

Japan tax alert

Ernst & Young Tax Co.

2014 tax reforms: Shift to "attributable income" approach in taxing PEs - branches must prepare transfer pricing documentation

Executive summary

On 31 March 2014, a Partial Amendment of the Income Tax Law was promulgated. A key amendment is the shift from the current entire income approach (also known as force of attraction) to an attributable income approach. Similar to transfer pricing, the arm's length principle will be applied in the taxation of intra-company transactions between a permanent establishment (PE) and its headquarters. Moreover, the arm's length principle will also be applied to calculate the foreign income attributable to a Japanese company's foreign PE when that company applies for a foreign tax credit for its foreign PE. Foreign corporations in Japan will be directly impacted in future tax filings, and therefore we recommend preparing well in advance of the April 2016 enforcement date of the new rule. 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 intra-company transactions of foreign corporations.

Key points

- ▶ The taxation of foreign corporations will shift from the current entire income approach to an attributable income approach
- ▶ A PE of a foreign corporation will be assumed to be a separate and independent entity from its headquarters, and the arm's length principle will be applied to income attributable to the PE arising from intra-company transactions
- ▶ Rules similar to those on transfer pricing will be applied to transactions between a headquarters and its branches, including rules on the extension of deadlines for corrections, secret comparables, presumptive taxation and the non-deductibility of the entire amount of donations
- ▶ Documentation similar to that for transfer pricing will be required, including documents indicating functions and facts regarding intra-company transactions from which arise PE-attributable income, and documents indicating the calculation of arm's length prices or results



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Detailed discussions

1. Shift from entire income approach to attributable income approach

Until now, the taxation of a foreign corporation with a branch in Japan (a Japanese PE) has been based on an “entire income approach”, under which all Japan-sourced income is aggregated for tax calculation purposes regardless of whether it is attributable to the Japanese PE, and conversely any foreign-sourced income of the Japanese PE is untaxed. However, Japan’s tax treaties with other countries are generally based on the OECD model treaty, which adopts an “attributable income approach”, which taxes all income attributable to a domestic PE. As a result, the taxation of foreign corporations in Japan is conducted according to two different approaches, creating some inconsistencies.

The complexities of PE taxation resulted from advances in technology and an increase in the variety of forms of business. The OECD has adopted what is known as the Authorized OECD Approach (AOA) for calculating income attributable to a PE as a result of the 2010 reforms to Article 7 of the OECD model treaty. The AOA is intended to prevent double taxation and lost taxation caused by differences in each country’s interpretation of PE-attributable income. Under the AOA, it is assumed that the PE is a separate and independent entity. Therefore, the income is calculated by conducting a functional and factual analysis, and recognizing the attribution of assets, risks, free capital and the dealings of the PE with other parts of the enterprise. This has provided an opportunity for Japanese tax law also to shift from the entire income approach to the attributable income approach, and reforms to this effect were included in the 2014 tax reforms.

According to the new rules for taxation of foreign corporations as stated in the reforms, all Japan-sourced income of a foreign corporation with a PE in Japan shall be classified into either PE-attributable income or non-PE-attributable income. This attribution will be made according to the functions performed and assets used by the foreign corporation, the intra-company transactions between the foreign headquarters and the PE, and other factors. The PE-attributable income shall be treated as Japan-sourced income and taxed in Japan (Corporate Tax Law (CTL) 138).

In calculating the PE-attributable income according to the AOA, the most important concept to consider is that of “significant people functions”. Stated briefly, this concept intends that the income of a PE should be greater if there are many significant people functions executed at the PE. This is an important departure from the former approach to PE recognition which emphasized the association of a PE with a physical location.

The above reforms shall be applied to corporate tax in fiscal years beginning on or after 1 April 2016.

2. Main tax reforms of the attributable income approach

a. Recognition of gain/loss from intra-company transactions

Since a PE is assumed to be a functionally separate entity from its headquarters, gains or losses from intra-company transactions which are not recognized under the current rule may be recognized under the new rule. Except where there is a separate rule, PE-attributable income is the amount of profit or loss incurred by the foreign company from business conducted through its PE calculated according to the rules for calculating income of Japanese companies (CTL 142). Taxable income from transactions between the PE and headquarters or other branches will be calculated as transactions between third parties, similar to transfer pricing rules (Special Taxation Measures Law (STML) 66-4-3,1).

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 treaty¹.

b. Taxation based on rules similar to transfer pricing rules will be applied

Rules relating to the extension of deadlines for corrections, secret comparables, documentation of the calculation of arm’s length prices in intra-company transactions, presumptive taxation, statute of limitation, and grace period, etc. will be similar to the transfer pricing rules. Further, if an intra-company transaction constitutes a donation from a PE to the headquarters, the entire amount shall be non-deductible, just as with donations to a foreign related party (STML 66-4-3, 2 to 12).

c. Allocation of headquarters expenses

Expenses arising at the headquarters from joint business activities of the headquarters and PE that are reasonably allocated to the PE will be recognized as expenses of the PE. However, if there are no documents supporting the calculation of the expense allocation, the expenses will be non-deductible (CTL 142-7). While this is not a significant departure from the current rules (as defined in the circulars), it is advisable to make a distinction between headquarters expense allocations and service fees for intra-company transactions which require arm’s length pricing.

¹ In light of the 2010 version of the OECD model treaty, Japan will amend its tax treaties in due order following the protocol used to amend the Japan and the United Kingdom of Great Britain and Northern Ireland treaty signed in December 2013.

d. Documentation of the calculation of PE-attributable income

A foreign corporation with a PE in Japan will be required to prepare the following documents and submit them in a timely manner if requested by the Japanese tax authorities. Intra-company transactions should be recorded on the books in the same manner as transactions with third parties (CTL 146-2, 1 and 2).

- i. Documents that should be prepared relating external transactions attributable to a PE (Corporate Tax Law Enforcement Order (CTLEO) 62-2, 1 to 4)
 - ▶ Documents detailing the transactions attributable to the PE (PE external transactions)
 - ▶ Details of assets used by headquarters and the PE in the PE external transactions, and of liabilities relating to the PE external transactions
 - ▶ Documents detailing the functions and risks assumed by the headquarters and the PE in the PE external transactions. Risks refer to events that may lead to a decrease in profit or increase in costs to the headquarters or PE, such as currency exchange rate fluctuations, market interest rate fluctuations or changes to the economic environment. Functions include labor functions relating to management and labor functions relating to asset ownership
 - ▶ Details of the departments that relate to the functions of the PE or headquarters in the PE external transactions and their business activities
- ii. Documents that should be prepared relating to intra-company transactions (CTLEO 62-3, 1 to 5)
 - ▶ Orders, agreements, invoices, receipts and estimates, and documents equivalent thereto, or copies thereof, that indicate the facts of the sale of assets or provision of services corresponding to intra-company transactions between the PE and headquarters
 - ▶ Details of assets used by headquarters and the PE in the intra-company transactions, and of liabilities relating to the intra-company transactions
 - ▶ Documents detailing the functions and risks assumed by the headquarters and the PE in the intra-company transactions. Risks refer to events that may lead to a decrease in profit or increase in costs to the headquarters or PE, such as currency exchange rate fluctuations, market interest rate fluctuations or changes to the economic environment. Functions include labor functions relating to management and labor functions relating to asset ownership

- ▶ Details of the departments that relate to functions performed in intra-company transactions of headquarters and the PE, and details of the duties thereof
- ▶ Documents indicating any other facts arising related to the intra-company transactions (any other facts relating to the intra-company transactions such as the sale of assets or provision of services)

e. Necessary documents to calculate the arm's length prices or returns relating to the application of presumptive taxation

If documents related to calculating the arm's length prices are not submitted in a timely manner, presumptive taxation will be applied. These documents, stipulated in Special Taxation Measures Law Enforcement Order (STMLEO) 22-10-3, 1 and 2 are as follows:

- i. The following documents detailing intra-company transactions
 - ▶ Documents detailing assets and services in intra-company transactions
 - ▶ Documents detailing functions performed and risks assumed by headquarters and the PE in intra-company transactions. Risks refer to events that may lead to a decrease in profit or increase in costs to the headquarters or PE, such as currency exchange rate fluctuations, market interest rate fluctuations or changes to the economic environment.
 - ▶ Documents detailing intangible and fixed assets used in intra-company transactions between headquarters and PE
 - ▶ Agreements or equivalent documents detailing the sale of assets or provision of services in the intra-company transactions
 - ▶ Documents detailing the method of setting consideration and any related negotiations in the intra-company transactions
 - ▶ Profit and loss information of the intra-company transactions between the PE and headquarters
 - ▶ Market analyses relating to the intra-company transactions
 - ▶ Documents detailing business policy of foreign corporations, and the business activities of the PE and headquarters
 - ▶ Documents indicating whether there are any other transactions closely related to the intra-company transactions (including other intra-company transactions), and if so, details thereof

- ii. Documents related to calculating the arm's length prices or returns in the intra-company transactions, similar to those submitted according to the transfer pricing rules
 - Documents detailing the transfer pricing method selected by each foreign corporation and the reason(s) why it was selected
 - Documents produced to calculate the arm's length prices or returns by the foreign corporation
 - The documents listed in STMLEO 22-10,1,2 (b) to (e) (Taxation special ordinance relating to transactions with foreign related parties)

Since agreements are not normally concluded between a PE and its headquarters, it is essential to confirm the status of the functions performed, risks assumed and assets owned and prepare adequate documentation thereof. An analysis of significant people functions is also essential, and documentation must also be prepared indicating whether it is the headquarters or branch that has discretion in business activities, and the scope thereof.

3. Recommended actions

Although the new rule will not take effect until April 2016 or later, we highly recommend preparing now as there are several issues that will require coordination with your headquarters, such as:

- a. Identifying and documenting intra-company transactions (identifying applicable transactions)
- b. Undertaking a functional analysis and carrying out benchmarking studies
- c. Preparing documentation for headquarters expense allocations

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