The Japanese government has announced a cabinet decision formalizing the 2017 comprehensive tax reform plan. The proposed changes to the Japanese CFC rules, also referred to as the anti-tax haven rules, were one of the major reform topics discussed in the Tax Reform Plan.

Under the current CFC rules, a problematic situation arises whereby certain income of economic substance derived by a CFC is apportioned to its Japanese parent, while certain income of non-economic substance is not apportioned to the Japanese parent. The Tax Commission has depicted the situation in the following chart:
To address this situation and to conform the Japanese CFC Rules with the BEPS principle that profits should be taxed “where economic activities occur and where value is created,” the Tax Reform Plan revises the definition of a Foreign Controlled Company and proposes several necessary amendments in the new CFC Rules.

I. Definition of Foreign Controlled Company

The CFC rules apply to any “Foreign Controlled Company,” which is defined as any foreign entity:

(i) a majority of the shares of which are held directly or indirectly by a Japanese parent company or

(ii) which has a relationship with a resident individual in Japan or a Japanese company, such that the individual or company may claim “almost all of the residual assets of the foreign entity.”

II. New CFC Rules

Under the current CFC rules, only Foreign Controlled Companies that are subject to an income tax rate of less than 20 percent are considered “Specific Foreign Subsidiaries” and subjected to entity-based inclusion (i.e., income of the subsidiary is apportioned to the income of the Japanese parent and subject to taxation at the level of the Japanese parent company), unless an exemption test is satisfied.

The proposed CFC rules add complexity to the current CFC rules. The proposed CFC rules consist of three tests under which the income of a Foreign Controlled Company may be apportioned and subject to taxation at the level of the Japanese parent company:

(i) general full inclusion for Foreign Controlled Companies that do not satisfy the economic substance test (the General Full Inclusion Rule)

(ii) full inclusion for specified Foreign Controlled Companies (the Specific Full Inclusion Rule) and

(iii) partial inclusion of passive income (the Partial Inclusion Rule).

Whether one or more of the new CFC rules apply depends on the effective tax rate (the Applicable Tax Rate) of the Foreign Controlled Company. The following chart identifies which rules may apply to apportion income to the Japanese parent based on the Applicable Tax Rate of the Foreign Controlled Company:
Applicable Rules

| General Full Inclusion Rule, Specific Full Inclusion Rule, and Partial Inclusion Rule would apply |
| Exempt from CFC Rules |

(1) Applicable Tax Rate of Less Than 20 Percent

As demonstrated in the above table, a Foreign Controlled Company with an Applicable Tax Rate of less than 20 percent could be subject to all of the new CFC rules:

(a) General Full Inclusion Rule

The income of a Foreign Controlled Company with an Applicable Tax Rate of less than 20 percent is apportioned to the Japanese parent, i.e., full inclusion, unless the Foreign Controlled Company satisfies the economic substance tests. The economic substance tests are essentially the same as the tests under the current CFC rules, however, the tests have been redefined as “economic substance tests.” The proposed amendment includes additional changes to the economic substance tests that apply to Foreign Controlled Companies engaged in certain businesses (for details about the exemption tests under the current CFC rules, please see our December 2016 article).

(b) Specific Full Inclusion Rule

In addition to the General Full Inclusion Rule, which existed under the previous CFC regime, the newly-proposed Specific Full Inclusion Rule will apply to Foreign Controlled Companies that satisfy at least one of the following criteria:

i. A Foreign Controlled Company that is not:

- A Foreign Controlled Company with a fixed location necessary for the primary business of the Foreign Controlled Company
- A Foreign Controlled Company that manages, controls, or operates businesses in the foreign jurisdiction in which the Foreign Controlled Company is located

i. A Foreign Controlled Company with:

- Over 50 percent of its total assets consisting of securities, loans and intangibles, etc. and
- Over 30 percent of its total income derived from the categories of assets listed in (i)-(x) of (c) below

i. A Foreign Controlled Company located in a country or jurisdiction that the Minister of Finance designates as uncooperative regarding exchange of taxation information.

(c) Partial Inclusion Rule

Under the current CFC rules, certain income of a Foreign Controlled Company derived from passive assets is apportioned to the income of its Japanese parent. The Tax Reform Plan expands the types of income considered "passive income" and subject to inclusion under the Partial Inclusion Rule.

The proposed amendment includes the following categories of passive income, including new categories (iii), (v), (vii), (x), (xi):

(i) Interest

(ii) Dividends

(iii) Securities lending

(iv) Capital gain from transfer of securities
(v) Income from derivative transactions
(vi) Income from foreign exchanges
(vii) Any other financial income from assets which generates the income above
(viii) Fees from lending fixed tangible assets
(ix) Royalties from intangibles, etc.
(x) Capital gains from the transfer of intangibles and
(xi) Extraordinary excess profit remaining after deduction of the items above and
the amount of the income tax deduction.

In addition to the exemptions currently applicable,[7] a Foreign Controlled Company subject to
income tax of 20 percent or more is exempt from the Partial Inclusion Rule.

(2) Applicable Tax Rate between 20 Percent and 30 Percent

Only the Specific Full Inclusion Rule applies to a Foreign Controlled Company in this scenario. Thus,
the company would only need to confirm whether the criteria listed in (1)(b) are satisfied.

(3) Applicable Tax Rate of 30 Percent or More

A Foreign Controlled Company with an Applicable Tax Rate of 30 percent or more is exempt from the
proposed CFC rules.

An amendment bill regarding the above changes will be submitted to the National Diet in early 2017, and the
amended tax laws are expected to come into force on April 1, 2018.

[1] The Tax Reform Plan proposes changes to the calculation method for indirect shareholding ratios. Under the
new rules, a foreign company whose shares are held by another foreign company having more than a 50 percent
shareholding chain relationship with a Japanese parent could have an "indirect" shareholding relationship with the
Japanese parent.

[2] The proposed rules do not define what constitutes “almost all of the residual assets,” or provide examples of the
relationship other than as described above. While the definition is currently unclear, the governmental tax
commission minutes suggest that the definition may include a control element in addition to (or in lieu of) a
percentage of residual assets.

[3] These tests are generally the same as those of the Substance Test and the Management and Control Test under
the current CFC rules. These tests are intended to target certain holding and finance companies that do not have
employees or directors (except for nominee directors) and where the business substance of such companies is
outsourced to third party service providers.

[4] Certain exemptions apply to income derived by subsidiaries engaged in financial activities. The Tax Reform
Plan includes provisions addressing income derived by financial activities; however, the rules that apply to
financial activities are outside the scope of this newsletter.

[5] The Minister of Finance has not yet designated any uncooperative jurisdictions; however, considering the
amendment is proposed to conform with BEPS principle, it is expected that the designation will follow OECD’s
standard.

[6] The exemptions to each type of passive income and rules applicable to subsidiaries engaged in financial
activities are outside the scope of this newsletter.

[7] Currently Foreign Controlled Companies with (i) less than JPY10 million of income derived from assets and/or
(ii) 5 percent or less of income derived from assets in profits before tax, are exempted. Regarding (i) above, the
Tax Reform Plan proposes increasing the threshold to JPY20 million.

AUTHORS

Makiko Kawamura
Partner
Tokyo | T: +81 (0)3-4550-2800
[email protected]