Tax: Japan: International Joint Ventures

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Tax on international joint ventures. Country Q&A (Japan).

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1. Are partnerships tax transparent in your jurisdiction?

Partnerships, such as *kumiai* (general partnerships), *toshi jigyo yugen sekinin kumiai* (limited partnerships) and *yugen sekinin jigyo kumiai* (limited liability partnerships), are generally tax transparent in Japan and therefore profits and losses accrue directly to the partners. However, *godo kaisha* (limited liability companies (LLCs)) are treated as corporations for tax purposes.

2. Can losses of a foreign partnership be offset against the profits of a corporate partner that is tax resident in your country?

Generally yes, if the foreign partnership is treated as a "partnership" for Japanese tax purposes. Recently, an LLC established under New York law (even if the taxpayer chose pass-through treatment of the LLC under the "check-the-box" regulations in the US) and limited partnerships established under US state laws were not deemed to be *kumiai*, but were treated as corporations for tax purposes by the courts and the National Tax Tribunal in Japan. The material factors were whether or not:

- The entity was a "separate legal entity" that was independent of its members instead of a contractual relationship, such as a *kumiai*, under its governing law.
- The entity could own and/or dispose of its assets in its own name under its governing law.
- The entity could be a party in lawsuits and in transactions under its governing law.
- Members of the entity had any interest in the assets of that entity.

3. Do partnerships that are tax resident in your country generally receive similar benefits to companies under double tax treaties?

Partnerships may not receive benefits under double tax treaties, since they are not taxed. The partners of partnerships can generally receive benefits that are available under double tax treaties.

4. Does your country have rules that restrict the proportion of a company's capital that is comprised of loans by affiliates (thin capitalisation rules)? If so, please explain in what circumstances these rules apply and whether they can be circumvented.

Yes, Japan has thin capitalisation rules. If the average amount of loans from foreign controlling shareholders to its Japanese subsidiary exceeds three times the subsidiary's equity capital allocated to the foreign controlling shareholders, the interest expense of the Japanese subsidiary corresponding to such excess loan portion is not deductible.

This rule does not apply when the outstanding amount of loans of the Japanese subsidiary does not exceed three times its total equity capital. "Foreign controlling shareholders" include non-resident or foreign corporations that hold 50% or more of shares of a Japanese company. If the Japanese subsidiary is financed with the credit of the foreign controlling shareholders, the amount of financing will also be included into such "amount of loans".

An appropriate debt to equity ratio higher than 3:1 may be allowed, if a comparable Japanese company of similar size conducting similar business activities has such higher ratio.

5. If a company that is tax resident in your country transfers assets (including shares) to a company that is tax resident in another country, what taxes might arise? Are reliefs potentially available? (Please distinguish, if relevant, between assets that are located in your country and assets located in a foreign country.)

Capital gains tax

This is usually payable on the transfer of assets (including shares), regardless of the location of the assets. A tax credit may be available for any foreign tax paid. Capital gains are not recognised on a tax-qualified contribution-in-kind (*tekikaku genbutsu shusshi*), if it meets certain conditions, including no cash payment as consideration.

Consumption tax

This is applied to domestic transactions, including the sale of taxable assets located (such as movable assets) or registered (such as intellectual property) in Japan. However, the sale of certain assets, including land and shares, are not taxable for consumption tax purposes. Although sellers must pay consumption tax, this amount is normally passed on to purchasers under purchase agreements. The aggregate consumption tax rate is 5% (national consumption tax rate of 4% and local consumption tax rate of 1%). Export transactions by a company that is tax resident in Japan are generally tax-exempt for consumption tax purposes.

Stamp tax

This is payable by affixing a revenue stamp on taxable documents, including agreements executed in Japan regarding transfer of real property and intangible assets regardless of the location of such assets. No stamp tax is payable with respect to stock purchase agreements and any agreements that are executed abroad.

6. Is any tax or duty payable on the issue of shares by a company that is incorporated in your country?

The issue of shares by a company is generally not a taxable transaction in Japan. 50% or more of the amount contributed to the company by the issue of shares must be incorporated into the capital amount, and registration tax, which is 0.7% of the increased capital amount, is payable. In addition, a nominal amount of stamp tax is payable if the company issues share certificates.

7. What rate of tax do companies pay in your jurisdiction and how is it assessed?

A Japanese company is subject to corporation tax (national), prefectural inhabitant tax, municipal inhabitant tax and enterprise tax (prefectural) on all its domestic and foreign-sourced income. The effective corporate income tax rate is about 40.69%.

8. Can losses of a company that is tax resident in your country be surrendered for tax purposes to another company. If so, what conditions apply? Can losses be carried forward for tax purposes?

Losses can be surrendered between entities that are consolidated for tax purposes. The consolidated taxation system is applicable to a group of Japanese companies where a Japanese parent company directly or indirectly owns 100% of the shares of other Japanese subsidiaries. Only a Japanese company can be part of a consolidated group for tax purposes.

Net losses can generally be carried forward for the following seven years. The loss-carry-forward is only permitted for a corporation which both:

- Filed a blue tax return (*aoiro shinkoku*) for the business year when the losses were incurred.
- Has continued to file tax returns, whether blue or not, for subsequent business years.

9. Are interest payments tax deductible in your country?

Interest payments are generally tax deductible, subject to the thin capitalisation rules (see *Question 4*).

10. Are withholding taxes applied to dividends, interest and/or other payments made by a company that is tax resident in your country to a foreign company? If so, what rates apply? Can they be reduced or eliminated in any circumstances?

Dividends, interest and other payments (such as royalties paid by a Japanese company to a foreign company) are subject to a 20% withholding tax, to the extent that such payments constitute Japan-sourced income. The 20% withholding tax rate may be reduced or eliminated by the application of double tax treaties.

11. What is the tax treatment of dividends paid by a company that is tax resident in your country to a corporate shareholder (domestic or foreign)?

When domestic corporations receive dividends from other domestic corporations, 50% of the amount, less the amount of interest chargeable to the shares on which those dividends were paid, is excluded from income. When a domestic corporation receives dividends from another domestic corporation in which it has owned at least 25% of the shares for a period of at least six months before the determination date of the payment of the dividends, the total amount of dividends received, less the amount of interest chargeable to the shares on which those dividends were paid, is excluded from income.

Dividends paid by a Japanese company are subject to a 7% (dividend by listed companies) or 20% (dividend by non-listed companies) withholding tax. Income tax withheld from dividend income received from domestic corporations can be credited against corporate tax for the business year.

Foreign corporate shareholders are subject to withholding tax on dividends paid by a Japanese corporation (see *Question 10*). If the foreign corporate shareholder has a permanent establishment in Japan, they must file a tax return in the country. In such a case, income tax withheld from dividend income received from domestic corporations can be credited against corporate tax for the business year.

12. What is the tax treatment of dividends received by a company that is tax resident in your country from a foreign company?

When a Japanese corporation receives dividends from a "foreign subsidiary", 95% of the amount of dividends received is excluded from income. A foreign subsidiary is defined as a foreign corporation in which the Japanese corporation owns at least 25% or more shares of the foreign corporation for a period of at least six months before the determination date of the payment of the dividends. The 25% ownership ratio may be reduced by the application of double tax treaties.

13. Are there any circumstances in which (undistributed) profits of a company in a foreign country can be imputed to a corporate shareholder in your country by tax authorities (controlled foreign company rules)?

Yes. When a Japanese corporation owns, directly or indirectly, at least 5% of the shares of a "foreign subsidiary in a tax haven", certain undistributed profits allocated to the shares held by the corporation must be included in the corporation's income. A foreign subsidiary in a tax haven includes a foreign corporation if more than 50% of its shares are directly or indirectly owned by tax residents or Japanese corporations and if its income tax burden is 20% or less.

This rule does not apply to undistributed profits of a foreign company conducting actual business in the tax haven, subject to certain conditions.

14. Does your country have transfer pricing rules? If so, please explain broadly how they apply?

Yes. When taxable income of a Japanese company arising from transactions with its foreign-related entities is less than the amount of income calculated on arm's length principles, those transactions are assessed as if they were conducted at arm's length prices. The differential amount of income is included in, or is not deductible from, the taxable income of the corporation.