDP will be on the uptick again.

Additionally, new rules have been promulgated relating to taxation of permanent establishments ("PEs"), that will take effect in fiscal years beginning on or after April 1, 2016 for corporate taxpayers.[1] Specifically, the taxation of PEs in Japan will be changed from the "entire income approach" to the "attributable income approach". The arm's length principle will also apply to intra-company transactions in order to combat avoidance schemes, and new documentation requirements will be imposed on corporate groups. It is possible that with the introduction of the new rules, the Japanese tax authorities will increase focus on potential PE issues of multinational corporations, rather than on potential transfer pricing issues, as has generally been the case until this time.

1. Delay in Increase of Consumption Tax Rate

Japan's consumption tax, a flat tax on goods sold and services provided in Japan similar to VAT in the European context, had stood at 5% since 1997, before being increased to 8% in a highly controversial move in April 2014. Due to significant revenue needs in light of Japan's aging population and shrinking workforce, the Abe administration vowed to decide no later than December 2014 whether to increase the rate again, to 10%, effective 2015, taking into account Japan's economic conditions at the time of the decision in December 2014.

Recently released economic figures showed that Japan's economy did not grow, but rather shrunk, over the last quarter, possibly reflecting the effects of the last increase of the consumption tax rate earlier this year. The Abe administration announced on November 18 that it would dissolve the Lower House of Parliament and hold a general election in December 2014, effectively putting the question of whether an additional increase of the consumption tax rate would be acceptable to a referendum of the general populace. It remains to be seen whether the current administration will

[1] The new rules will take effect from January 1, 2017 for individual taxpayers.

survive the election, but if they do, Abe has publicly stated that there would be "no further delays" in the consumption tax increase. Along with the increase of the basic rate, the government is mulling introduction of other changes, including reduced rates for food and other basic consumables, and possibly introducing an invoicing system similar to that in the European context.

2. PE Rules - Change in the Scope of Domestic Income

2.1. Change from the Entire Income Approach to the Attributable Income Approach

Currently, Japan's *Corporation Tax Law* provides that a foreign corporation with a branch PE in Japan is liable to pay tax on all Japan-source income irrespective of whether the income is attributable to the PE or not. This "entire income approach" operates to include in a foreign corporation's tax base income derived from direct investment, even if that income is derived independently of the headquarters (or other PE outside of Japan). In contrast, most of Japan's tax treaties employ the "attributable income approach", where only the Japan-source income attributable to the PE is taxable in Japan.

Japan's 2014 Tax Reform program introduced a new definition of "PE attributable income":

> "Where a foreign corporation conducts business in Japan through a PE and the PE is an enterprise that conducts business independently of the foreign corporation (taking into consideration the function of the PE, the assets used at the PE, the intra-company transactions between the headquarters or other PEs outside of Japan, including branches and factories, and other factors), only income derived from the PE shall be subject to tax."

The new attributable income approach is consistent with many tax treaties, and with Article 7 of the OECD Model Tax Treaty (amended in 2010), referred to as the Authorized OECD Approach ("AOA").

Japan's 2014 Tax Reform program also provided a new definition of "non-PE attributable income", which specifies non-PE attributable income that will nevertheless be subject to Japanese corporate tax. This includes income derived from ownership or transfer of real estate located in Japan, transfer of shares in certain Japanese corporations (e.g., shares in certain Japanese subsidiary/affiliate corporations and those in certain real estate holding corporations), and provision of personal services in Japan not attributable to a PE in Japan. The creation of the taxable non-PE attributable income category does not expand the scope of taxable income for foreign corporations but is an attempt to clarify what is PE attributable income and what is non-PE attributable income.

Thus, for fiscal years beginning on or after April 1, 2016, income earned by the headquarters of a foreign corporation from a direct investment in Japan not connected to the corporation's Japan PE will not be subject to Japanese corporate tax.[2] Meanwhile, if a Japan branch recognizes income derived from investments in a foreign country and receives offshore income (e.g., dividends

[2] Interest and dividends are, however, still subject to withholding tax. Withholding tax may be exempted or a reduced withholding tax rate may apply under a treaty. If the foreign corporation sells its shares of a Japanese affiliate, any capital gain would be subject to Japanese corporate tax.

from an offshore company), such income would be Japanese source income attributable to the branch and therefore would be subject to corporate tax.

Branch PE, construction PE, and agent PE are treated in the same manner in Japan. The definition of PE *per se* will not change under Japanese law, with the effect that inventory-holding agents and order-taking agents—which do not fall under OECD Model Tax Convention definition of PE, and are not PEs under many tax treaties that Japan has concluded—will continue to be deemed PEs under Japanese corporate tax law.

2.2 New Foreign Tax Credit System for Japan Branches

A Japan PE of a foreign corporation will be eligible for a foreign tax credit with respect to foreign taxes levied on income earned by the PE outside of Japan.

3. Change to Calculation Method of PE Income

3.1. Computation of Income Attributable to a PE

Income attributable to a PE is computed on the assumption that the PE conducts business independently from the foreign corporation, taking into consideration the functions of the PE, its use of assets, and intra-company transactions with the headquarters or other PEs outside of Japan. This is in line with the AOA, which provides that profits attributable to a PE are the profits it might be expected to make in its dealings with other parts of a corporation if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used, and risks assumed by the enterprise through the PE and through other parts of the enterprise.

3.2. Intra-Company Transactions

Once the new rules take effect, for fiscal years beginning on or after April 1, 2016, most intra-company transactions will be subject to Japanese corporate tax, in principle. Intra-company transactions include transfers of assets and the provision of services between the headquarters (including other PEs) and the Japan PE that would be recognized if conducted between separate business entities. Guarantee and re-insurance transactions are not categorized as intra-company transactions so are not subject to tax in Japan. Also, funding received by the Japan branch from the headquarters at the time of the branch's opening, or remittance of retained earnings by the Japan branch to the offshore headquarters will not be subject to tax in Japan, as these are generally recognized as capital transactions for tax purposes. Intra-company transactions will be deemed to have been effected at an arm's length price.

Accordingly, the following transactions would be recognized for corporate tax purposes and subject to corporate tax, on the assumption that the transactions have been conducted at an arm's length price:

(a) A transfer of assets between the headquarters (including other PEs) and the Japan branch;

(b) Interest on debts between the headquarters (including other PEs) and the Japan branch;[3] and

[3] Interest payments between corporate headquarters (including other PEs) and a Japan PE are not subject to withholding tax.

(c) Royalties on intellectual property transferred between the headquarters (including other PEs) and the Japan branch.

Nevertheless, if a bilateral tax treaty between Japan and the headquarters country does not recognize intra-company transactions, the treaty overrides this treatment, and any interest and royalties would not be recognized in Japan, nor be subject to Japanese corporate tax.

3.3. Capital Allocation

The restriction on tax deductibility of interest expense on debts payable by a PE should be noted. Generally, if the capital amount on the balance sheet of the PE is less than the capital amount that should be attributed to the PE (and the difference has been shifted to interest-bearing debt of the PE), the interest expense on the debt corresponding to the shortfall of "the capital amount that should be attributable to PE" is not tax deductible. There are two methods of computing the capital amount that should be attributable to a PE.

(1) Capital Allocation Approach

$$\text{Capital amount that should be attributable to PE} = \text{Shareholder's equity in the foreign corporation} \times \frac{\text{Assets attributable to PE}}{\text{Total assets of the foreign corporation}}$$

(2) Thin Capitalization Approach

$$\text{Capital amount that should be attributable to PE} = \text{Assets attributable to PE} \times \frac{\text{Shareholder's equity in the comparable company}}{\text{Total assets of the comparable company}}$$

As a general rule, the assets noted in (1) and (2) should be weighed against the respective risks that the foreign corporation and the PE take. However, the assets can be calculated at book value, provided that the foreign corporation is not a financial institution. If the foreign company is a bank or a securities company, a stricter method is required: Shareholder's equity for purposes of the Bureau of Industry and Security ("BIS") regulations must be allocated to the PE according to the risks that the PE assumes.[4]

As a result of this restriction, Japan's earnings stripping rules will continue to apply to PEs, whereas Japan's thin capitalization rules will not.

3.4. Taxation on Valuation Gains/Losses Upon Closure of a Branch

Under existing rules, gains on the sale of certain assets (e.g., real estate) by the Japan branch of a foreign corporation after it ceases operations are subject to corporate tax in Japan if such assets are sold to a third party. The transfer of assets by a Japan branch to its corporate headquarters upon the

[4] Details will be discussed in a future Tax Alert.

conclusion of the company's Japan operations, however, currently gives rise to no corporate tax consequences in Japan.

For fiscal years beginning on or after April 1, 2016, unrealized gains or losses of appreciated assets attributable to a branch will be subject to corporate tax at the time of closure of the branch (or of any other type of PE). The new rule will not apply, however, to unrealized gains or losses arising from trade securities or certain other specified assets.

Also, for fiscal years beginning on or after April 1, 2016, a Japan branch will be able to claim a tax refund for past losses attributable to the branch upon the branch's closure via the tax loss carryback system, as is currently available upon liquidation of Japanese domestic corporations. Conversely, if a branch is re-opened, old net operating losses ("NOLs") cannot be revived.

3.5. Computation of Tax Liabilities Attributable to (and Not Attributable to) a PE

PE-attributable tax liabilities and non-PE attributable tax liabilities are to be separately computed. PE attributable income (or losses) cannot be offset against non-PE attributable losses (or income). NOLs of the respective income types are also computed separately.

For example, assume that a foreign corporation has a PE in Japan, and also directly holds shares in a Japanese company not connected to the PE's business activity in Japan. Even if the PE incurs losses from its business, the foreign headquarters could not offset capital gain derived, for example, from the transfer of its shares, with losses recognized by the PE.

4. Documentation

Foreign corporations with a PE in Japan will be required to routinely prepare and keep documentation with respect to transactions with third parties and intra-company transactions.

4.1. Transactions with Third Parties

Documentation must provide the following details:

(i) An explanation of the transaction;

(ii) The assets and liabilities that the PE and the headquarters (and other PEs outside of Japan) used in the transaction;

(iii) The functions of the PE and the headquarters (and other PEs outside of Japan) in the transaction and the relative risk relating to such functions, specifically the following:

- (a) Personnel functions in relation to the assumption and management of risk;
- (b) Personnel functions in relation to the ownership of assets; and
- (c) Any other functions.

(iv) An explanation of the role of various departments of the PE and the headquarters (and other PEs) in relation to the above functions.

4.2. Intra-Company Transactions

In addition to the details noted at 4.1., the following documents are required in the case of intra-company transactions:

(i) Any order forms, agreements, invoices, receipts, price quotations or the like in which the transaction is specified; and

(ii) Documents that corroborate the occurrence of the intra-company transaction.

5. Arm's Length Principle

With regard to intra-company transactions, documents establishing the basis of the computation of the arm's length price are also required. These may include the methodology of transfer price calculations and a marketing analysis, among other documents. If these documents are not immediately submitted upon the request of the National Tax Authority ("NTA"), the NTA may make a presumptive assessment (which may involve the use of "secret comparables").

6. Anti-Avoidance Rules

Anti-avoidance rules targeting PEs will also be introduced for fiscal years beginning on or after April 1, 2016. Where the tax authorities recognize that if certain transactions or bookings of a PE allowed corporate tax liability of the PE to be unreasonably reduced, the NTA may make an assessment according to the method that it determines to be appropriate, notwithstanding the taxpayer's actual transactions or bookings.

The same anti-avoidance rules already exist for certain closed corporations, reorganizations, and tax consolidations, which would result in some overlap of the anti-avoidance rules targeting PEs. That said, commentators have expressed the view that this broadening of the anti-avoidance rules to PEs may catch tax avoidance situations not currently caught by the current rules. One example is the commissionaire structure frequently used by listed corporations (*i.e.*, non-closed corporations) in the cross-border tax planning field. As it currently stands, in challenging a commissionaire structure, the NTA will generally raise a transfer pricing issue with the commissionaire operator and propose taxing the income of the commissionaire, a Japanese company. Although existing anti-avoidance rules apply to foreign corporations, once the anti-avoidance rules specifically apply to PEs from fiscal years beginning on or after April 1, 2016 - irrespective of whether such corporations are closed corporations or listed corporations - if the NTA were to recognize a Japan PE of the commissionaire's principal, the NTA would seek to tax the income attributable to the PE.[5] Indeed, authoritative commentary in this regard suggests that such an anti-avoidance rule is necessary because the functions, assets and risks of the Japan PE can too easily be artificially structured through intra-company transactions to avoid potential tax liability. It

[5] With regard to the recognition of a PE, the OECD issued on October 12, 2011 a discussion draft "*Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention*", and on October 19, 2012, the discussion draft "*OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)*". These discussion drafts include proposals for revision to the commentary on Article 5 of the OECD Model Tax Convention. An issue related to the commissionaire structure is discussed in this discussion. The OECD was scheduled to finalize proposals for inclusion in the next update to the OECD Model Tax Convention in 2014, however, it was announced on July 16, 2014 that "the 2014 Update to the OECD Model Tax Convention" approved by the OECD Council on July 15, 2014 does not include any of the changes put forward in the above discussion drafts; this is because it is expected that work on Action 7 ("*Prevent Artificial Avoidance of PE Status*") of the BEPS (Base Erosion and Profit Shifting) Action Plan will result in changes to Article 5, therefore, the proposed Commentary changes included in the discussion drafts will not be finalized until the work on Action 7 has been completed. BEPS Action 7 seeks to "develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions". Work on Action 7 is due to be completed by September 2015.

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is likely that audit scrutiny of the functions, assets and risks of Japan PEs will intensify. This may be relevant not only to foreign corporations with a branch in Japan, but also to corporations operating in the form of a Japanese domestic company transacting with an offshore affiliate. This may be relevant not only for foreign companies with a branch in Japan, but also to those operating in the form of a Japanese domestic company transacting with an offshore affiliate.

7. Conclusion

Corporate taxpayers with Japan PEs will be subject to the following key changes after introduction of new rules in the 2014 Tax Reform for fiscal years beginning on or after April 1, 2016:

(i) Additional tax liability on income derived by the Japan PE from investment in third countries, less any available foreign tax credits;

(ii) Requirement to differentiate between PE attributable income and non-PE attributable income, and the possibility of additional tax being due as a result of restrictions against offsetting these categories of income;

(iii) Need to calculate capital that should be attributable to a Japan PE;

(iv) Requirements under new legislation for companies to document and report certain intra-company transactions that they were not, until this time, necessary to recognize; and

(v) Need to document third party transactions and intra-company transactions, and to prepare an arm's length pricing analysis.

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