

Japan Tax Update

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PwC Japan Tax Newsletter

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Proposed Introduction of Foreign Dividend Exemption System

As a major item of the Tax Reform Request for FY 2009, it has been proposed that a new exemption rule for dividends received by Japanese corporations from foreign subsidiaries should be enacted.

This proposal has attracted a lot of attention not only in Japan, but overseas as well. The outline of the proposal concerning changes to facilitate repatriation of foreign profits to Japan was included within a report entitled "Toward a Foreign Dividend Exclusion System" was published by the Ministry of Economy, Trade, and Industry ('METI') on August 22, 2008 and was reported in major newspapers in Japan on August 17, 2008. If the new exemption rule is introduced, it will have a major impact on Japanese corporations which have subsidiaries outside of Japan.

Corporate Taxation

Recently, the foreign production ratio of Japanese corporations has reached 30% and the profits of foreign subsidiaries of Japanese companies quadrupled between 2001 and 2006. However, the amount of foreign dividends received by Japanese companies increased by only 60%. This implies that large amounts of profits have been retained by foreign subsidiaries of Japanese companies. The tax reform is intended to promote domestic investments in R&D or equipment and stimulate the Japanese economy by allowing tax free repatriation of foreign retained earnings. The amount of undistributed foreign subsidiary earnings for first tier subsidiaries is estimated to be as much as JPY 17 trillion (at the end of FY 2006). If second-tier subsidiaries were included, the amount of undistributed earnings is estimated to be significantly higher.

Current rules and circumstances

The current Japanese tax rules provide foreign tax credits as a method to eliminate double taxation on dividends received from foreign subsidiaries when the dividend received is included in taxable income of the Japanese parent corporation. An alternative method for eliminating double taxation, besides the foreign tax credit method, is the foreign income exemption method. Among thirty OECD members, currently twenty one countries have adopted the foreign income exemption method for eliminating double taxation. As a representative example, the well known participation exemption rule in Netherlands has been used by many Japanese corporations when setting up holding companies in the Netherlands to hold European subsidiaries.

The Japanese foreign tax credit system utilizes an overall limitation system and does not calculate the foreign tax credit limitation on each item of income or country. This allows taxpayers to utilize excess credits generated in a high tax country against excess limitation generated in a low tax country ('Overall Limitation'). This is generally called "cross-crediting" or "Mixing / Blending" and it is one of the characteristics of the Japanese foreign tax credits system.

Since Japanese corporate income tax rate is relatively high compared with many other countries, Japanese corporations are inclined to avoid the additional Japanese tax burden which would arise on profit repatriation by retaining foreign profits abroad by using foreign holding companies.

The tax reform proposal – Introduction of the Foreign Dividend Exemption

The following is METI's 2009 tax reform proposal. The direct foreign tax credit system would also be changed under this proposal.

Taxes to be covered	Corporate income tax (National and Local corporate income tax)
Income to be covered	Dividends from foreign subsidiaries (not including profits from foreign branches, foreign investment income such as interest, royalties or capital gains from the transfer of shares in foreign subsidiaries)
Foreign subsidiaries to be covered	Ownership of 25 percent or more for at least six months
Amount to be excluded	“Certain percent of dividend received from foreign subsidiaries (e.g. 95 percent of dividends)” or “Dividend received from foreign subsidiaries less actual expenses (e.g. interest expense) incurred to hold shares”
Withholding tax	Neither subject to direct foreign tax credit nor tax deduction for foreign withholding tax imposed on dividends
Corresponding changes in anti-tax avoidance rules	To be appropriate and minimum if reinforcement of the anti-tax avoidance rules (i.e. CFC rules and transfer pricing) is required accompany this proposal.
Others	(i) Provisional measure including the treatment of excess limitation and unused limitation carried forward under the existing foreign tax credit rules (ii) The indirect foreign tax credit may be abolished.

The effect of the proposal

The proposed rule may give Japanese management more freedom for dividend distribution although repatriation is not actually encouraged. In addition, there are no requirements as to how the repatriated funds must be used in Japan or whether the proposed rules will serve to discourage exportation of domestic business activities. Furthermore, by changing to the foreign income exemption method, the amount of foreign dividend income is calculated in a separate basket which prevents “cross-crediting” (as mentioned above) to a certain extent. Accordingly, the proposed rule may increase tax burdens for some taxpayers. However, corporations should generally benefit from the proposed rules if they are meeting domestic capital demands by loans from third parties or through capital markets financing mainly because repatriation of foreign retained earnings is not preferable under the current foreign tax credit system.

The details of tax reform for foreign tax credits system have not been defined under this proposal. Therefore, it depends on each company’s situation as to whether the proposed rule increases or decreases their tax burden.

The proposed rule implies a significant change in Japanese international tax rules. Further, most observers believe it is highly likely that it will be enacted in one form or another. However, because of the unstable political situation in Japan, it is possible that the changes will not be made. Accordingly, depending on the present management profiles such as the make up of foreign source income, dividend policy and current utilization of foreign tax credit, Japanese corporate groups should reconsider efficient tax cost management at early stage and assess the administrative burden of remittance, the legal procedures for distribution, currency risk, etc.

For more information, please consult your international tax representative or contact any of the following members listed below:

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