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Financial services
tax alert

Ernst & Young Tax Co.

2014 Tax Reform Outline – Impact of reform of permanent establishment taxation on inbound financial institutions

Contents

Executive summary

On 24 December 2013, the Japanese Cabinet officially released its 2014 Tax Reform Outline. The Outline introduces several corporate tax reforms including the repeal of the special reconstruction surtax one year early, and relief for entertainment expense taxation. One of the most significant reforms is that the taxation of permanent establishments will shift from the current entire income rule (also known as force of attraction) to an attributable income rule. We highly recommend that banks which conduct business through branches in Japan in particular make preparations well in advance of the enforcement date of the new rule (expected to be April 2016) since it will directly impact future corporate tax returns. This alert is an overview of the main issues relating to the reform of the international taxation principle which will impact the tax positions of inbound financial institutions.

Detailed discussions

1. Change from entire income approach to attributable income approach

Until now, taxation of foreign corporations with branches in Japan has been based on the entire income approach, under which all Japan sourced income is aggregated. On the other hand, most tax treaties with other countries use the attributable income approach, and as a result there have been two different rules for the taxation of foreign corporations.

In 2010, it was agreed that the calculation of income to be attributed to a permanent establishment (PE) under the Article 7 of the OECD model treaty should be based on the Authorized OECD Approach (AOA). Under the AOA, income attributable to a PE should be calculated by a functional and factual analysis, attribution of assets, risks and free capital, and recognition of its dealings with other parts of the enterprise (internal dealings) based on the assumption that the PE is a separate and independent entity. As a result of this agreement, it became necessary for the Japanese authorities to change from the entire income approach to the attributable income approach and therefore this reform was included in the 2014 Tax Reform Outline.

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Under the new taxation rule introduced in the Outline, all Japan-sourced income of foreign corporations which have PEs in Japan will be divided into two types of income, either income attributable to the PE or income not attributable to the PE. PEs in Japan shall only be taxed on their PE-attributable income. Therefore, Japan-sourced income not attributable to PEs in Japan, such as interest on a loan to a corporation conducting business in Japan, will be taxed separately. On the other hand, income that is currently treated as non-Japan sourced income, such as investment income earned outside of Japan, will be taxed in Japan if it is attributable to the PE.

This new rule will be applied for tax years beginning on or after 1 April 2016. For December year-end companies, this rule will be applied from the tax year beginning 1 January 2017.

2. Basic concept of PE-attributable income

(1) Recognition of gain/loss from internal dealings

Since a PE is assumed to be a functionally separate entity from its head office, gains or losses from internal dealings which are not recognized under the current rule may be recognized under the new rule. Taxable income from internal dealings will be calculated based on the arm's length principle, as in transfer pricing rules.

However, if a PE and its head office are the same legal entity, an internal guarantee will not be recognized in calculating income since a PE and its head office should have the same level of creditworthiness. The same applies to internal reinsurance, which will also not be recognized.

Furthermore, if the applicable tax treaty follows the old OECD model treaty before the 2010 revision, internal royalties for the use of intangible assets will not be recognized since internal royalties are not recognized under the old OECD model treaty.

(2) Recognition of capital transactions

Intra-entity funding transactions such as funding a PE from its head office in order to set up a new branch or profit repatriation from a PE to its head office will be treated as capital transactions.

(3) No withholding taxes

Interest paid from a PE to its head office will not be subject to withholding tax. Interest payments on external loans from outside of Japan will be subject to withholding tax as under the current rule.

3. Calculation of PE-attributable income

(1) Significant implications for banks

i. Limitation of interest expense deduction corresponding to PE-attributable free capital

   If a PE's head office account for book purposes is less than the capital attributable to a PE for tax purposes (i.e., the free capital of the PE), which is calculated based on the assumption that the PE is a functionally separate entity from its head office, interest expenses incurred at the PE (including interest payments to third parties, internal interest expenses, and interest expenses included in the head office expense allocations) corresponding to the excess free capital will not be deductible at the PE. In other words, only interest expenses corresponding to the debt capital will be deductible.

   Further, although LIBOR has generally been used to calculate the limit of the deductible internal interest expenses, arm's length interest rates will be used under the new rule.

   For the calculation of PE-attributable free capital for tax purposes, one of the following approaches needs to be used consistently.

   (i) Capital allocation approach
   Allocate the foreign corporation's free capital amount according to the risk weighted assets ratio, which is calculated based on credit risks, market risks, operational risks and other risks. For banks, it is expected to be calculated according to the BIS regulations. Foreign corporations other than financial institutions can use assets as a basis instead of the risk-weighted assets.

   (ii) Thin capitalization approach
   Calculate the PE-attributable free capital based on the comparable debt-to-equity ratio of a corporation which conducts similar business with a similar volume and in similar situations as the PE.

ii. Deduction of interest expenses on tier 2 capital

   If banks and securities companies (registered in Japan as a Type I Financial Instrument Business only) have tier 2 capital, interest expenses on tier 2 capital attributable to a PE will be deductible.

iii. Head office expense allocation

In order to deduct reasonably allocated expenses incurred at the head office and other offices, a PE will be required to prepare and maintain documentation explaining the methods of allocation. Although the new rule does not differ significantly from the current rule, it is advisable to make a distinction between head office expense allocations and service fees for internal dealings which require arm's length pricing.

(2) Investment assets and income attributable to PEs of insurance companies

If the balance of investment assets recorded on the PE's balance sheet is less than the amount attributable according to the amount of policy reserves, the investment income corresponding to the excess investment assets will be treated as PE-attributable income.

This rule will not be applied if one of the following conditions is met:

i. The excess investment assets are less than 10% of the PE-attributable investment assets.

ii. The investment income corresponding to the excess investment assets is USD100,000 or less.

iii. The amount of the PE total assets (excluding the head office account) exceeds the amount of the total liabilities and certain net assets (excluding the head office account).

(3) Other issues

i. Application of thin capitalization rule and Japanese earnings stripping rule

Since the deductible interest expenses of PEs will be limited by the amount of free capital (see (1) i above), PEs will not be subject to the thin capitalization rule.

Under the Japanese earnings stripping rule, internal interest expenses paid to the head office or other offices will be included in interest expenses paid to related parties. Interest expenses to be deducted corresponding to tier 2 capital (see (1) ii above) will not be included in interest expenses paid to related parties.

ii. Foreign tax credits

Since only Japan-sourced income of foreign corporations has been subject to tax in Japan, there was no double taxation in principle and foreign tax credits were not available for PEs.

Under the new rule, foreign tax credits will be available for PEs if income earned in a non-head office foreign jurisdiction is taxed in that jurisdiction, or if PE-attributable income earned in the head office jurisdiction is taxed but tax credits are not granted in the head office jurisdiction.

However, even if worldwide income is subject to income tax in the head office jurisdiction and income tax corresponding to the PE-attributable income is allocated to a PE, the allocated tax will not qualify as a foreign income tax to which foreign tax credits may apply.

In addition, if there is a tax treaty between the country from which a PE earns the income and Japan, foreign income tax to which foreign tax credits may apply will be limited to the amount calculated with the tax rates provided under the treaty, and any excess will be treated as deductible expenses.

iii. NOL carryforwards

According to the new rule, PEs will only be assessed on PE-attributable income, which is calculated separately from non-PE attributable income. PE-attributable NOL will also be separated from non-PE attributable NOL and can only be offset against PE-attributable income.

4. Documentation of the calculation of PE-attributable income

Foreign corporations which have PEs will be required to prepare the following documents and submit them in a timely manner if requested by the Japanese tax authorities. Internal dealings should be recorded on the books in the same manner as the transactions with third parties.

(1) Documents to be prepared relating to internal dealings

i. Purchase orders, invoices, receipts of internal dealings (as required for blue form tax returns)

ii. Documents describing the functions of the PE, head office, and other offices

iii. Documents describing calculations of the arm's length prices as required for transfer pricing purposes

(2) Documents for external transactions

Details of the transactions if the income from the transactions is attributable to the PE.

5. Recommended preparations

Although the new rule will not take effect until April 2016 or later, we highly recommend making early preparations as there are several issues that will require coordination with your head office, such as:

i. Identification and documentation of internal dealings (identifying applicable dealings, conducting pricing studies)

ii. Preparation of documentation for head office expense allocations

iii. Review of PE-attributable free capital

iv. Review of foreign tax credit applicability

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