Japan Tax Reform – changes to the Japanese CFC regime

Issue 137, June 2018

In brief

The Japanese CFC ("JCFC") rules were fundamentally revised under the 2017 and 2018 Japan Tax Reforms. The updated rules now more closely reflect the recommendations of Article 3 of the OECD's final BEPS reports, and abolish the 'trigger rate' used under the old rules to determine whether a foreign subsidiary is a CFC.

Instead, CFC status is determined based on the economic activities undertaken by the foreign subsidiary. Three new categories of CFC were also introduced – 'Paper Companies', 'Cash Box Companies', and companies based in a 'Black List' territory. New rules were also introduced which exclude capital gains arising on certain group restructuring transactions from any JCFC charge.

The changes set out in both the 2017 and 2018 tax reforms will apply to fiscal periods beginning on or after 1 April 2018.

There remain significant uncertainties around the scope and application of the reforms. In an effort to address these uncertainties, in January 2018 the NTA released a Circular and Q&A in respect of the rules, adding more detail on their application. Whilst useful, they do not deal with all material uncertainties, and as such the application of these rules remains complex.

In detail

Under the 'old' JCFC rules, CFC status was determined, first of all, by the corporate tax rate (a trigger rate) of a foreign subsidiary (foreign related corporation or "**FRC**"), and secondly by the economic substance of the FRC (as determined by the Active Business Exemption ('ABE') Tests). As a result, income earned by FRCs for which the effective corporate income tax rate was on or above the trigger rate of 20% were not subject to CFC rules even if such FRC's did not have economic substance. On the other hand, income earned by a FRC for which the effective corporate tax rate was lower than the trigger rate were subject to a JCFC charge even if such CFCs had economic substance (unless the ABE Tests were satisfied). To fix these issues that could hinder foreign expansion of Japanese corporations, the old CFC Rules were fundamentally revised under the 2017 and 2018 tax reforms.

Under the new JCFC rules, (i) income earned by a FRC which satisfies the Economic Activity Tests (broadly equivalent to the ABE under the old rules) will not generally be subject to a JCFC charge regardless of the corporate tax rate (passive income may still be subject to the CFC rules when the corporate tax rate is less than 20%), (ii) income earned by a FRC which does not satisfy the Economic Activity Tests and which is subject to a corporate tax rate of less than 20% will be subject to the CFC rules on an entity level basis, (iii) income earned by a FRC which is a Paper Company, a Cash Box or a Black List Company and which is subject to a corporate tax rate of less than 30% will be subject to the CFC rules on an entity level basis. Under the New CFC Rules, the *de minimis* exemption rule for passive income has also been updated.

The New CFC Rules will come into force for **fiscal periods (of the FRC) starting on or after 1 April 2018**.

Details of changes

i) Definition of FRC

Under the New CFC Rules, a FRC will be determined by either an "equity ownership test" or a "*de facto* control test" (i.e. foreign corporations where Japanese resident individuals or Japanese corporations have rights to claim almost all residual assets). Therefore, a foreign entity which was not a FRC under the Old CFC Rules will be treated as a CFC under the New CFC Rules if it is controlled "in substance" by Japanese resident shareholders.

In addition, the calculation of an indirect holding ratio has also been reviewed. Under the Old CFC Rules, in determining a FRC, the total Japanese ownership of an indirect subsidiary was determined on a multiplication method. Under the New CFC Rules, when a foreign intermediary owns a foreign subsidiary (second tier foreign subsidiary), the holding ratio of the second tier foreign subsidiary is determined by the holding ratio of the intermediary of the second tier foreign subsidiary.

Japanese multinational corporations will be required to assess whether the changes in the definition of a CFC under the New CFC Rules will result in an increase in the number of CFCs to be reported.

ii) Changes to general entity based aggregation rules

Under the Old CFC Rules, to the extent that all the Active Business Tests ((i) Main Business Test, (ii) Substance Test, (iii) Management & Control Test, (iv) Local Business Test or Unrelated Party Test) were met, the FRC was not subject to the CFC rules. Under the New CFC Rules, these tests remain but have been partially modified to narrow the scope of FRC's to be subject to CFC rules.

As a result of changes to the Active Business Tests, certain aircraft leasing businesses, insurance businesses and contracted manufacturers will now pass the Main Business Tests, and thus may no longer be subject to the CFC rules under the New CFC Rules. However, changes to the Unrelated Party Test may mean that some FRC's which were not subject to the Old CFC rules will now be subject to the New CFC Rules.

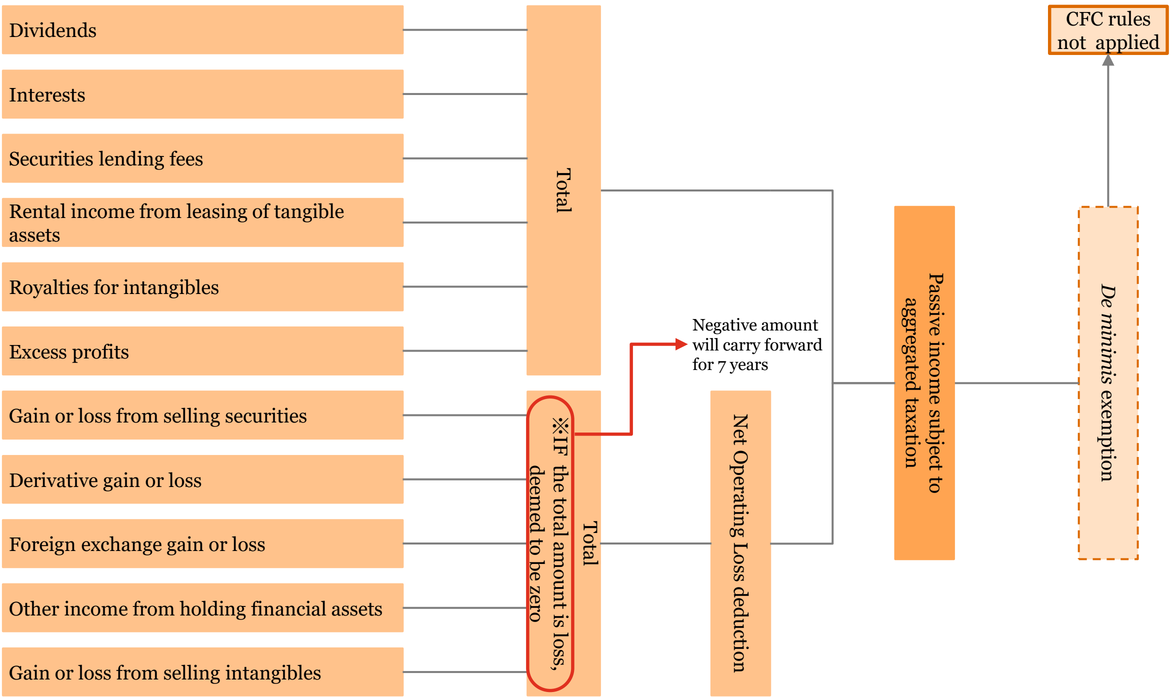
iii) Income based aggregation

Under the Old CFC Rules, the scope of 'passive income' was limited to six categories and was included in the aggregated taxable income regardless of the FRC's business. Under the 2017 tax reforms, the scope of passive income is expanded (with a different scope where the FRC engages in certain financial services), and the income calculation has also been updated. Under the New CFC Rules, where a net loss arises on the aggregation on certain categories of passive gains or losses (gains or losses on transferring securities or intangibles, gains or losses on derivative transactions, foreign exchange gains or losses), the net loss is carried forward for seven years, to be set off against future net gains on the same group of assets.

Passive income will not be taxable under the New CFC rules if the gross amount does not exceed JPY 20m, or does not exceed 5% of net income before tax. This is an increase on the *de minimis* under the Old CFC rules, which was JPY 10m.

Due to the expansion of the scope of passive gains and the changes in the calculation of passive income (i.e. the passive income subject to the aggregated taxation will not be limited to the net income at the entity level), the taxable income may increase especially for FRC's conducting a non-financial business.

Calculation of aggregated taxable income of passive income of non-financial business FRC



iv) Entity based aggregation of "specified" CFCs

Income earned by a FRC which is a Paper Company, a Cash Box or a Black List Company will be subject to aggregated taxation at the entity level unless the corporate tax rate of the FRC is not less than 30%. Japanese resident shareholders should therefore check if FRC's located in countries where the corporate tax rate is less than 30% will be subject to the CFC rules and evaluate the potential tax costs, or take proper action prior to the effective date of the New CFC Rules.

v) Certain capital gains excluded from income subject to the full-inclusion rule

Where a Japanese company acquires a foreign group and later the shares of an acquired indirect subsidiary are sold or transferred as a result of a post-acquisition restructuring, any capital gains that arise from the sale or other transfer of such shares can be excluded from income subject to the full-inclusion rule under the CFC legislation if certain requirements are met.

Specifically, the capital gain arising from the sale or other transfer of the shares can be deducted from the calculation of income subject to the full-inclusion rule if:

a) the foreign related company that sold the shares is expected to be dissolved within two years from the date the shares were sold;

b) the shares were sold or transferred to the Japanese company or another foreign related company; and

c) the sale or other transfer takes place within a specified period and is part of a reorganization implementation plan that covers the integration of the foreign related company selling the shares.

Note that capital gains arising from the sale of shares issued by the foreign related company resulting from the merger and dissolution of the foreign affiliate where residual assets were distributed are not subject to this exclusion from the CFC full-inclusion rule.

vi) Effective tax rate for CFCs located in a "no tax" jurisdiction

The effective tax rate for a CFC located in a no tax jurisdiction will be calculated by dividing the taxes of the CFC for the fiscal year by the CFC's income (taxable income calculated under the laws of the no tax jurisdiction with adjustments). If the CFC receives dividends, the dividend amount will be deducted from the CFC's income to calculate the effective tax rate. If the CFC does not have income or is in a loss position, the effective tax rate will be zero.

Certain other amendments will be made to the treatment of foreign related finance subsidiaries depending on the type of foreign related finance subsidiaries (e.g., bank, insurance company, other type of finance company).

DENSO Case

On 24 October 2017, the Supreme Court held that a Singapore subsidiary of DENSO, a leading global automotive supplier, satisfied the Active Business Tests notwithstanding that a significant proportion of its assets comprised investments in subsidiaries. In general, when assessing the main business of a FRC for the purposes of the Active Business Tests, a FRC whose assets primarily comprise investments in subsidiaries is likely to be treated as being a holding company. In the DENSO case, the Supreme Court determined that although DENSO's Singapore subsidiary was a holding company, it also provided services to its group affiliates and the value of such services was so important that it was reasonable to conclude that its main business should be the provision of services.

It should be noted that the DENSO case considered the application of the JCFC rules in fiscal years prior to the introduction of the Regional Headquarters ("RHQ") exemption, which now allow a holding company to qualify for the Active Business Tests if it provides certain management services to its directly held subsidiaries. Accordingly, the practical impact of the DENSO case may not be significant if a FRC can satisfy the conditions for the RHQ exemption, although it may provide juridical guidance regarding the interpretation of the Main Business Test.

2018 NTA Circular and Q&A

In January 2018, the NTA released a circular and Q&A summary which was intended to provide guidance on the application of the 2017 tax reforms and the 2018 tax reform proposals. In particular, the Circular and Q&A provide more detail on the definition of a Paper Company (focusing on the Substance Test and Management & Control Test) and such guidance should also be applicable to the Economic Activity Tests. In addition, guidance is provided on the calculation of passive income as well as some other matters.

Whilst the additional guidance is useful, there still remain significant uncertainties around the application of the 2017 and 2018 tax reforms.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

PwC Tax Japan
Kasumigaseki Bldg. 15F, 2-5, Kasumigaseki 3-chome, Chiyoda-ku, Tokyo 100-6015
Tel: 81-3-5251-2400
Email: pwcjapan.taxpr@jp.pwc.com
www.pwc.com/jp/e/tax

Yoko Kawasaki	Takashi Murakami	Dave Cohen
Partner	Partner	Senior Manager
81-3-5251-2450	81-80-3592-6121	81-80-3708-2049
yoko.kawasaki@pwc.com	takashi.a.murakami@pwc.com	dave.cohen@pwc.com