

# Financial Services Tax News

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## PwC Japan Tax Newsletter

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## 2009 Tax Reforms on Taxation of Discount Bonds

With respect to bonds issued at a discount by a foreign corporation, where the premiums are connected with the business that the foreign bond issuer carries on through a permanent establishment in Japan, to a foreign corporation, the 2009 Tax Reform amended the corporate tax treatment of premiums received by a foreign bond holder at redemption. This newsletter summarizes this amendment. (A summary of the 2009 tax reform was included in our two December 2008 newsletters.)

## Tax treatment before the 2009 Tax Reform (Note 1)

When bonds are issued at a discount to their face value, generally 18% withholding tax is imposed on the original issue discount (i.e., the difference between the issue price and its redemption price at maturity) at the time of issue. (Note 2) Prior to the 2009 Tax Reform, if the bonds were issued by a Japanese corporation to a foreign corporation, premiums received by the foreign corporation at redemption would generally be subject to Japanese corporate tax in the hands of the foreign corporation. In such case, the tax withheld at issue would be creditable against the corporate tax liability when the foreign corporation filed its corporate tax return in Japan. However, where the bonds were issued by a foreign corporation to a foreign corporation, the corporate tax law did not clearly state that premiums received by the foreign corporation at redemption were treated as Japan source income.

## Outline of the 2009 Tax Reform

With respect to bonds issued at a discount to a foreign corporation ("foreign bond holder"), the 2009 Tax Reform amended the corporate tax treatment of premiums received by the foreign bond holder at redemption as follows:

- (1) Premiums received by a foreign bond holder at redemption would be treated as Japan source income for Japanese corporate tax purposes where the premiums are connected with the business that the foreign bond issuer carries on through a permanent establishment in Japan; and
- (2) Premiums received by a foreign bond holder at redemption would not be subject to Japanese corporate tax in the hands of the foreign bond holder, where the premiums are treated as Japan source income provided that the foreign bond holder does not have a permanent establishment in Japan. (Note 3&4)

Premiums received by a foreign bond holder at redemption are subject to Japanese corporate tax in the hands of the foreign bond holder where: (i) the premiums are connected with the business that the foreign bond issuer carries on through a permanent establishment in Japan; and (ii) the foreign bond holder receiving the premiums has a permanent establishment in Japan.

According to the earlier 2008 Tax Reform, interest on bonds received by a foreign corporation would be treated as Japan source income where the bonds are issued by a foreign corporation and the interest on the bonds are connected with the business that the foreign bond issuer carries on in Japan. Under the 2009 Tax Reform, premiums received by a foreign bond holder at redemption would also be treated as Japan source income in the same manner as interest on bonds received by a foreign corporation.

This amendment applies to premiums on discount bonds issued on or after April 1, 2009.

(Note 1) The tax treatment could be modified by the application of a tax treaty.

(Note 2) When bonds are issued at a discount by a foreign corporation, original issue discount would be subject to 18% Japanese withholding tax when: (i) the bonds are issued in Japan; or (ii) the bonds are issued outside Japan and the original issue discount is connected with the business that the foreign bond issuer carries on through a permanent establishment in Japan.

(Note 3) Designated short-term bonds, now not subject to Japanese withholding tax, are excluded from the scope of the amendment in (2) above.

(Note 4) A foreign bond holder having a permanent establishment in Japan would be exempt from Japanese corporate tax on premiums, if (i) the foreign bond holder has only a so-called construction PE or an agent PE in Japan and (ii) the premiums are not connected with the business that the foreign bond holder carries on through such a construction PE or an agent PE in Japan.

**For more detailed information, please do not hesitate to contact your financial tax services representative or any of the following members:**

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