



KPMG Japan Tax Newsletter

12 December 2016



2017 TAX REFORM

JAPANESE ANTI-TAX HAVEN (CFC) REGIME

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The ruling coalition (the Liberal Democratic Party and New Komeito) agreed on the 'Outline of the 2017 Tax Reform Proposals' ('Proposal') on 8 December 2016. We have set out below the main points of the amendments to the Japanese anti-tax haven (CFC) regime indicated in the Proposal.

The Proposal itself is only an indicative outline and is unclear with respect to some of the contemplated changes. The details of the tax reform will be unveiled in the bills revising the tax laws and the succeeding amended tax laws, cabinet orders and ministerial ordinances. Please note that the final tax reform could differ from the Proposal depending on the outcome of discussions in the Diet.

Background

The Japanese CFC regime is a mechanism to include income derived by certain foreign companies in taxable income of their Japanese shareholding companies under certain criteria in order to deter tax avoidance by utilizing foreign subsidiaries of Japanese companies.

Under the 2017 tax reform, the Japanese CFC regime will be extensively amended in light of the final report of Action 3 (Designing Effective Controlled Foreign Company Rules) of the Base Erosion and Profit Shifting (BEPS) Project, which was released by the Organisation for Economic Co-operation and Development (OECD) on 5 October 2015.

(Although the Japanese CFC regime are applicable to Japanese individual residents as well, this newsletter covers only the tax treatment for Japanese companies in principle.)

Key Points of Amendments

- The tax rate exemption rule whereby the CFC regime would only apply to a Foreign Related Company whose effective income tax rate is less than 20 percent will be abolished, thereby resolving under-inclusion issues (i.e. where the effective income tax rate of a Foreign Related Company is 20 percent or more, even if it generates income without economic substance, such income is automatically exempt from the CFC regime.).
- However, considering the administrative burden for Japanese taxpayers, a Foreign Related Company whose effective income tax rate is 20 percent or more will be exempt from applying the Economic Activity Tests.
- Therefore, a Foreign Related Company whose effective income tax rate is 20 percent or more is subject to the CFC regime only when it is one of three types of company (a Paper Company, a Cash Box or a Black-List Company). (Note that a threshold test of 30 percent will be set up)
- The Exemption Tests (to be renamed the Economic Activity Tests) will be amended and it is expected that over-inclusion issues such as for aircraft leasing companies will be resolved.
- The scope of passive income will be expanded.
- A de facto control test will be added to the criteria of a Foreign Related Company and Japanese shareholder subject to the income inclusion rules.

1. Overall Picture of CFC Regime

The following tables illustrate the overall picture of the CFC regime under the current tax law and the Proposal:

[Current law]

Effective income tax rate of Foreign Related Company	Scenario	Income inclusion
20% or more		No income inclusion
Less than 20% (including those whose head office is located in a jurisdiction not imposing tax on income)	Where at least one of the 'Exception Tests' is not satisfied	Full-inclusion (i.e. all income of the Foreign Related Company is included in taxable income of its Japanese shareholders)
	Where all of the 'Exception Tests' are satisfied	Passive income inclusion (i.e. only certain passive income is included in taxable income of its Japanese shareholders)

[Proposal]

Effective income tax rate of Foreign Related Company	Scenario	Income inclusion
30% or more		No income inclusion
20% or more but less than 30%		
Less than 20%	Falling under one of the following: <ul style="list-style-type: none"> • Paper Company • Cash Box • Black-List Company 	Full-inclusion (i.e. all income of the Foreign Related Company is included in taxable income of its Japanese shareholders)
	Where at least one of the 'Economic Activity Tests' is not satisfied	
	Where all of the 'Economic Activity Tests' are satisfied	Passive income inclusion (i.e. only certain passive income is included in taxable income of its Japanese shareholders)

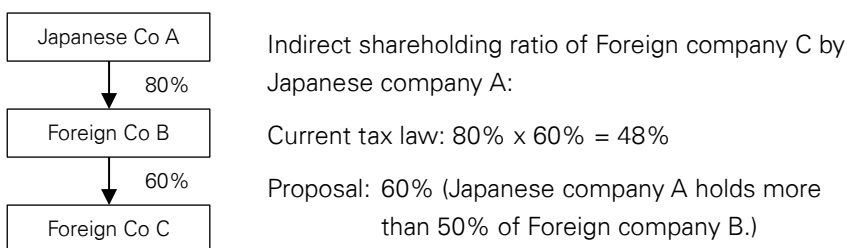
2. Foreign Related Company

The scope of a Foreign Related Company will be amended as follows. By virtue of this amendment, even when the shareholding ratio of a foreign company held by Japanese shareholders is not over 50 percent, if there is a de facto control relationship between a Japanese company (or a Japanese resident individual) and the foreign company, such foreign company will be treated as a Foreign Related Company.

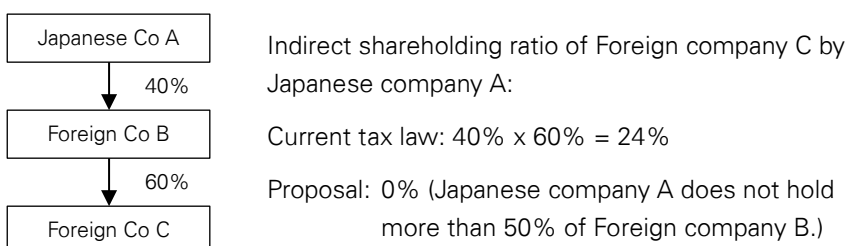
Current tax law	Proposal
A foreign company more than 50 percent of which is directly or indirectly owned by Japanese companies, Japanese resident individuals and non-resident individuals having special relationships with the Japanese companies or Japanese resident individuals.	<ul style="list-style-type: none"> • Same as on the left • A foreign company which has certain relationships with a Japanese company or a Japanese resident individual, such as a relationship where the Japanese company or the Japanese resident individual has the right to claim almost all of the residual property of the foreign company (De facto control test)

The indirect holding ratio is calculated by the multiplying method under the current law. The law will be amended to calculate the indirect holding ratio by the shareholding ratio held by a foreign intermediary holding company that has more than 50 percent shareholding chain relationships with a Japanese company.

(Example 1)



(Example 2)



3. Taxpayers

The scope of Japanese taxpayers to report income of Foreign Related Companies will be amended as follows:

Current tax law	Proposal
(i) or (ii) (i) Japanese companies or Japanese resident individuals holding directly or indirectly at least 10% of a Foreign Related Company (ii) Japanese companies or Japanese resident individuals belonging to a family company group holding directly or indirectly at least 10% of a Foreign Related Company	<ul style="list-style-type: none"> • Same as on the left • A Japanese company or a Japanese resident individual which has certain relationships with a foreign company, such as a relationship where the Japanese company or the Japanese resident individual has the right to claim almost all of the residual property of the foreign company (De facto control test)

4. Definition of Paper Company, etc.

(1) Paper Company

A Paper Company means a Foreign Related Company that meet neither of the following conditions:

- The Foreign Related Company maintains a fixed place of business such as an office necessary to conduct its primary business.
(including where a Foreign Related Company conducting insurance business is under similar circumstance but without a fixed place of business)
- The Foreign Related Company functions with its own administration, control and management in the jurisdiction where its head office is located.
(including where a Foreign Related Company conducting insurance business is under similar circumstance but without its own administration, control and management)

Note that where tax officials request a Japanese company to show them evidence for meeting the above conditions, if the Japanese company does not show them the evidence by the deadline, it will be presumed that the conditions are not satisfied.

(2) Cash Box

A 'Cash Box' means a Foreign Related Company meeting both of the following criteria:

$\frac{\text{Passive income (from (1) to (10) discussed in '7')}}{\text{Total assets}} > 30\%$
$\frac{\text{Securities + Loan receivables + Intangibles, etc.}}{\text{Total assets}} > 50\%$

If a Foreign Related Company is a financial subsidiary discussed in '8,' the following criteria will be applied instead:

$\frac{\text{Larger amount of A or B (i) discussed in '8'(3)}}{\text{Total assets}} > 30\%$
$\frac{\text{Securities + Loan receivables + Intangibles, etc.}}{\text{Total assets}} > 50\%$

(3) Black-List Company

A 'Black-List Company' means a Foreign Related Company whose head office is located in a jurisdiction designated by the Minister of Finance of Japan as a non-cooperative jurisdiction with respect to the exchange of tax information.

The OECD is planning to release a so-called black list indicating non-cooperative jurisdictions with respect to tax transparency standards that are selected based on the Global Forum peer review and commitment to implement the Automatic Exchange of Information (AEOI), etc. in July 2017.

Although details of the scope of Black-List Companies are not indicated in the Proposal, it is expected that jurisdictions on the OECD black list will be designated by the Minister of Finance of Japan.

5. Exception Tests/Economic Activity Tests

The 'Exception Tests' under the current law will be renamed and revised as the 'Economic Activity Tests' as follows:

[Current law – Exception Tests]

(1)	Primary business test	The primary business of the Foreign Related Company is not any of the following businesses: <ul style="list-style-type: none"> • Holding of shares or bonds • Licensing of intangibles • Leasing of vessels or aircraft
(2)	Substance test	The Foreign Related Company maintains an office, store, factory or other fixed place of business necessary to conduct its primary business in the jurisdiction where its head office is located.
(3)	Administration and control test	The Foreign Related Company functions with its own administration, control and management in the jurisdiction where its head office is located.
(4)	A. Unrelated party test	The Foreign Related Company conducts its business primarily (more than 50%) with unrelated parties. (Businesses subject to this test: wholesale, banking business, trust business, financial instrument business, insurance business, ocean transport or air transport business)
	B. Country of location test	The Foreign Related Company conducts its business primarily in the jurisdiction where its head office is located. (Businesses subject to this test: businesses not subject to A)

[Proposal – Economic Activity Tests]

The following amendments are proposed:

(1) Primary business test

Where a Foreign Related Company conducting aircraft leasing business meets certain conditions (e.g. directors or employees of the Foreign Related Company are engaged in all tasks normally necessary to conduct properly aircraft leasing business), the primary business test is treated as being satisfied.

(2) Substance test/Administration and control test

Where the substance test and administration and control test are judged for an insurance consigner, if an insurance consignee for the insurance consigner meets the substance test or the administration and control test, the insurance consigner will be treated as meeting the substance test or the administration and control test.

(An 'insurance consigner' means a certain Foreign Related Company which conducts insurance business with an official license. Where an 'insurance consigner' declares a person to be engaged in their insurance business in the process of obtaining official insurance license, the person is an 'insurance consignee' for the 'insurance consigner.' An example of this arrangement is members and managing agents in the London Lloyd's Market.)

(3) Unrelated party test

- Transactions with unrelated parties in which goods or services are determined to be transferred or provided to related parties in advance under a contract, so called back-to-back transactions, will be treated as transactions with related parties.
- In the unrelated party test for an insurance consignee that is a Foreign Related Company whose primary business is insurance business, transactions between the insurance consignee and its insurance consigner will be treated as transactions with an unrelated party.
- The unrelated party test will apply to a Foreign Related Company whose primary business is aircraft leasing instead of the country of location test.

(4) Country of location test

A special measure with respect to the country of location test will be set up for a Foreign Related Company whose primary business is manufacturing and which is independently engaged with important functions in the jurisdiction where its head office is located.

(It is expected that a Foreign Related Company conducting certain types of toll manufacturing will satisfy the country of location test.)

(5) Evidence for meeting the Economic Activity Tests

It is necessary to preserve evidence for meeting the Exception Tests under the current law. A new rule will be set up under the Economic Activity Tests, i.e. where tax officials request a Japanese company to show them evidence for meeting the Economic Activity Tests, if the Japanese company does not show them the evidence by the deadline, it will be presumed that the Economic Activity Tests are not satisfied.

6. Income Subject to Full-Inclusion Rules

Under the current tax law, when calculating income of a Foreign Related Company subject to the full-inclusion rules, dividends received from its subsidiary are excludable where 25 percent or more of the shares are held by the Foreign Related Company for 6 months or more.

A special rule for the 25 percent test will be set up, whereby a 10 percent threshold will be applied to dividends from a foreign company whose principal business is mining fossil fuel (crude oil, oil gas, combustible natural gas or coal) (including businesses closely related to mining fossil fuel) and which has a place to mine fossil fuel in a jurisdiction with which Japan has concluded a tax treaty.

7. Passive Income

The scope of passive income of a Foreign Related Company that is subject the passive income inclusion rules will be amended as follows:

[Current law]

(1)	Dividends (except for dividends from a company 10% or more of which is owned by the Foreign Related Company)
(2)	Interest on bonds
(3)	Profits from redemption of bonds
(4)	Capital gains from transfers of shares through financial markets, etc. (except for sales of shares in a company 10% or more of which is owned by the Foreign Related Company)
(5)	Capital gains from transfers of bonds through financial markets, etc.
(6)	Royalties from patents, etc. (excluding royalties from self-developed intangibles and purchased/licensed intangibles for consideration that are utilized for certain business)
(7)	Fees from leasing of vessels or aircraft

Income indicated from (1) to (5) above is excludable from passive income if such income is derived from activities that are fundamental and essential to the business (except for the three businesses listed in the primary business test of the Exception Tests).

[Proposal]

(1)	Interest (except for certain interest ^(*1))
(2)	Dividends (except for dividends from a company 25% or more of which is owned by the Foreign Related Company ^(*2))
(3)	Securities lending fees
(4)	Capital gains/losses from transfers of securities (except for transfers of shares in a company 25% or more of which is owned by the Foreign Related Company)
(5)	Profits/losses derived from derivatives transactions (except for profits/losses derived from transactions for hedging purposes and profits/losses derived from commodity futures transactions conducted by certain commodity futures transaction dealers ^(*3))
(6)	Foreign exchange gains/losses (except for those generated in the ordinary course of business unless the purpose of the business is to earn income from fluctuations in foreign exchange rates)

(7)	Income similar to income discussed above (from (1) to (6)) and derived from assets that could generate such income (except for income derived from transactions for hedging purposes)
(8)	Fees from leasing of tangible assets (except for certain fees from leasing of tangible assets ^(*4))
(9)	Royalties from intangibles (excluding royalties from self-developed intangibles and purchased/licensed intangibles for substantial consideration that are utilized for certain business)
(10)	Capital gains/losses from transfers of intangibles (excluding capital gains/losses from self-developed intangibles and purchased/licensed intangibles for substantial consideration that are utilized for certain business)
(11)	Income equivalent to the amount calculated by using the following formula: (Profits for the current year) – (Passive income from (1) to (10)) – (Income deduction ^(*5))

(*1) Certain interest

‘Certain interest’ means the following interest:

- Interest derived from loans between the following parties:
 - Lender: A Foreign Related Company meeting certain conditions, e.g. directors or employees of the Foreign Related Company are engaged in all tasks normally necessary to conduct properly money-lending business in the jurisdiction where its head office is located
 - Borrower: A related party of the lender
- Interest derived from loans between the following parties:
 - Borrower: A Foreign Related Company meeting certain conditions, e.g. directors or employees of the Foreign Related Company are engaged in all tasks normally necessary to conduct properly money-lending business in the jurisdiction where its head office is located
 - Lender: A Foreign Related Company that is a related party of the borrower
- Interest derived from loans lent by the following lender
 - Lender: A Foreign Related Company conducting money-lending business in accordance with the regulations in the jurisdiction where its head office is located and meeting certain conditions, e.g. directors or employees of the Foreign Related Company are engaged in all tasks normally necessary to conduct properly money-lending business in the jurisdiction where its head office is located
- Bank interest earned in the ordinary course of business

(*2) Dividends from a company 25 percent or more of which is owned by the Foreign Related Company

- Where dividends are tax deductible in the hands of a dividend paying company, such dividends are not included in 'dividends from a company 25 percent or more of which is owned by the Foreign Related Company'.
- Where dividends are paid from a foreign company whose principal business is mining fossil fuel (including businesses closely related to mining fossil fuel) and which has a place to mine fossil fuel in a jurisdiction with which Japan has concluded a tax treaty, the threshold of the holding ratio will be reduced to '10 percent or more.'

(*3) Certain commodity futures transaction dealers

'Certain commodity futures transaction dealers' means a Foreign Related Company conducting commodity futures dealing business in accordance with the regulations in the jurisdiction where its head office is located and meeting certain conditions, e.g. directors or employees of the Foreign Related Company are engaged in all tasks normally necessary to conduct properly commodity futures dealing business in the jurisdiction where its head office is located.

(*4) Certain fees from leasing of tangible assets

'Certain fees from leasing of tangible assets' means the following fees:

- Fees from leasing tangible assets that are primarily used in the jurisdiction where the head office of a Foreign Related Company is located
- Fees from leasing tangible assets received by a Foreign Related Company meeting certain conditions, e.g. directors or employees of the Foreign Related Company are engaged in all tasks normally necessary to conduct properly leasing business in the jurisdiction where its head office is located

(*5) Income deduction

The 'Income deduction' is calculated as follows:

$(\text{Total assets} + \text{Accumulated depreciation} + \text{Personnel costs}) \times 50\%$

8. Passive Income Inclusion Rules

(1) De minimus threshold

Where a Foreign Related Company meets either of the following de minimus thresholds, passive income for the Foreign Related Company for the fiscal year is exempt from the passive income inclusion rules under the current tax law:

(i)	Gross amount of passive income	\leq JPY10 million
(ii)	$\frac{\text{Total of passive income}}{\text{Profits before tax}}$	\leq 5%

It is proposed that the threshold of JPY10 million in (i) will be increased to JPY20 million.

Although it is necessary to attach a certain schedule to a corporate tax return and to preserve certain evidence in order to apply the above rule under the current tax law, such requirement will be eliminated.

(2) Calculation of income subject to passive income inclusion rules

The total amount of A and B for a Foreign Related Company will be income subject to the passive income inclusion rules:

A	B
Total of the following income	Total of the following income (The minimum amount is zero.)
(1) Interest	(4) Capital gains/losses from transfers of securities
(2) Dividends	(5) Profits/losses derived from derivatives transactions
(3) Securities lending fees	(6) Foreign exchange gains/losses
(8) Fees from leasing of tangible assets	(7) Income similar to income (from (1) to (6)) and derived from assets that could generate such income
(9) Royalties from intangibles	(10) Capital gains/losses from transfers of intangibles
(11) Income calculated by using certain formula	

Where the amount of B for a Foreign Related Company is negative, such amount will be carried forward for 7 years to offset future income generated in B for the Foreign Related Company.

(3) Special rules for financial subsidiaries

Special rules will be set up for financial subsidiaries, i.e. a Foreign Related Company conducting banking business, financial instrument business or insurance business in accordance with the regulations of the jurisdiction where its head office is located and meeting certain conditions, e.g. directors or employees of the Foreign Related Company are engaged in all tasks normally necessary to conduct properly these businesses in the jurisdiction where its head office is located.

Income subject to the passive income inclusion rules for a financial subsidiary will be the larger amount of A or B:

A	B
<ul style="list-style-type: none"> • Income generated from the overcapitalization 	(i) + (ii) (i) Total of the following income <ul style="list-style-type: none"> • Fees from leasing of tangible assets • Royalties from intangibles • Capital gains/losses from transfers of intangibles (The minimum amount is zero.) (ii) Income calculated by using certain formula (passive income (11) discussed in '7')

Where a financial subsidiary suffers capital losses from transfers of intangibles, such amount will be carried forward for 7 years to offset future income generated from capital gains from transfers of intangibles for the Foreign Related Company.

9. Other Points

(1) Requirement to attach financial statements for Foreign Related Companies

Japanese companies will be required to attach financial statements for the following Foreign Related Companies:

- Foreign Related Companies whose effective income tax rate is less than 20 percent
- Foreign Related Companies whose effective income tax rate is less than 30 percent if they are Paper Companies, Cash Boxes or Black-List Companies

(2) Adjustments for double taxation

- Where income of a Foreign Related Company is included in Japanese companies and Japanese tax (income tax, special reconstruction income tax and corporation tax) is imposed on such income, the Japanese tax will be eligible for a tax credit for the Japanese companies.
- Where a Japanese REIT (or Toshi-Houjin) receives dividends from its Foreign Related Company, the dividend will be exempt from tax to the extent of the amount of income included in taxable income for the Japanese REIT for previous 10 years.

10. Timing of Application

The above amendments will be applied for fiscal years of a Foreign Related Company beginning on or after 1 April 2018.

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