

Insurance Tax Highlights – Asia Pacific

Japan

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2014 Japanese tax reforms: aligning Japanese tax principles of international taxation with the authorised OECD approach to the taxation of permanent establishments

The OECD released its final Report on the Attribution of Profits to Permanent Establishments (“PEs”) on 22 July 2012. This followed the release of a revised Model Tax Convention in 2010, including a new Article 7 (“New Article 7”) that applies the Authorised OECD Approach (“AOA”) to the calculation of attributable income under the principle of what is generally referred to as the separate entity hypothesis.

The 2014 Japanese tax reforms amend the Japanese domestic rules (that were based on the entire entity approach) to an attribution approach in line with the revised Model Tax Convention, as reflective of trends in international tax law and practice. The new attribution rules are effective for fiscal years beginning on or after 1 April 2016 for corporation tax purposes. This reform will significantly affect both the taxable income calculation of Japanese branches of foreign corporations as well as the calculation of foreign tax credits for Japanese corporations.

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1. Basic principles underlying the AOA

The amendments to Japanese tax law bring the domestic rules in line with the principles as applied by the New Article 7. Whilst the prior Japanese tax principles were based on an entire legal entity approach, this is amended to that of an attribution approach. This change, as described in the OECD commentary and by the principles of the New Article 7, will result in the attributable income of a PE being calculated based on a functional and factual analysis of the PE by (i) first, allocating assets, risks and capital to the PE, (ii) then, recognising intra-entity dealings, and (iii) thereby recognising dealings as if the PE was a separate and independent enterprise.



2. Domestic source income and attribution of income to a PE in Japan

Under the prior Japanese domestic tax rules governing the attribution of profits to PEs, all Japan sourced income was taxable in Japan, regardless of whether it was attributable to the PE. The prior Japanese tax law further regulated the scope of Japanese sourced income where business was conducted both inside and outside Japan. Japan sourced income of a PE was generally calculated as the “portion” of the enterprise’s business income to be earned by the Japanese PE, based on the separate enterprise theory or the degree of the contribution by the Japanese PE.

The revised definition of domestic income and attributable income to a PE will change as follows:

1) Sourcing rules

A PE’s attributable income (that is, the business income of the PE) is to be included in domestic source income. Under the sourcing rules, income of a foreign corporation not attributable to its Japanese PE will be considered and treated separately from attributable income of the PE (where the taxation of a PE’s non-attributable income will be consistent with the taxation of a foreign corporation without a PE in Japan).

2) Calculation of attributable income

Pursuant to the inclusion of the concepts underlying the New Article 7, a PE’s attributable income will be calculated based on a functional and risk analysis for dealings by the PE on an arm’s length basis as if it were a separate and independent enterprise.

3) Intra-entity dealings

Under the attribution approach, profit or loss arising from intra-entity dealings is to be recognised in the calculation of a PE’s attributable income on an arm’s length basis, whereas costs of an enterprise are to be allowed as a deduction for an amount reasonably allocated to the PE by the head office or other branches for the actual costs incurred by the enterprise.

[However, specific for insurers, internal reinsurance (reinsurance within a single legal entity) is excluded from intra-entity dealings.]

4) Tax adjustments for differences from an arm’s length price

Where the price of intra-entity dealings differs from the arm’s length price and the PE’s attributable income is



understated, the difference is adjusted to increase the PE’s attributable income. Where, however, the PE’s attributable income is overstated, the difference is not allowed to decrease the PE’s attributable income.

5) Allocation of free capital to a PE and interest deduction limitation

An appropriate level of capital of the foreign corporation is to be allocated to the PE. Where capital of the PE is less than that attributable, any interest deductions are subject to a limitation, i.e., interest corresponding to the deficient capital (“free” or “notional” capital) are not deductible in the calculation of the PE’s attributable income.

6) Allocation of investment assets and attribution of investment income to a PE of foreign insurance company

For insurance companies, investment income arises largely due to insurance reserves, which are required to assume insurance risks. In the allocation of investment assets to PEs of foreign insurance companies, different rules apply. Where the investment assets actually

booked in a PE of a foreign insurance company are less than the investment assets attributable to a PE in Japan based on the PE's relative share of the foreign insurance company's overall insurance reserves (i.e., total of policy reserves and claim reserves), the investment income corresponding to such deficient portion of investment assets, computed by using the company's average return on investments, should be added to the taxable income of the PE in Japan. However, this rule does not apply in the following cases:

- a. The deficient portion of investment assets does not exceed 10% of the investment assets attributable to a PE;
- b. The amount to be added to taxable income computed under this rule does not exceed JPY 10 million; or
- c. The PE's total assets exceed the total of the PE's liabilities and net assets.

7) Foreign tax credits

Under the prior Japanese corporation tax law, foreign tax credits were not available to a Japanese branch of a foreign corporation. However, under the new rules introduced by the 2014 Japanese tax reform, the PE is able to take a foreign tax credit in Japan where income earned by the PE in Japan under the AOA is subject to taxation in another country.

3. Foreign source income and foreign tax credits for Japanese corporations with a PE in foreign jurisdictions

The introduction of attribution rules will change the foreign tax credit regime applied to Japanese corporations. Under the prior tax law, when a Japanese corporation with a PE in a foreign jurisdiction was subject to foreign country taxation, the tax was generally creditable against corporate tax in Japan. Under the 2014 Japanese tax reforms, the scope of foreign source income, based on which the amount of foreign tax credit of the Japanese corporation is calculated, is clarified as follows.

1) Intra-entity dealings

The attributable income of a foreign PE (of a Japanese corporation) is to be calculated taking into consideration income or loss from intra-entity dealings (however, internal reinsurance is not included in intra-entity dealings).

2) Tax adjustments for differences from an arm's length price

Where the price of intra-entity dealings differs from the arm's length price and the foreign income base on which the amount of foreign tax credits is calculated is overstated, the difference is adjusted to decrease the foreign income. Where, however, the foreign income is understated, the difference is not allowed to increase the foreign income.

3) Allocation of free capital to a PE and interest deduction limitation

The calculation of attributable income of a foreign PE (of a Japanese corporation) is to be based on the allocated free capital and subject to the interest deduction limitation.

4) Allocation of investment assets and deductions of investment income from a foreign PE of a Japanese insurance company

Where the investment assets actually booked in a foreign PE of a Japanese insurance company exceed the investment assets attributable to a foreign PE based on the PE's relative share of insurance company's overall insurance reserves (i.e., total of policy reserves and claim reserves), the investment income corresponding to such excess portion of investment assets, computed by using the company's average return on investments, should be deducted from the foreign source income. However, this rule does not apply in the following cases:



- a. The excess portion of investment assets does not exceed 10% of the investment assets attributable to a PE;
- b. The amount of investment assets booked in a foreign PE does not exceed 5% of the overall of investment assets; or
- c. The amount to be deducted from foreign source income does not exceed JPY 10 million.

4. Documentation

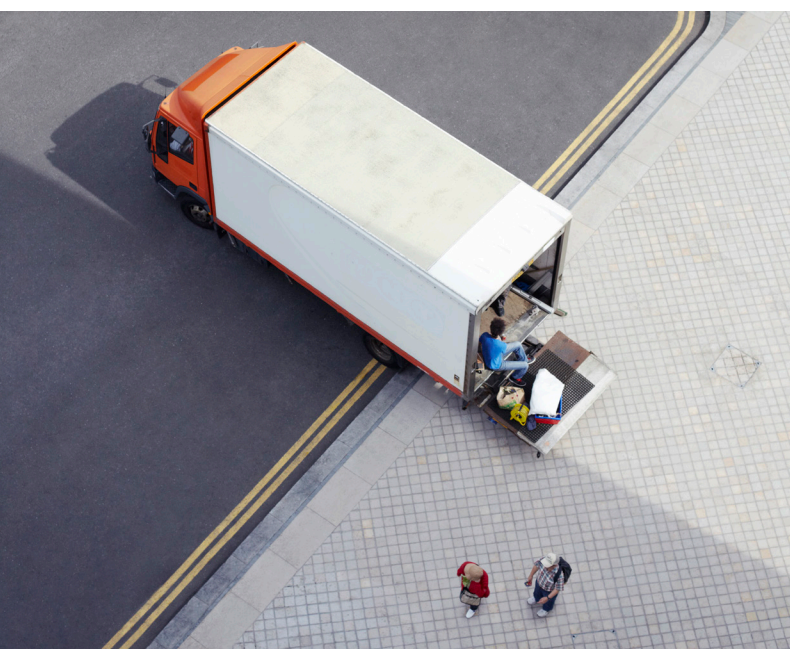
To determine a PE's attributable income, documentation for (i) external transactions with third parties attributable to a PE, (ii) intra-entity transactions and (iii) allocation of headquarter expenses and service fees for intra-entity transactions, is required.

The documentation for intra-entity transactions includes for example (a) purchase orders, invoices, receipts of internal dealings, (b) documents describing the functions of the PE, head office, and other offices, and (c) documents describing calculations of the arm's length prices as required for transfer pricing purposes.

5. Conclusion

Both foreign and Japanese corporations should begin to consider and to prepare themselves for the introduction of this significant reform. Areas of particular focus should be concentrated on beginning to document dealings for recognition purposes, and on considering the arm's length pricing for those dealings.

Moreover, the impact on Japan's treaty network will also need to be considered. Where a foreign government has also implemented the AOA in its domestic rules, the question that arises how should the provisions of the existing treaty with that counterparty be considered.



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