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JAPAN'S GOVERNMENT RELEASES 2010 TAX LEGISLATION PROPOSAL

On December 22, 2009, the draft proposal for 2010 tax legislation was released by Japan's Cabinet.

Changes In Tax Legislation Process With Change Of Government

The process for developing tax legislation proposals has undergone changes due to the historic change in government from the Liberal Democratic Party ("LDP"), which ruled Japan almost continuously for 55 years, to a coalition led the Democratic Party of Japan ("DPJ").

In the past, while the LDP (and its coalition partner in recent years, the New Komeito) were in power, two Tax Commissions were involved in developing tax legislation proposals in Japan -- (1) the Government Tax Commission, nominally under the Prime Minister but controlled in substance by Japan's Ministry of Finance ("MOF") of which the main members were scholars, and (2) the LDP's (or coalition government parties') Tax Commission, controlled by the LDP party apparatus -- with further input, since establishment under the Koizumi government in 2001, of the Council on Economic and Fiscal Policy under the Cabinet Office

The Government Tax Commission met annually in the summer and fall of each year and mainly articulated long-term policies for future tax legislation and high level policies for the following year's tax legislation. The LDP Tax Commission, which met subsequent to the report of the Government Tax Commission, was the ultimate decision-maker for specifics of tax legislation including tax rate changes, introduction of new tax regimes, temporary measures, etc. In addition, the Nippon Keidanren, the primary industry lobbying group for large companies in Japan, exerted influence on corporate tax reforms (and sometimes negotiated with the Tax Commissions), and usually issued a position paper on tax legislation in mid September in time to influence discussions at the LDP Tax Commission.

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The final tax legislative proposal was completed late each year and submitted to the Diet for consideration in the first session of each year, with tax legislation normally adopted in time to take effect as of the beginning of the government fiscal year on April 1 of each year.

During the LDP's long running rule, each year's final tax legislation typically mirrored the proposed legislation generated by the above process. Going forward, it is uncertain whether this will be the case with 2010 tax legislation because this is the first time for the DPJ to take the initiative to develop tax legislation.

In August, 2009, the DPJ (with its coalition partners the Social Democratic Party (SDP) and the People's New Party (PNP)), won a landslide victory over the LDP/New Komeito on a platform of increasing transparency and replacing LDP/bureaucratic control of government with a Cabinet and party-centered government.

In the tax area, this was reflected in termination of the party-centric LDP Tax Commission, and reconstitution of a new Government Tax Commission (under the Cabinet Office) to comprise Cabinet members and ruling party politicians, as the main body to formulate tax legislative proposals. In its first round of developing tax legislation, the Tax Commission carried over some proposals from the prior Government Tax Commission, particularly in technical areas including (see discussion below) changes in corporate taxation including the introduction of a new group company tax regime and changes to Japan's CFC rules, while focusing its discussion on implementing DPJ electoral planks in tax legislation.

The DPJ found itself caught between a severe fiscal crunch caused by the global financial crisis and ambitious electoral promises for tax reform, particularly elimination of a longstanding "temporary" surcharge on gasoline excise tax and introduction of a system of tax subsidies for parents of children through junior high school age.

Release of the tax legislation proposal was delayed from the original mid-December expected date to December 22, mainly due to discussions of the tax subsidy for minor children and the gasoline excise tax, where the DPJ settled on the curious compromise of "eliminating" the temporary surcharge, while leaving the actual excise tax rate unchanged.

2010 Proposed Tax Legislation

The following summarizes the key points of the December 22, 2009 tax legislative proposal from the DPJ Tax Commission, focusing of proposals of interest to foreign corporations investing and doing business Japan.

1. Corporate Taxation

A. Introduction of Corporate Group Taxation Regime

A comprehensive tax reform is proposed for taxation of transactions conducted within a corporate group. The scope of such a "corporate group" will include the domestic parent and its domestic subsidiaries that are controlled 100% by the parent. Group taxation will apply whether or not the corporate group elects to consolidated tax filing status. Key features of the corporate group taxation regime are as follows;

No gain or loss recognition on the transfer of certain assets within the corporate group including the transfer of assets by way of "non-tax qualified" merger.

Exclusion of "non-tax qualified share for share exchanges" performed within a corporate group from the asset revaluation rule (or deemed asset sale rule).

The dividends received deduction will apply to intra-group dividends without application of the general rule reducing the deduction to reflect attributable interest expense

No gain/loss recognition on dividends in-kind within a corporate group, and no withholding obligation with respect to such dividends in-kind as well.

No dividend exclusion treatment available for deemed dividend associated with the acquisition of treasury shares.

B. Introduction of “SRLY”-Type Rules in Tax Consolidation Regime

Currently, NOLs of a subsidiary that newly joins a Japanese tax consolidated group are eliminated upon joining. The proposed change will preserve such NOLs of a subsidiary joining a tax consolidated group and will permit such NOLs to be utilized to the extent of the new entrant’s future taxable income. This change will become effective on April 1, 2010.

C. Changes in Anti-Tax Haven Regime (“CFC Rules”)

The 2010 tax legislative proposal calls for substantial changes in Japan’s CFC rules that, overall, should have the effect of easing compliance by Japanese multinationals.

The Following changes will take effect from the initial taxable year of foreign subsidiaries beginning on or after April 1, 2010.

The central mechanism of Japan’s CFC rules is an effective rate test, with income of foreign subsidiaries subject to local tax at rate below a threshold rate presumptively treated as CFC income subject to immediate inclusion by the Japanese corporate shareholders unless an exception applies. Under the proposed legislation, the threshold effective tax rate which triggers the immediate income inclusion will be lowered from 25% to 20%. This will eliminate automatic CFC treatment of subsidiaries other than those satisfying the “active business” exception in a number of jurisdictions including China, Denmark, Malaysia and Vietnam.

The “active business” exception to CFC status will be significantly expanded by addition of an active business exemption for certain “headquarters functions”. This should facilitate use of holding company structures by Japanese multinationals.

The scope of “qualified exempt dividends” which can be disregarded in applying the effective tax rate test will be expanded. This will exclude the application of CFC treatment to holding companies established in the UK which introduced a participation exemption this year.

A “tainted income” concept will be introduced that requires immediate inclusion of certain “tainted income” of a foreign subsidiary even if the subsidiary qualifies for the “active business” exemption from CFC status. Such “tainted income” includes dividend income received from a company in which the foreign subsidiary owns less than a 10% interest, royalties received on intangible assets that the foreign subsidiary did not develop by itself, etc.

2. Withholding Tax on Securities

A. Narrowing of WHT Exemption for Interest Paid on Eurobonds

The exemption from withholding tax currently available for interest paid on certain Eurobonds (*minkan kokugai sai*) will be narrowed to exclude the following types of Eurobonds:

- Eurobonds paying interest calculated with reference to the profits of the issuer

- Euro bonds owned by a nonresident that controls or is controlled by issuer

These changes will be applicable to interest on euro bonds issued on or after April 1, 2010.

B. Expansion of WHT Exemption to Corporate Book Entry Bonds

The existing exemption from withholding tax on book entry bonds issued by Japanese national and local governments will be expanded to including qualifying book entry bonds issued by Japanese corporations subject to certain disclosure requirements. This change will be applicable to interest accrued on or after June 1, 2010.

3. Transfer Pricing

In contrast to the corporate tax, withholding tax, etc. provisions, the transfer pricing section of the legislative proposal contains only general language, and it is not certain at this point to what extent, and in what form, it will be reflected in actual legislation introduced to the Diet for consideration.

The proposal notes two areas for action:

A. Clarification of Documentation Requirements

The report notes that Japanese tax authorities may utilize secret comparables to determine arms length prices where taxpayers do not provide adequate information on audit regarding foreign related party transactions and how prices for such transactions are determined, and further notes that the treatment of individual taxpayers is variable do to inconsistent handling of these issues by individual audit teams. To correct this problem, the proposal calls for adoption of more specific rules regarding documentation that taxpayers must produce in transfer pricing audits regarding (1) the specifics of foreign related party transactions and (2) the manner in which the intercompany pricing for such transactions is determined.

As noted, it is unclear what specific form this proposal may take in actual draft legislation submitted to the Diet, but we speculate that the draft legislation may contain provisions instructing the tax authorities to promulgate regulations or guidelines that more specifically identify and define documentation requirements.

B. Clarification of Related Party Status

The report notes that current transfer pricing rules creates a bright line rule that ownership of 50% of more of the stock of a foreign entity creates a related party relationship such that Japan's transfer pricing rules apply to transactions with the foreign party, but further notes taxpayer complaints that, in the case of some joint ventures, even where more than a 50% interest is held, the shareholder does not exercise effective control over the subsidiary, such that it is unfair to apply transfer pricing rules to transactions with the joint venture.

The proposal calls for promulgation of rules to require a review to determine whether a taxpayer exercises effective control over a foreign entity as a threshold test for applying transfer pricing taxation. While it is not certain how this position will be reflected in actual tax legislation submitted to the Diet for consideration, we speculate that the legislation might propose a modified definition of "foreign related party" in the Special Tax Measures Law section containing Japan's transfer pricing rules or may contain provisions instructing the tax authorities to promulgate regulations or guidelines requiring a determination of effective control to establish a "foreign related party" status.