

# Japan Tax Update

Monthly tax update

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## Establishment of PRC Integrated Income Tax Law - Impact on Japanese taxation

At the China's Peoples' Congress that was held on March 16, 2007, The "PRC Corporate Income Tax Law" (the "New Law") was enacted. This law integrates tax regulations that have been separately applied to foreign-capitalized enterprises marketed in PRC and PRC domestic enterprises, in order to meet the request of WTO for the elimination of discrimination of domestic and foreign enterprises.

The New Law will become effective on January 1, 2008, and will apply to fiscal years beginning on or after that date. The New Law is intended to simplify the tax system, widen the tax base, lower the tax rate and tighten the tax collection system. Specifically, a review on preferred tax treatment given to certain taxpayers (primarily foreigners), special tax adjustments (for transactions between related parties) and a change in the tax rate are likely to have an impact on Japanese taxpayers. The practical contents of the preferred taxation and details of the applicable range will be provided under Enforcement Regulations that will be issued on a later date.

## **I. Regulated Tax Measures for transactions between related parties**

### **1. Outline of the New Law**

The New Law provides measures to prevent tax avoidance activities among related parties (Articles 41 to 48) as stated below including:

- (1) **Transfer pricing taxation**  
In addition to the general transfer pricing taxation, provisions relating to cost sharing, advanced pricing agreements (APA), obligations to submit information, documentation obligations, and presumed taxation provisions are included in the New Law.
- (2) **Thin capitalization rule**  
If the portion of interest payable with regard to the loan payable and contribution exceeds the statutory limitation that is provided by taking into account different gearing ratios (the ratio depends upon different factors), such excess portion is not tax deductible.
- (3) **Anti-tax haven legislation**  
If a related foreign subsidiary that is located in a country with a low tax rate does not pay a dividend without justifiable reason, the retained earnings of the said subsidiary are included in the taxable income of the parent company in the PRC. Under the current circumstances, the case where a foreign-capitalized enterprise locates its Chinese subsidiary as an investment base for third countries is generally not feasible so that the anti-tax haven legislation is mainly aimed to apply to the domestic enterprises.

### **2. Impact on Japanese taxation**

Among the measures to prevent tax avoidance activities under the New Law, particular attention should be paid to the measures relating to the transfer pricing taxation. While contents of major rules will be maintained, there are many opinions saying that the fact that these measures became regulated means a change of PRC government's stance. Namely, it seems that PRC government will put more emphasis on the transfer pricing taxation.

In fact, there have been many cases where Japanese-capitalized enterprises were subject to the PRC transfer pricing taxation, and newspaper articles reporting the strengthening of transfer pricing taxation have been seen recently. Enterprises with subsidiaries in PRC which conduct transactions with Japanese parent companies should pay more attention to the transfer pricing taxation. Further, for the advance preparation for dealing with such matters, the use of APA becomes more important.

## **II. Reduction of basic tax rate**

### **1. An outline of the new tax rate**

Under the New Law, the corporate tax rate is 25% (currently 33%). In case of certain small-sized enterprises with low margins, a reduced tax rate of 20% will apply, and further reduced tax rate of 15% will apply to certain high-technology enterprise. However, definitions and range of these small-sized enterprises with low margin and high-technology enterprises are not announced.

### **2. Impact on Japanese taxation**

Tax reduction to a uniform tax rate of 25% in PRC is significantly important for Japanese parent companies with subsidiaries in PRC, as the subsidiaries are subject to Japanese anti-tax haven legislation.

For current Japanese anti-tax haven legislation purposes, the retained earnings of subsidiaries located in tax haven countries are included in the Japanese taxable income of their parent companies for Japanese corporate tax purposes. Subsidiaries located in tax haven countries are defined as foreign subsidiaries whose effective tax rate is 25% or less. Specifically, subsidiaries located in PRC will be included in this

definition as a result of the tax reduction to 25% under the new law.

On the other hand, Japanese anti-tax haven legislation provides measures of “non-applicable rules” whereby retained earnings of the related foreign subsidiaries are not included in the taxable income of their parent companies provided that the subsidiaries have reasonable business substance and business activities. The judgment of the reasonableness is made according to the following tests:

- (1) Business test: Their main business is not related to holding company function.
- (2) Substance test: Physical facilities such as offices should be located in the head office country.
- (3) Administration and control test: The head office has administration and control functions.
- (4) Non-related parties test: In the case of wholesalers, transaction volume with non-related parties should be more than 50%.
- (5) Location test: Actual business activities are conducted in the head office country.

If the above tests are satisfied, anti-tax haven legislation does not apply for Japanese tax purposes even if PRC subsidiaries are subject to an effective tax rate of 25% or less.

Taking a look at Japanese enterprises conducting business in PRC, many of them are “umbrella type companies” who conduct business locating several business companies in PRC. While the umbrella company is regarded as the ultimate parent company in PRC, and seems to conduct administration and control activities for subsidiaries in PRC, what is important is the judgment of the business category of the umbrella company.

If the umbrella company functions as a holding company, it does not satisfy the business test. Also, if it functions as an intermediary party for administration purposes, it does not satisfy the non-related party test. From these reasons, it becomes necessary to investigate and consider the business substance and functions of umbrella type companies as a result of the reduction of the basic tax rate to 25% in PRC.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments or ideas for what you'd like to see covered in future issues.

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