taxanalysts
Respectfully disagreeable since 1970.
tax notes international
VOLUME 49, NUMBER 11 ■ MARCH 17, 2008

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Japan's Political Parties Announce 2008 Tax Proposals

by Paul Previtera, Kumiko Miyajima, Eric Keuling, Yuka Iizumi, and Naoki Takaku

Reprinted from *Tax Notes Int'l*, March 17, 2008, p. 916

Reprinted from *Tax Notes Int'l*, March 17, 2008, p. 916

taxanalysts tax notes international

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Japan's Political Parties Announce 2008 Tax Proposals

by Paul Previtera, Kumiko Miyajima, Eric Keuling, Yuka Iizumi, and Naoki Takaku

Japan's ruling coalition and the opposition Democratic Party of Japan have released their 2008 tax proposals for consideration by the Ministry of Finance. The proposed reforms include measures to capture interest income paid between related foreign entities under double Special Purpose Company (SPC) schemes, and a change to the definition of permanent establishment under Japanese domestic law.

Double SPC Structures

The double SPC is a popular tax structure used by U.S. investors acquiring loans and other interest-bearing financial instruments from Japanese credit institutions. The attraction of the double SPC from a tax viewpoint is that it allows interest income to be repatriated out of Japan, exempt from withholding tax. However, under the tax reform proposals recently announced for 2008, interest income paid between related parties on instruments issued to support a business in Japan would be subject to Japanese withholding tax, effective April 1, 2008.

Overview of Double SPC Structure

To illustrate the concept of the double SPC structure, assume that two companies — SPC (1) and its wholly owned subsidiary, SPC (2) — are set up in a tax haven jurisdiction (typically the Cayman Islands), with SPC (1) establishing a branch office in Japan (JBO). SPC (2) solicits and receives funds from U.S. investors and then purchases bonds from SPC (1), which in turn lends the money it has raised from SPC (2) to the JBO. The JBO then uses the funds to purchase loans from Japanese credit institutions and receives interest income from the debtors to the loans.

The JBO then makes an election with the Japanese authorities claiming to be a permanent establishment of SPC (1). Under Japanese law, the result is that the interest paid from the credit institutions to the JBO is exempt from Japanese withholding tax. Technically, that income will be taxed when the JBO files a corporate income tax return, a requirement for PEs located in Japan. Moreover, because the JBO is part of the same legal entity as its head office in the foreign jurisdiction (SPC (1)), the interest paid from the JBO to SPC (1) is also exempt from Japanese withholding tax.

It is important to note that the interest paid to the head office is not a deductible expense for the branch for corporation tax purposes, as it is treated as a mere transfer of cash. However, if the bond interest paid by the head office to SPC (2) is directly charged to the JBO, the interest paid by the JBO to the head office would no longer be considered a mere transfer of cash. The interest would be a deductible expense for the JBO and at the same time, the JBO would be required to pay Japanese withholding tax, as the interest would constitute Japanese-source income. However, because the interest paid from SPC (1) to SPC (2) is bond interest issued by a foreign corporation, under article 161.4 of Japan's Income Tax Law (ITL), it is not considered Japanese-source income. Therefore, the JBO does not have a withholding tax obligation.

Next, SPC (1) pays interest on the bonds issued to SPC (2). Currently, bond interest paid by a foreign corporation is not classified as Japanese-source income even if the cash raised is used for a business in Japan.

Finally, SPC (2) pays a return to the U.S. investors (depicted in the diagram below as being resident in the United States). If SPC (2) did not exist, the interest paid from SPC (1) to a resident of a tax treaty-partner country (for example, the United States) would be subject to Japanese withholding tax, as prescribed under article 11(5) of the OECD model income tax treaty. By establishing SPC (2) in a nontreaty country, the application of article 11(5) is avoided. Through the use of

this scheme, SPC (2) earns tax-free interest income, and the U.S. investors avoid Japanese tax entirely.

Because the JBO in many cases does not conduct activities of any substance, the National Tax Agency (NTA) could maintain that the JBO is not a true PE of the foreign head office (SPC (1)), with the result that the interest paid from the debtors to the JBO would be subject to withholding tax. However, that would require the NTA to apply a facts and circumstances test to determine whether a PE truly exists, and to make a finding of fact. The alternative approach is the option in the 2008 tax reforms, which is to define bond interest paid between SPC (1) and SPC (2) as Japanese-source income if the cash is used to fund a business in Japan. In that case, interest received by the JBO from the Japanese financial institution would be subject to a 20 percent withholding tax (in accordance with article 161.6, 212 of the ITL).

Government's Position

The rationale behind the proposed change is simple: Japanese-source interest income is subject to withholding tax, so if the bond interest income paid between SPC (1) and SPC (2) under the double SPC scheme originated in Japan, that income should also be taxed. It would be SPC (1)'s responsibility to withhold 20 percent of the interest paid to SPC (2) and to remit that amount to the NTA. Details regarding how the NTA would monitor and enforce the new rules have not been released.

Steps (1) through (10) explain the double SPC structure as illustrated in the figure below:

(1) Foreign investors invest in SPC (2).

(2) SPC (2) purchases bonds from SPC (1).

(3) SPC (1) lends money to JBO.

(4) JBO purchases loans from Japanese credit company (JCC).

(5) JCC extends loans to Japan debtors (JD), who enter into agreements with JCC to repay the loans with interest.

(6) Debtors pay interest to JCC.

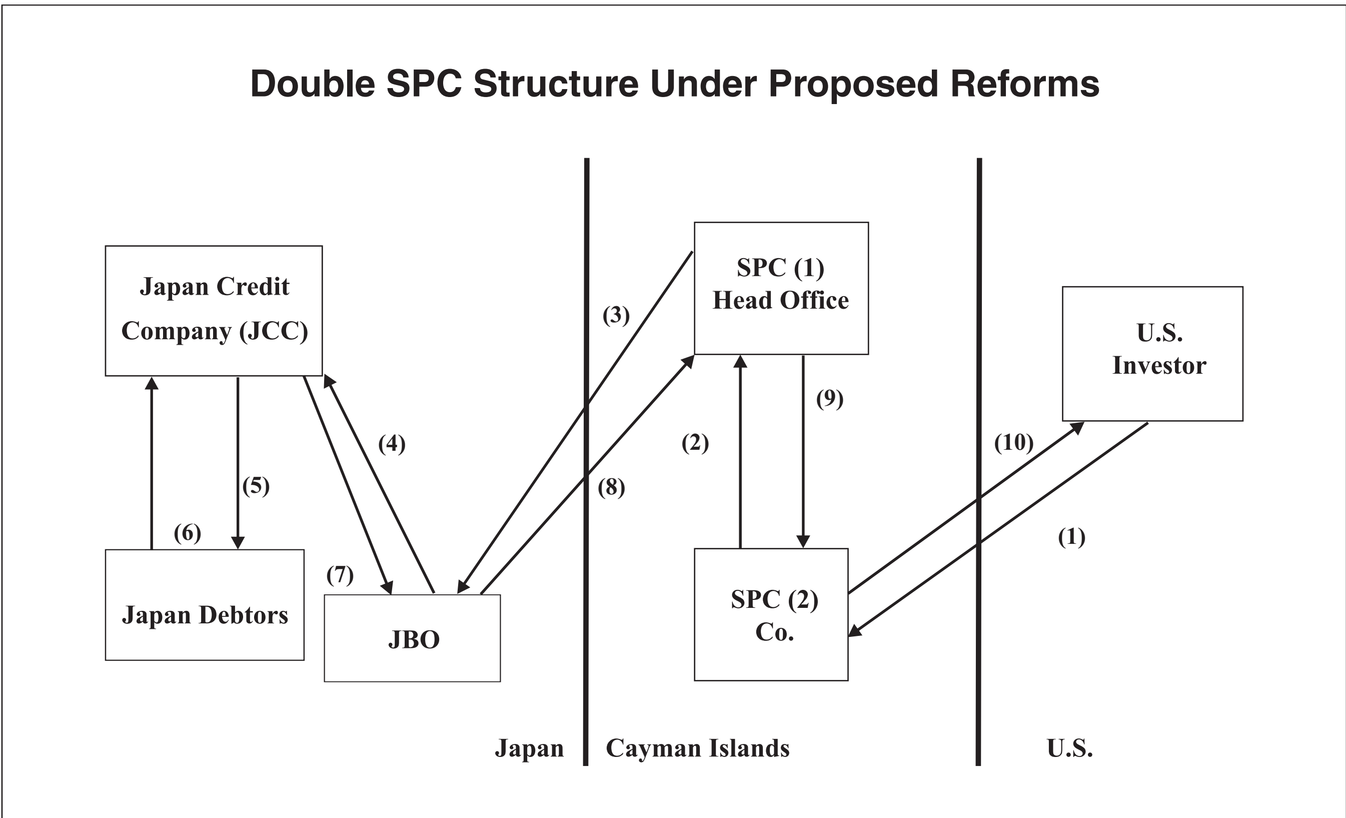
(7) JCC pays loan interest to JBO, exempt from withholding tax.

(8) JBO pays interest to SPC (1), exempt from withholding tax.

(9) SPC (1) pays bond interest to SPC (2), subject to a 20 percent withholding tax because the interest is deemed Japanese-source income because the cash was used to fund JBO.

(10) SPC (2) pays a return to the foreign investors.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Revisions to PE Rules

The second major reform proposal concerns the definition of a PE under Japanese tax law. The proposal seeks to revise the definition to conform to the OECD model income tax treaty. Under the OECD model, an independent agent conducting activities on behalf of a foreign corporation in its ordinary course of business is not a PE of a foreign corporation.

PE — Japanese Tax Law

Under article 141 of Japan's Corporation Tax Law, there are three forms of foreign corporation PE:

- foreign corporations carrying on business through a branch office, factory, mine, or other fixed place of business situated in Japan;
- foreign corporations carrying on business through construction, installation, or assembly activities in Japan for longer than one year, or through the supervision of such activities undertaken in Japan for longer than one year; and
- foreign corporations carrying on business through an agent in Japan who has, and habitually exercises, the authority to conclude contracts (excluding contracts only for the purchase of goods) for or on behalf of foreign corporations; habitually maintains a stock of goods in Japan from which he or she regularly fills orders and delivers goods on behalf of a foreign corporation; or habitually conducts important activities for securing orders, such as negotiating with customers for or on behalf of a foreign corporation.

Under the current rules, foreign investors from a jurisdiction that doesn't have an income tax treaty with Japan run the risk of the NTA claiming they have a PE in Japan when they engage the services of an independent agent. If deemed to have a PE, foreign investors are required to file tax returns in Japan, and their profits will be taxed at an effective rate of up to 42 percent.

Agent PE Under the OECD Model

The OECD model makes a distinction between dependent and independent agents. Article 5(5) states that when a person other than an agent of independent status acts on behalf of a foreign enterprise (FE) and habitually exercises authority to conclude contracts in the name of the FE, the FE will be deemed to have a PE in the state regarding the activities that person undertakes for the enterprise. In contrast, under article 5(6), an FE will not be deemed to have a PE merely because it carries on business in another jurisdiction through a broker, general commission agent, or any other agent of an independent status, provided such persons are acting in the ordinary course of business.

Under the proposed rules, agents of an independent status would be granted an independent agent exception to Japan's PE rules, in line with the exception provided under the OECD model as explained above. For example, under the proposed treatment, a Hong Kong company that engages an independent agent in Japan would only have a PE if the agent did not act in the ordinary course of its business. Currently, the exact requirements for independent status and any regulatory measures that might be introduced are unclear. As the reforms are finalized in the coming months, the guidelines and regulations governing the new legislation will become clear.

Additional Reform Proposals

Capital Gains

Capital gains earned and dividends paid on listed shares are currently taxed at a reduced rate of 10 percent (a 7 percent national tax and a 3 percent local inhabitants tax). From January 1, 2009, the rate would return to 20 percent (a 15 percent national tax and a 5 percent local inhabitants tax). However, the reduced rate of 10 percent would still apply to gains of up to ¥5 million and dividends up to ¥1 million in the 2009 and 2010 fiscal years.

Currently, capital gains realized from the sale of company shares are taxed separately from other types of income. Thus, capital losses incurred from those activities can only be used to offset current and future capital gains. The 2008 reform would allow taxpayers to aggregate capital losses against dividend income from shares in listed companies, interest income earned through bank deposits, and bonds and futures transactions.

Inheritance Tax

Shares in close companies (small and medium-size unlisted companies) received through inheritance are currently subject to Japanese inheritance tax at marginal rates of up to 50 percent. A proposal has been introduced to allow heirs of close company stock to postpone payment of inheritance taxes. The new legislation would apply retroactively to inheritances received on or after the enforcement date, preliminarily set for October 1, 2008.

Research and Development

The reform also would expand the tax credit system for research and experimentation expenses. In addition to the current tax credit based on total R&D spending (up to 20 percent of the amount of corporation tax), a new framework would be created to provide tax credits based on incremental R&D spending or R&D spending over 10 percent of sales (up to 10 percent of the amount of corporation tax).

Training-Related Expenses

This proposal would expand the scope and lengthen the time limit for tax credits applicable to training-related expenses. The special tax credit for education

and training costs for small and medium-size enterprises would allow a certain portion of the total education and training costs to be credited if the ratio of those costs to total labor costs exceeds 0.15 percent.

Public Interest Organizations

The reform also would introduce a public interest association and foundation and treat all member entities as qualified public interest organizations. Further, the new legislation would allow businesses to exclude the value of donations given to public interests from their taxable income, and would raise the maximum amount of eligible donations to qualified public interest corporations based on income to 5 percent (currently 2.5 percent). Under the proposed system for nonprofits, the requirements for obtaining authorization would be relaxed to ease the burdens of application.

Real Estate

The fixed asset tax is currently levied on newly built homes at a rate of 0.7 percent, a temporary reduction from 1.4 percent. The reduced rate is scheduled to expire on March 31, but would be extended through March 31, 2010.

A proposal has been submitted to introduce a new registration and license tax scheme for newly built, long-life houses (known as 200-year houses). The proposed rate for registration would be 0.1 percent (reduced from 0.4 percent). To qualify, a structure must receive certification from local government authorities.

Another proposed reform would extend the application of the reduced-rate registration and license tax on land sales for an additional three years and maintain the current rate of 1 percent for one year. Afterward, the rate reduction would be scaled back to 1.3 percent through March 31, 2010, and then to 1.5 percent through March 31, 2011.

Useful Life Categories

The reform would simplify the current regime for the economic useful life of fixed assets by reducing the number of categories, which currently totals 319. ◆

♦ *Paul Previtera is a senior manager, Kumiko Miyajima and Eric Keuling are managers, and Yuka Iizumi and Naoki Takaku are assistant managers in international tax with Grant Thornton Japan in Tokyo.*

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.