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Japanese Taxation of the Foreign Income of Japanese Corporations

by Rosser H. Brockman***

1. Introduction

As international trade and investment between Japan and the United States have grown, the Japanese domestic tax treatment of the foreign income of Japanese corporations has become increasingly important to American businessmen, attorneys, legal scholars and government officials. An American businessman, for example, may wish to structure his Asian regional activities through a wholly owned Japanese subsidiary rather than his U.S. company, in which case the nature and structure of Asian operations outside Japan should be arranged with an eye to the way in which non-Japanese profits will be taxed to the Japanese subsidiary. An American attorney advising Japanese clients concerning U.S. activities should take into account how income generated in the U.S. will be taxed to his Japanese client in Japan. American legal scholars in the tax field should find the Japanese case an interesting example of tax policy and structure for purposes of comparative study. In recent years American government officials have become very sensitive to the question of whether Japanese domestic tax law (and other rules) unfairly subsidize or otherwise encourage Japanese exports and overseas investment.

This paper seeks to describe in general terms some of the most important features of Japanese taxation of corporate income generated outside Japan and to estimate whether such taxation treatment tends to encourage or discourage overseas business activities by Japanese corporations.

The Japanese Government imposes both national and local taxes on corporate income. Of the local corporate income taxes, the inhabitants tax, levied by both prefectural and municipal governments, is calculated as a percentage of the national corporate income tax due, and is thus assessed on the same taxable income as

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the national corporate income tax. The remaining local tax, the enterprise tax, is levied by prefectural governments and is calculated separately.\textsuperscript{1}

In general, Japanese corporations are subject to the national corporate income tax (and thus the local inhabitants taxes) on all current worldwide income, including income generated through branch offices located in foreign countries but not repatriated to Japan.\textsuperscript{2} Income earned by foreign subsidiaries is not included in the taxable income of their Japanese parents until repatriated in the form of dividends or proceeds from the sale of shares or on liquidation, except that Japanese corporate taxpayers must report currently the “taxable undistributed profits” of their “designated tax haven subsidiaries”.\textsuperscript{3} To avoid double taxation, foreign taxes paid on foreign income may generally be credited against national and local inhabitants’ corporate income tax liability.

Income attributable to the activities of permanent establishments of Japanese corporations in foreign jurisdictions is not subject to the local enterprise tax on income. Other foreign source income, including dividends, “taxable undistributed profits” of “designated tax haven subsidiaries” and so on, is included in taxable income for enterprise tax purposes.\textsuperscript{4} Foreign taxes may not be credited against enterprise tax liability.

2. Source Rules\textsuperscript{5}

A. General

As the foreign activities of Japanese corporations have ex-

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1. Corporate Tax Law (hojinzeiho), Law No. 34 of March 31, 1965 [hereinafter cited as CTL]; Local Tax Law (chihozeiho), Law No. 226 of July 31, 1950 [hereinafter cited as LTL].
2. CTL, ch. II, art. 4(1); Ch. III, art. 5; LTL, art. 23(1) (iii) and (iv); art. 292(1)(iii) and (iv); a foreign branch office is an office of a Japanese corporation located in a foreign country as opposed to a separately incorporated foreign subsidiary.
3. Special Tax Measures Law (sozei tokubetsu sochiho), Law No. 26 of March 31, 1957 [hereinafter cited as STML], arts. 66-6 - 66-9. Designated Tax Havens—First Group: Andorra, Bahama, Bahrain, Bermuda, British Channel Islands, British Virgin Islands, Cayman Islands, Djibouti, Hong Kong, Isle of Man, Lichtenstein, Macao, Nauru, New Hebrides, and Turks and Caicos Islands; Second Group: Panama; Third Group: Antigua (international business company); Barbados (international business company); Grenada (international business company); Gibraltar (exempt company); Jamaica (international finance company); Liberia (nonresident Liberian entity or a company which is engaged in operation, lease and/or sale of vessels and/or aircraft); Luxembourg (holding company); Montserrat (offshore company); Netherlands Antilles (investment company or patent holding company); St. Vincent (international business company or international company); and Switzerland (holding company or domicile company).
4. LTL, art. 72-15.
5. Foreign source rules are rules which are applied to determine whether a specific item
panded, it has become increasingly important to determine what portion of corporate income should be considered income derived from foreign sources, in order, for example, to calculate the statutory limitation on the foreign tax credit. Despite the importance of this determination, however, the Japanese tax laws and regulations contain very few provisions directly addressed to this question. Instead, it is necessary to infer most foreign source rules, as they apply to Japanese corporations, from the rather extensive provisions regarding the Japanese domestic source income of foreign corporations.  

In general, the determination of the source of income for domestic Japanese purposes will be made exclusively in accordance with Japanese principles and the source rules of foreign jurisdictions will be ignored. Income which is considered foreign source income under Japanese principles will be so classified for domestic purposes even if the foreign jurisdiction where the income is generated does not consider such income as domestic source and therefore does not tax the Japanese corporation in respect to such income. Conversely, even if the foreign jurisdiction does tax the income of a Japanese corporation, such income will not be considered to be derived from a foreign source for Japanese purposes unless it is so classified under Japanese rules. The source of income and the allocation of income between Japan and foreign jurisdictions will be affected, however, by the tax treaties which Japan has entered with more than twenty-five countries, and which override domestic law.

B. Source of Main Items of Income: The rules concerning the source of the most important categories of income for Japanese domestic corporate income tax purposes are as follows:

(1) Business Income: Where a Japanese corporation carries on both domestic and overseas businesses, the allocation of income between the two jurisdictions will be determined by (a) considering the domestic and overseas businesses as separate entities dealing

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6. CTL, arts. 138-140; Corporate Tax Law Enforcement Order (hojinzeiho shikorei), Cabinet Order No. 97 of March 31, 1965 [hereinafter cited as CTL Enf. Order], arts. 176-184.


8. E.g., Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, March 8, 1971, United States-Japan, Part I, 23 U.S.T. 967, T.I.A.S. NO. 7365. Presently, there are tax treaties with the following 28 countries: Unites States, Sweden, Norway, Denmark, Austria, England, Canada, France, West Germany, Pakistan, India, Singapore, New Zealand, Thailand, Malaysia, Brazil, Sri Lanka, Egypt, Belgium, Australia, Zambia, Korea, Holland, Switzerland, Finland, Italy, Ireland and Spain.
with each other as third parties on an arm’s length basis or (b) allocating income to Japan on the basis of Japanese revenues and expenses and the value of Japanese assets which can be presumed to contribute to income generated, with the remainder being considered foreign source.⁹

(2) Sales Income: In general, sales income will have its source at the place of sale. Sales by a Japanese corporation will be considered made outside Japan if the goods are located outside Japan immediately prior to the time the obligation to deliver arises or if the contract of sale is made outside Japan.¹⁰ Where products are acquired outside Japan and sold within Japan from inventory, all income will be considered domestic source income if the Japanese seller has not manufactured, processed or otherwise added value to the products outside Japan. Where the Japanese seller has added value to the products outside Japan, the income will be divided between domestic and foreign sources as if the unit of the Japanese seller adding value outside Japan and the selling unit inside Japan were dealing with each other as independent parties on an arm’s length basis.¹¹

(3) Construction Income: In contrast to sales income which may be apportioned between domestic and foreign sources, all income from construction, installation and assembly operations has its source at the place where the work is performed.¹² Therefore, even though all of the construction materials, personnel, the place of contract, etc. originate or take place in Japan, the income from the construction of a plant in a foreign country will be considered as foreign source income.¹³

(4) International Transportation Income: Under Japanese domestic law all income from international shipping is sourced where the passengers board or the freight is loaded on the ship, regardless of where the ship travels or the freight or passenger depart. In the case of air transportation and air freight, however, the regulations are more ambiguous. These regulations provide that an airline’s revenues and expenses in Japan, the value of its fixed assets in Japan, and other factors in Japan which can be presumed to contribute to the overall business of the company, shall be taken into consideration in determining the income which should be at-

⁹. CTL Enf. Order, art. 176(i)(vii).
¹⁰. CTL Enf. Order, art. 176(4).
¹¹. CTL Enf. Order, art. 142(4), 176 (1)(i).
¹². CTL Enf. Order, art. 142(4), 176(1)(iii).
¹³. Watanabe, supra note 6, at 55.
tributed to its business in Japan.\textsuperscript{14}

(5) \textit{Insurance Business Income}: Income from contracts of insurance (casualty or life) concluded through offices or agents located outside Japan will be regarded as foreign source insurance business income.\textsuperscript{15}

(6) \textit{Advertising Income}: Income realized by an advertising or broadcasting company from advertising within and without Japan is based upon the place where the advertising activity is carried out. Thus to the extent that income arises from advertising activities carried on outside Japan, it will be foreign source income.\textsuperscript{16}

(7) \textit{Business Interest Income}: Interest normally has its source at the place where the funds are used by the debtor. Consequently, when a Japanese corporation, including a bank or other financial institution, loans funds to a borrower who is doing business outside of Japan in connection with its business outside Japan, the source of the interest income will be foreign.\textsuperscript{17} In the case of interest paid as a part of the deferred payment of the purchase price of products sold by a Japanese company in export to a purchaser in a foreign country, the portion of the purchase price which represents the interest charged for deferred payment will be foreign source income.\textsuperscript{18}

Interest on loans to a foreign corporation or nonresident individual for the purchase of ships or aircraft for use in the foreign purchaser’s business will be regarded as foreign source income regardless of where the ships or aircraft are used.\textsuperscript{19}

(8) \textit{Investment Interest Income}: Interest on foreign national and local government bonds, interest on bonds issued by foreign corporations, interest on deposits with an institution (e.g., a bank, etc.) located abroad, and distributions of profit of a joint operation trust or a public and private debenture investment trust with an institution abroad will be considered foreign source interest income.\textsuperscript{20}

(9) \textit{Income in Respect to Assets}: Income from the use or possession of assets outside Japan, and the transfer of assets outside Japan, is foreign source income. For example, the income from the transfer of the following assets should be regarded as foreign source income:

15. CTL Enf. Order, art. 176(1)(v).
17. Watanabe, supra note 6, at 57.
18. CTL Enf. Order, art. 180(3), Watanabe, supra note 6, at 57.
19. Id.
20. CTL art. 138(1)(iv).
(a) Rights based on a license or approval given under foreign law;
(b) Shares of stock transferred on a foreign stock exchange;
(c) Shares of stock transferred through an office abroad of a securities company;
(d) Shares of stock located abroad immediately prior to the time of transfer as provided in the contract (if stock certificates have not been issued, then the written evidence of rights to the shares);
(e) Goodwill attached to the overseas business; and
(f) Any other assets (other than inventory assets) located abroad immediately prior to the time of transfer as provided in the contract of sale or other evidence of sale.21

(10) **Personal Service Business Income:** Business income received for providing the services of persons outside of Japan will be regarded as foreign source income. Personal service business income arises from the services of (a) motion picture or theater artists, musicians, other public entertainers and professional athletes, (b) lawyers, certified public accountants, architects, or others from the liberal professions, and (c) persons with specialized knowledge or special technical skill in scientific techniques, management administration or similar areas in which the services consist of using specialized knowledge and technical skill, except where services are rendered incidentally to other business such as sales of equipment, supervision of construction, installation or assembly. In the latter case, the source follows that of the sale or construction, etc.22

(11) **Income from Rental of Immovables and Ship Charters:** Consideration for the rental of real property or rights thereon, of quarrying rights and of mining rights, located abroad and the income paid by a nonresident individual or foreign corporation for the bare boat charter23 of ships or aircraft will be foreign source income.24

(12) **Dividend Income:** Dividends paid out of profits of a foreign corporation, distributions of earned surplus of a foreign corporation, and distributions of profit from a securities investment trust located abroad other than a public or private debenture investment trust will be considered foreign source dividend income.25

(13) **Royalties and Rental Income:** Royalties for the license of industrial property rights, know-how, copyrights, etc. and rent re-

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21. CTL Enf. Order arts. 142(3), 177 and 178; Watanabe, supra note 6, at 59-61.
22. CTL art. 138(1)(ii).
23. Bareboat charter is a lease by an owner of a vessel or aircraft under which the lessee provides all crew, provisions, etc. and pays all expenses of operation.
24. CTL art. 138(1)(iii).
25. CTL art. 138(1)(v).
ceived in respect to the use of machinery and equipment (including certain rentals of ships and aircraft other than bare boat charters) will be foreign source income if received from a person or corporation using such assets abroad.²⁸

(14) Income from Undisclosed Partnership: A distribution of profits from an undisclosed partnership based upon an investment with a person carrying on business abroad is considered foreign source income.²⁷

(15) Insurance Proceeds and Miscellaneous Income: The following income received abroad will be considered as foreign source income:

(a) Proceeds of insurance or compensation for damage to property or business located abroad;
(b) Income from a gift of property located abroad;
(c) Income from buried treasure discovered abroad or lost property found abroad; and
(d) Money or other valuables received as a prize in a prize contest held abroad.²⁹

(16) Non-income Producing Activities: The regulations treat certain overseas corporation activities as not productive of income. First, no foreign income will be attributed to a Japanese corporation whose branch overseas conducts promotional activity, advertising, reporting of information, conducting of market or basic research or other activities which are auxiliary to the business of the company. If these are carried on in addition to other activities, they do not increase the foreign income from the place of business abroad.²⁹ Secondly, where a head office in Japan makes available funds, technology and other capital assets to its branch office abroad, no income will be attributable to such acts.³⁰ In other words, no interest or royalties are recognized for tax purposes between a head office and its branches. Third, income is attributable to the act of purchasing. When a Japanese corporation purchases products through its branch overseas and transfers them back to the head office which sells them in Japan, no foreign income is created by the branch in purchasing the goods abroad.³¹

²⁶. CTL art. 138(1)(vii).
²⁷. CTL art. 138(1)(x); Watanabe, supra note 6, at 49.
²⁸. CTL Enf. Order art. 178.
²⁹. CTL Enf. Order art. 176(3)(i); Watanabe, supra note 6, at 59.
³⁰. CTL Enf. Order art. 176(3)(ii).
³¹. Implicit in CTL Enf. Order arts. 176(2) and 185(2)(i).
3. TAXATION OF UNDISTRIBUTED PROFITS OF DESIGNATED TAX HAVEN SUBSIDIARIES

A. General

Japanese corporate income tax on the profits of foreign subsidiaries of Japanese corporations is deferred until such profits are repatriated in the form of dividends, liquidation proceeds, or the proceeds from the sale of shares. As the international activities of Japanese corporations have expanded, certain corporations have sought to take advantage of this tax deferral by accumulating undistributed profits in subsidiaries located in so-called tax havens or jurisdictions with corporate income tax rates significantly lower than those prevailing in Japan. The amendments to the Special Tax Measures Law, effective as of May 19, 1978, and applicable to fiscal periods beginning on or after April 1, 1978, are intended to eliminate this deferral of tax for certain Japanese shareholders in respect to the taxable undistributed profits of certain designated tax haven subsidiaries.

The general scheme of this new legislation is in some respects similar to the U.S. rules providing for the current taxation of "Subpart F income" of controlled foreign corporations. However, there are also important differences. The main thrust of the U.S. rules is to identify the types of shielded income which must be currently reported by the U.S. shareholders of a controlled foreign corporation. Under the new Japanese legislation, the main focus is on the identification of designated tax haven subsidiaries. Once a foreign corporation has been so identified, then all of its undistributed profits must be currently reported by certain of its Japanese shareholders, regardless of the source or classification of such profits. This means that if a foreign subsidiary of a Japanese corporation meets the requirements for exclusion from the definition of a designated tax haven subsidiary, then it may realize substantial amounts of what would be classified in the U.S. as Subpart F income without its parent having to report any portion of such undistributed income currently. On the other hand, if a foreign subsidiary falls within the

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33. STML, arts. 66-6 - 66-9. Although the legislation does not contain elaborate statutory definitions as this terminology would imply, for purposes of simplicity and convenience I have used these terms as if they were defined in the statute.
34. U.S. rules for "Subpart F income" are Internal Revenue Code §§ 951-964. In fact, this legislation was drafted after study of the treatment of tax haven income in various tax systems, primarily those of the U.S., West Germany, Canada, the U.K., and France.
definition, then all of its undistributed profits must be currently reported by the Japanese parent, even if a significant portion thereof is legitimate business income which would not be included in Subpart F income in the U.S.

B. Japanese Shareholders Subject to Current Reporting Requirement

The shareholders required to report currently the taxable undistributed profits of their designated tax haven subsidiaries are Japanese corporations (but not individuals) which (a) hold, directly and/or indirectly, ten percent or more of the outstanding shares of a designated tax haven subsidiary or (b) are part of an affiliated group of shareholders, which group holds in the aggregate ten percent or more of such shares. Although individual shareholders do not fall under the income reporting requirement, the shareholding of such individuals (residents and nonresidents of Japan) will be considered in determining whether Japanese corporate shareholders affiliated with them will be subject to the current reporting requirement. For example, if each of an affiliated group of five Japanese corporations, two Japanese resident individuals, and three nonresident individuals owns one percent of the shares of a designated tax haven subsidiary, each of the five Japanese corporations (but none of the individuals) will be subject to the current reporting requirement. Affiliated non-Japanese corporations will not be considered for these purposes, except to the extent that the shares in a designated tax haven subsidiary are held by Japanese shareholders (including affiliated non-resident individuals) indirectly through such non-Japanese corporations.

Each Japanese shareholder subject to this requirement must report currently its pro rata portion of the taxable undistributed profits of the designated tax haven subsidiary. The pro rata portion is the sum of the percentage of outstanding shares owned directly plus the percentage of outstanding shares owned indirectly through intervening foreign subsidiaries. In the affiliated group example above, each of the five Japanese corporate shareholders must report currently one percent of the taxable undistributed profits of the designated tax haven subsidiary. If a Japanese corporate shareholder owns five percent of the shares of a designated tax haven

35. STML art. 66-6(1-1).
36. STML art. 66-6(2)(iv).
37. Affiliated means affiliated with the group of Japanese shareholders.
38. STML art. 66-6(1-1).
subsidiary directly and another five percent indirectly through a foreign subsidiary, it must report currently ten percent of the taxable undistributed profits. The chain of indirect ownership stops at the first tier of Japanese shareholders. For example, if a Japanese corporation has ten Japanese subsidiaries, each of which owns one percent of a designated tax haven subsidiary, the Japanese parent corporation need not report taxable undistributed profits. However, each of the ten Japanese subsidiaries must report one percent of such profits.

C. Definition of Designated Tax Haven Subsidiary

(1) Organized in Specified Tax Haven: A designated tax haven subsidiary must be a joint stock corporation or other corporate entity organized under the laws of or having its head office in one of the tax havens identified in a Ministry of Finance (MOF) notification. Initially, the MOF has identified twenty-seven jurisdictions which will be considered tax havens for this purpose. These tax havens have been classified into three groups: (i) jurisdictions where all corporate income is tax exempt or taxed at a low rate (e.g., Hong Kong, the Bahamas, Bermuda, the New Hebrides, etc.); (ii) jurisdictions where foreign source income of a domestic corporation is tax exempt or taxed at a low rate (Panama); and (iii) jurisdictions where corporate income from certain but not all lines of business is tax exempt or taxed at a low rate (e.g., Liberia, Netherlands Antilles, Switzerland, etc.). The MOF is authorized to make additions or deletions from this list, as conditions warrant. The intent of the new legislation is to tax in Japan only that portion of the subsidiary’s income which is tax exempt or taxed at a low rate. However, in the case of categories (ii) and (iii) above, this is not accomplished by segregating the relevant portions of the subsidiary’s income. Instead, all income, whether shielded from tax or not, is included in determining the taxable undistributed profits which must be currently reported. The Japanese shareholder reporting such income is then allowed to take foreign taxes on unshielded income into account through a tax credit.

(2) Controlled by Japanese Shareholders: A designated tax haven subsidiary must be controlled, directly or indirectly, more than 50% by Japanese shareholders. Unlike U.S. law, there is no requirement that each Japanese shareholder considered to deter-
mine whether control exists must hold ten percent or more of the shares. The shareholding of all unrelated\(^41\) Japanese shareholders will be considered to determine whether there is control, regardless of their percentage ownership. A corporation owned ten percent by one Japanese shareholder and one percent each by forty-one other unrelated Japanese shareholders will be controlled by Japanese shareholders for these purposes. Although only Japanese corporations may be subject to the current reporting requirement, the shareholding of individuals (both resident and affiliated nonresident individuals) will be taken into account, for purposes of determining whether the subsidiary is controlled by Japanese shareholders and thus a designated tax haven subsidiary.\(^42\)

(a) *Indirect Ownership*: Lower tier foreign subsidiaries will be considered owned by Japanese shareholders through the usual indirect ownership principles even if intervening subsidiaries are not themselves considered to be controlled. There are no limitations on the number of tiers of foreign subsidiaries which will be considered for these purposes, and fourth, fifth and even lower tier subsidiaries may be designated tax haven subsidiaries if the control and other requirements are met.

For example, Japanese corporation A (the only Japanese shareholder) owns eighty percent of foreign corporation B, ninety percent of foreign corporation C, fifty percent of foreign corporation D and twenty percent of foreign corporation E. E is owned twenty-five percent by B, ten percent by C, and twenty percent by D.

\[
\begin{array}{c|c|c|c}
 & A & B & C \\
\hline
80\% & 25\% & 10\% \\
90\% & & \\
50\% & 20\%
\end{array}
\]

In the above example, B, C and E are controlled by A. D is not controlled by A because A's shareholding in D does not exceed fifty percent, but A's indirect shareholding in E through D is considered in determining whether E is controlled or not. The calculation of A's ownership of E is as follows:\(^43\)

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\(^{41}\) Unrelated means not affiliated with each other or not part of a group.

\(^{42}\) STML art. 66-6(2)(i).

\(^{43}\) Saito Minato, Takkusu Heibun Zeisei No Kozu (Structure of the Tax Haven System) 100 (1978).
Direct 20%
Indirect through B (80% x 25%) 20%
Indirect through C (90% x 10%) 9%
Indirect through D (50% x 20%) 10%
Total 59%

(b) Constructive Ownership: The members of a group of affiliated Japanese shareholders will all be considered as one shareholder for purposes of determining whether a tax haven subsidiary is controlled by Japanese shareholders and also whether any Japanese corporate members of the group will be subject to the current reporting requirement. The shares held by individuals who are nonresidents of Japan but who are affiliated or have a special relationship with Japanese corporate or resident individual shareholders will be attributed to the Japanese shareholders for both of these purposes. For example, if a tax haven corporation is owned forty-one percent by Japanese corporation A, and one percent each by the ten members of the affiliated group mentioned in 3.B. above, the tax haven subsidiary is considered controlled by Japanese residents and thus a designated tax haven subsidiary. A and each Japanese corporate member of the group will then be subject to the current income reporting requirement. The shareholding of affiliated non-Japanese corporations will be ignored except to the extent indirect shareholding principles apply.

To date, no published Japanese regulations have been issued to determine whether control by Japanese residents exists where substantive but not nominal control is exercised through two classes of shares, through the ability of a Japanese shareholder to appoint a majority of directors, or through artificial voting arrangements. Such regulations, a familiar feature of U.S. law, may be developed as the need arises.

(3) Exclusion from Definition: The Japanese rules concerning tax haven subsidiaries are intended to require the current reporting of undistributed profits only if those profits are being shielded from higher income tax rates through the artificial diversion of income to low tax jurisdictions. Therefore, if a foreign subsidiary is engaged in legitimate business activities in the tax haven or with unrelated parties and does not act as a holding company for the receipt of royalties, dividends, or revenue generated outside the jurisdiction of

44. STML arts. 66-6(2)(i) and (iv).
45. Substantive means actual or real control as opposed to nominal control.
its location, it will not be considered as a designated tax haven subsidiary for these purposes, even if it is located in an identified tax haven. In order to avoid being considered a designated tax haven subsidiary, the tax haven company must meet all of the following five requirements:

(a) It must have a fixed place of business, such as an office, store, manufacturing plant, etc. in the tax haven;
(b) It must have a local staff which independently administers and controls its business in the tax haven;
(c) Its main line of business must not be the holding of shares or other securities; the licensing of industrial property rights, know-how, or copyrights; or the lease of vessels or aircraft;
(d) Dividends received from other designated tax haven subsidiaries must not exceed five percent of its total current revenues; and
(e) The majority of its business transactions must be in the tax haven or in the case of sales companies, banks, trust companies, securities companies, insurance companies, shipping companies, and air freight companies, more than 50% of the volume in its main line of business during a fiscal year must be with unrelated parties.

For these purposes, related parties include the following: (1) Japanese shareholders subject to the current reporting requirement and their affiliates or specially related persons, (2) a company holding 50% or more of the shares of such a Japanese shareholder and its affiliates or specially related persons, and (3) intervening foreign corporations through which Japanese shareholders hold an interest in the subsidiary.46

It is not yet clear whether, e.g., in the case of sales companies, both the purchases and resales must be to unrelated parties in order to qualify for the exception. If a sales company may qualify for the exception when buying from a related party and reselling to an unrelated party, or buying from an unrelated party and reselling to a related party, it would seem that Japanese shareholders could continue to shield a substantial amount of foreign income from high tax jurisdictions through a diversion to tax haven sales companies. This question may be clarified in the future.

Although not definite, it is anticipated that the Ministry of Finance will establish an informal clearance procedure to advise Japanese companies whether their tax haven subsidiaries will fall within the above exception in any individual case.

46. STML art. 66-6(2)(iii).
D. Calculation of Taxable Undistributed Profits

The amount of taxable undistributed profits which must be currently reported by Japanese shareholders subject to the requirement is calculated by first determining the income of the designated tax haven subsidiary and deducting therefrom certain carried over losses, corporate income taxes paid in the tax haven and dividends declared. 48

(1) Adjusted Pre-Tax Subsidiary Income: The pre-tax (i.e., before deduction of income taxes paid to the tax haven) income of a designated tax haven subsidiary may be determined in accordance with the principles of Japanese domestic corporate income tax law or in accordance with the laws of the tax haven where the subsidiary is located. Once selected, the particular method chosen must be applied consistently and may be changed only with the prior consent of the Japanese tax office having jurisdiction over the head office of the Japanese shareholder.

If Japanese domestic principles are selected to calculate the income of the subsidiary, almost all of the deductions allowed under Japanese domestic law may be taken. However, unlike the usual calculation under domestic law, all dividends received by a designated tax haven subsidiary must be fully included in income, all corporate income taxes paid are included in income, and corporate income tax refunds received are excluded from income.

If the income of the subsidiary is calculated in accordance with the local law of the tax haven, the following additions must be made to the income so calculated (if such items are not included in income under local rules), to approximate the result which would be reached under Japanese law:

(a) any corporate income which is exempt from tax in the tax haven;

(b) any depreciation of depreciable assets in excess of the maximum amount of depreciation of the same assets allowed under Japanese law;

(c) bonuses to officers and payments of compensation and retirement benefits to officers if such payments would be considered as excessive (and thus nondeductible) under Japanese standards;

(d) corporate donations to the extent such donations exceed the Japanese statutory limitation on the deductibility of corporate donations; and

47. Supra note 3.

(e) entertainment expenses which are in excess of the maximum amount which could be deducted under Japanese law.

Finally, in order to avoid double counting in the remaining steps of the calculation of taxable undistributed profits, the amounts of any dividends declared, corporate income taxes paid, and carried over losses, which have been deducted under tax haven rules, are added back into income. The amounts of any corporate income tax refunds received, which have been included in income under tax haven rules, are deducted.

(2) Deduction of Carried Over Losses: A designated tax haven subsidiary may deduct from current adjusted pre-tax income any losses (calculated in accordance with the rules outlined above) which the subsidiary has incurred during the immediately preceding five years. However, no losses may be carried over from fiscal periods prior to the classification of the subsidiary as a designated tax haven subsidiary. Thus, no losses may be carried over from fiscal periods beginning prior to April 1, 1978. In Japan consolidated tax reporting of subsidiaries is not permitted. Therefore, losses incurred by a designated tax haven subsidiary may not be used to reduce profits realized by the parent or another designated tax haven subsidiary. If the subsidiary of a designated tax haven subsidiary (i.e., a second tier subsidiary) has incurred losses, such losses may not be used to reduce the current income of the first tier subsidiary.

(3) Taxable Undistributed Profits: Once carried over losses have been deducted from adjusted pre-tax income, corporate income and withholding taxes paid to the local tax haven and dividends declared currently are deducted in order to determine the amount of taxable undistributed profits. An illustration of this calculation is given in 4.C. (2) below.

E. Later Receipt of Taxable Undistributed Profits

(a) Dividends: Where undistributed profits which have been taxed in one fiscal period are distributed to the shareholder in subsequent fiscal periods in the form of dividends, e.g., where a designated tax haven subsidiary declares dividends in excess of its current profits, adjustments are made to prevent the previously taxed profits from being taxed twice. The affected Japanese shareholder is allowed to deduct from current income the amount of previously taxed undistributed profits (i.e., the pro rata share of current divi-
dends in excess of pro rata current profits) in respect to the subsidi-
ary concerned which was taken into taxable income during the im-
mediately preceding five years.50

(b) Sale of Shares: On the sale of the shares of a tax haven
subsidiary, any undistributed profits will presumably be reflected
in a higher price for the shares. Under domestic Japanese corporate
tax law, gains from the sale of shares are not subject to favorable
tax treatment and are fully included in corporate income taxable at
ordinary rates.51 In this case, however, the portion of the sales price
attributable to taxable undistributed profits already will have been
taxed to the Japanese shareholder. It is not yet clear how such
profits will be treated on the sale of shares. To avoid double taxa-
tion, it would seem that the amount of gain realized on the sale
should be reduced by the amount of any previously reported taxable
undistributed profits, e.g. through an upward adjustment of basis.
An alternative would be to use the same approach as that used for
dividends, that is, to include all gain from the sale of shares in
current income, and then to deduct the amount of taxable undistri-
buted profits which had been reported and taxed within the pre-
vious five years.

c) Liquidation: On liquidation of a subsidiary, the proceeds
distributed to the Japanese shareholder in excess of acquisition cost
are considered constructive dividends. In the case of liquidation of
a foreign subsidiary, these are fully included in income and taxed
at the normal rates. Where a designated tax haven subsidiary is
liquidated the amount of previously taxed undistributed profits
which had been taken into income during the immediately preced-
ing 5 years may be deducted from the current income of the affected
Japanese shareholder in order to avoid double taxation.52

F. Filing and Reporting Requirements

A Japanese shareholder required to report its pro rata share of
taxable undistributed profits must report such income in its return
and must attach to the return a balance sheet and profit and loss
statement of “and certain other information concerning” the design-
nated tax haven subsidiary.53 A Japanese shareholder, having a sub-
sidiary in an identified tax haven which meets the requirements for

50. STML art. 66-8(1).
51. On the point that all gains from share sales are taxed at ordinary rates, there are no
provisions in Japanese tax law. This conclusion simply flows from an absence of provisions
giving special or preferred treatment to such gains.
52. STML art. 66-8(i)(6).
53. STML art. 66-6(4).
exclusion from the definition, must attach to its tax return a statement to the effect that the business of the subsidiary meets such requirements and must retain relevant documents and other information to substantiate the exclusion.\textsuperscript{54}

4. FOREIGN TAX CREDIT

A. \textit{Overall Limitation}: A Japanese corporation may credit against its Japanese national corporate income tax liability any foreign income taxes paid within a statutory limitation that are equal to the proportion of the corporation's Japanese national (but not local) corporate income tax liability (before the credit) attributable to its foreign source income.\textsuperscript{55} The limitation is calculated by multiplying such national corporate income tax liability by a fraction in which the numerator is the corporation's total foreign source income subject to the national corporate income tax and the denominator is the corporation's total world-wide income.\textsuperscript{56} The limitation is calculated on an over-all basis. There is no optional per country limitation. In determining the numerator of the limitation fraction, however, net operating losses from one foreign jurisdiction may be disregarded and need not be deducted from income from other foreign sources. This is so even though such foreign losses are taken into account to reduce corporate tax liability before the credit and to reduce the denominator of the limitation fraction.\textsuperscript{57} Thus, Japanese corporate taxpayers may receive the primary advantages of both the overall method of calculating the limitation (i.e., the averaging of rates from high tax and low tax jurisdictions) and the per country method (i.e., avoiding the necessity of deducting foreign losses from total foreign profits, which deduction would result in a lowering of foreign source income and, in turn, the limitation), without having to choose between them.

In general the Japanese rules for determining the limitation fraction are quite liberal and tend to maximize the numerator (foreign source income) and to minimize the denominator (world-wide income), thus increasing the amount of the limitation. For example, all of the following items may be included in the numerator: (a) foreign source income from jurisdictions which have no corporate income tax system, income which is subject to low foreign income taxes (such as interest income, the limitation for which is not com-

\textsuperscript{54} STML art. 66-6(5).
\textsuperscript{55} CTL art. 69.
\textsuperscript{56} CTL Enf. Order art. 142.
\textsuperscript{57} Id.
puted separately as in the U.S.) or none at all, and certain types of foreign income which are subject to favorable domestic Japanese treatment (such as foreign source royalties and sales proceeds from self-generated technology, in respect to which a special domestic deduction of 35% of the proceeds is allowed); (b) the full grossed-up amount of foreign source dividends (including any withheld taxes) for which the deemed paid credit may be taken; (c) the full amount of foreign source dividends (including any withheld taxes) which are not eligible for the deemed paid credit; (d) currently reportable taxable undistributed profits of a designated tax haven subsidiary (grossed-up by income taxes paid in the tax haven, if any); (e) gain from the sale of foreign assets such as shares, even where such a gain is not taxed or is taxed at a low rate in the foreign jurisdiction; (f) proceeds which are considered constructive dividends under domestic tax law, such as the excess of proceeds over acquisition costs in the case of liquidation or redemption of shares in a foreign subsidiary; and (g) the amount of share dividends declared by a foreign subsidiary, even when the declaration of share dividends is not considered a taxable event in the foreign jurisdiction. The Japanese corporate taxpayer may choose to ignore foreign losses from one jurisdiction and need not deduct such losses from the numerator of the limitation fraction.

The denominator of the limitation fraction includes currently reportable world-wide income, including taxable undistributed profits of a designated tax haven subsidiary. Current losses from domestic and foreign sources are deducted in the computation of the denominator even when foreign losses are excluded from the numerator in determining foreign source income. Losses incurred in previous taxable years by the taxpayer, however, may not be carried over and deducted from current income to determine the denominator. The fraction may not have a value greater than 1. Thus, if total world-wide income is less than total foreign income, foreign income will be considered the same as world-wide income. Only foreign taxes levied on income which are generally similar to the Japanese corporate income taxes may be credited. Such foreign taxes may be national or local and may be assessed on gross as well as net income. Penalty and delinquency taxes may not be credited.

58. Grossed up means that foreign taxes are added to the amount of profits to reach a "grossed up" figure which is used for these purposes.
59. See, e.g., CTL art. 28, CTL Enf. Order art. 27, for dividends not eligible for the deemed paid credit.
60. CTL Enf. Order art. 142.
61. Id.
62. CTL Enf. Order art. 141.
Foreign taxes are realized and may be credited in the year they become due.\(^3\) For example, if the foreign income tax of a Japanese corporate taxpayer, engaged in business through a foreign branch office, becomes due after the end of the taxpayer's fiscal year, foreign taxes paid on profits realized in year 1 may be taken as a credit against the Japanese corporate income tax liability for year 2. Likewise, if both the Japanese parent and its foreign subsidiary use the same fiscal year, the income tax owed by the subsidiary on its income for year 1 may not become due until the first part of year 2. In these circumstances the Japanese parent may take the deemed paid credit,\(^6\) if available, against its Japanese income tax liability for year 2, even though the dividends in respect to which the deemed paid credit is taken are paid out of the subsidiary's profits for year 1, and even though the subsidiary may have declared dividends during year 1 which were taken into the parent's year 1 taxable income.

B. **Direct Foreign Tax Credit:** All foreign income taxes paid directly by a Japanese corporate taxpayer, such as taxes paid on profits generated through branch operations, taxes withheld from royalties and interest income, etc., may be credited against its Japanese corporate income tax liability, subject to the applicable limitations.\(^5\)

C. **Foreign Tax Deemed Paid Credit:**

(1) **Dividends:** All dividends received by Japanese corporate taxpayers from foreign corporations are fully included in gross income.\(^6\) Dividends are considered received when they are declared. A Japanese corporation may credit against its Japanese corporate income tax liability foreign income taxes which the Japanese corporation is deemed to have paid with respect to the dividends received if (a) the foreign corporation was not established for the purpose of avoiding Japanese taxation and (b) the Japanese corporate taxpayer has held, for a continuous period of at least six months immediately prior to the date on which the dividends were declared, 25% or more of the voting equity of the foreign corporation declaring the dividend. In the case of dividends received from U.S. and Australian corporations, this 25% ownership requirement is reduced to 10% by

\(^3\) Honjo & Nishikawa, Kokusai Torihiki Kazei No Chishiki (Understanding the Taxation of International Transactions) 431.

\(^4\) Deemed paid credit, i.e., the Japanese corporate shareholder is deemed to have paid the foreign taxes, even though the taxes were actually paid by the foreign subsidiary.

\(^5\) CTL art. 69.

\(^6\) CTL art. 23(1).
If these requirements are not met, the deemed paid credit may not be taken. For designated tax haven subsidiaries different rules apply. The amounts of foreign income and foreign tax deemed paid are calculated by grossing-up the dividends, that is, by adding to the amount of dividends received (including any taxes withheld thereon) the foreign income taxes paid by the foreign corporation in respect to such dividends (i.e., the total foreign income taxes paid multiplied by the ratio of the dividends received by the Japanese corporation to the total current after-tax retained earnings of the foreign corporation). The entire amount of grossed-up dividends is included in the taxable income of the Japanese corporation and the foreign tax deemed paid may be credited against the corporation's Japanese corporate income tax liability.

Both dividends declared and foreign taxes paid are treated on a last-in-first-out basis for purposes of the deemed paid credit. Dividends will be considered as paid first out of profits from the current year, then from the immediately preceding year and so on. Foreign taxes will be treated similarly, that is, foreign taxes paid currently will be attributed to the dividends considered as paid out of current profits. The previous year's foreign taxes will be attributed to the previous year's profits and so on.

The deemed paid credit may be taken only in respect to distributions from profits. For these purposes, dividends received as a percentage of face value of preferred shares are not considered to be distributions from profits, even where the foreign subsidiary must realize distributable profits before preferred dividends may be declared. Instead, such preferred dividends are considered the equivalent of interest on corporate debentures. Preferred dividends are included in taxable income, but only taxes which are paid directly by the Japanese taxpayer in respect thereto, such as taxes withheld from the dividends, may be taken as a credit. On the other hand, a deemed paid credit may be taken in respect to dividends declared on participating preferred shares to the extent that such dividends are declared on the same basis as dividends declared on the common shares of the foreign subsidiary.

Under Japanese domestic corporate tax law, certain types of reorganizations and recapitalizations will produce dividends or constructive dividends where the same transaction would not produce

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68. CTL Enf. Order art. 146.
69. CTL Enf. Order art. 147(2)(i).
70. CTL Enf. Order art. 147(2)(iii).
dividends in foreign jurisdictions. For example, in Japan dividends declared in the form of shares will be considered taxable dividends for Japanese purposes,\(^7\) while such share dividends would not be currently taxable to the recipients under, for example, U.S. law. As in the U.S., constructive dividends may result in the course of liquidation of a subsidiary or a redemption of shares. However, a sale of shares will not produce constructive dividends in Japan as it would in the U.S. This is because under Japanese corporate income tax law there is generally no favorable tax treatment for capital gains. Capital gains realized by a corporate taxpayer will be included in taxable income and taxed at ordinary corporate rates.

In the cases discussed above, where there is a difference between the Japanese and foreign treatment of the same transaction, the Japanese rules will be used for purposes of computing the foreign income and the deemed paid credit of the Japanese corporate shareholder. For example, a share dividend declared by a foreign subsidiary will be considered a currently received dividend for all Japanese purposes. It will be included in both foreign source and world-wide income (i.e., in both the numerator and denominator of the limitation fraction) and will also be included in the amount of dividends received by the Japanese corporate shareholder for purposes of computing the deemed paid credit. Likewise, in the event of liquidation or redemption of shares of a foreign subsidiary, the amount of constructive dividends will be considered as dividends from foreign sources for all Japanese purposes, and a deemed paid credit may be taken in respect to such constructive dividends. In the U.S. a deemed paid credit could not be taken in these circumstances. In the case of a sale of shares, all gain will be included in both foreign source and world-wide income, but will not be included in dividends received for the computation of the deemed paid credit.

(2) Taxable Undistributed Profits of a Designated Tax Haven Subsidiary: As mentioned above, Japanese corporate shareholders holding 10% or more of the shares of a “designated tax haven subsidiary” must report currently their pro rata portions of the subsidiary’s “taxable undistributed profits”. In order to avoid double taxation of such profits, where the tax haven involved has assessed a corporate income tax on part or all of the taxable undistributed profits, a deemed paid credit is allowed for the income taxes paid. In general, this credit is computed as if the subsidiary had distributed the taxable undistributed profits in the form of a dividend. The credit is limited to the amount of corporate income tax paid by the

\(^7\) CTL Enf. Order art. 42.
designated tax haven subsidiary which is attributable to the taxable undistributed profits. The taxable undistributed profits are grossed up by the amount of foreign tax attributable thereto, the entire amount is included in the income of the Japanese corporate shareholder, and a credit for the foreign tax deemed paid is allowed. The formula for determining the deemed paid credit in respect to taxable undistributed profits is as follows:

\[
\text{Foreign tax} \times \frac{\text{taxable undistributed profits}}{\text{shareholding percentage}} = \text{foreign tax deemed paid}
\]

\[
+ \text{dividends declared currently}
\]

Example:

Assume: Designated tax haven subsidiary (C) is owned 75% by Japanese company (A) and 25% by Japanese company (B)

C's taxable undistributed profits:

- Adjusted pre-tax income: 120
- Deductible carried over losses: (20)
- Net income: 100
- Income tax paid in tax haven: 10
- Dividends declared: 40
- Taxable undistributed profits: 50

In general, the Japanese deemed paid credit in respect to dividends may be taken only by Japanese corporate shareholders holding 25% or more of the foreign subsidiary's shares. The requirement that undistributed profits of a designated tax haven subsidiary must be reported currently applies to Japanese corporate shareholders holding 10% or more of the shares or even less than 10%, if the affected Japanese shareholder is a member of an affiliated group. To prevent a tax penalty for such shareholders, the credit deemed paid may be taken in respect to both declared dividends and taxable undistributed profits of a designated tax haven subsidiary by any Japanese corporate shareholder subject to the current income reporting requirement, regardless of its shareholding percentage. For foreign subsidiaries other than designated tax haven subsidiaries, the normal 25% ownership rules still apply.

72. STML art. 66-7.
73. STML art. 66-7(3); CTL art. 69(4).
Japanese Corporate Taxation

<table>
<thead>
<tr>
<th>Dividends:</th>
<th>Tax effect to A</th>
<th>Tax effect to B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Received: 30</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Foreign tax deemed paid: 3.33</td>
<td>1.11</td>
<td></td>
</tr>
<tr>
<td><em>(10 \times 30 = 3.33)</em></td>
<td><em>(10 \times 10 = 1.11)</em></td>
<td></td>
</tr>
<tr>
<td>Undistributed profits:</td>
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<tr>
<td>Currently taxable: 37.50</td>
<td>12.50</td>
<td></td>
</tr>
<tr>
<td>Foreign tax deemed paid: 4.16</td>
<td>1.39</td>
<td></td>
</tr>
<tr>
<td><em>(10 \times 37.50 = 4.16)</em></td>
<td><em>(10 \times 12.50 = 1.39)</em></td>
<td></td>
</tr>
<tr>
<td>Amount included in income currently in Japan:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends: 30</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Grossed-up: 3.33</td>
<td>1.11</td>
<td>11.11</td>
</tr>
<tr>
<td>Undistributed profits: 37.50</td>
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<td><em>(10 \times 12.50 = 1.39)</em></td>
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</tr>
<tr>
<td>Total taken into income: 74.99</td>
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<td>25.00</td>
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<tr>
<td>Total deemed paid credit: 7.49</td>
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<td>2.50</td>
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</tbody>
</table>

D. Tax Sparing: Japanese corporate income tax law does not provide for special computation of foreign tax credits for branch or subsidiary operations in developing countries. In treaties with certain developing countries, however, Japan is obligated to allow Japanese corporations the so-called tax sparing credit, whereby a Japanese corporate taxpayer offered certain waivers or reductions of tax by host countries as an incentive to invest will be allowed to take a credit against its Japanese income tax liability for the taxes it would have paid, had such incentives not been granted by the host country. At present, such provisions are contained in the tax treaties Japan has concluded with Pakistan, India, Singapore, Thailand, Malaysia, Brazil, Sri Lanka, Korea, Zambia, Spain and Ireland.74

E. Excess Foreign Tax Credits:

(1) Application Against Local Income Taxes: In addition to the national corporate income tax, there are two types of local corporate income taxes in Japan, the inhabitants taxes and the enterprise tax. There are two local inhabitants taxes, one levied by prefectures and

74. See Individual treaties with each country.
one by municipalities. Both types of inhabitants taxes are calculated as a percentage of the corporation's national corporate income tax liability at the standard rates of 5.2% of the national tax (for the prefectural inhabitants tax) and 12.1% of the national tax (for the municipal inhabitants tax), and thus are assessed on the same taxable basis (including foreign income) as the national income tax.\textsuperscript{75}

The foreign tax credit limitation is calculated on the basis of the national corporate income tax liability alone without regard to local tax liability. Once the foreign tax credit limitation has been calculated in this way, the amount of foreign taxes accrued up to the full amount of the limitation may be taken as a credit against the Japanese taxpayer's national corporate income tax liability.\textsuperscript{76} Excess foreign taxes accrued over the limitation may then be applied in the current taxable year against the local prefectural inhabitants tax to the extent of 5.2% of the statutory limitation, and against the local municipal inhabitants tax to the extent of 12.1% of the statutory limitation.\textsuperscript{77} In some localities the inhabitants tax rates are increased to the permitted maximums of 6.2% and 14.5%, respectively. In such cases, foreign taxes may be credited against inhabitants' tax liability to the extent of these higher percentages. In this way, foreign taxes may be credited against the local inhabitants taxes in the same proportion as against the national corporate income tax. It should be noted that foreign taxes may not be credited against the local enterprise tax, even though certain types of foreign income such as foreign dividends received and taxable undistributed profits of a designated tax haven subsidiary are included in taxable income for purposes of the local enterprise tax.

(2) Carry Over of Excess Credits and Limitations: Any excess foreign taxes accrued still remaining after application against national and local taxes to the full amount of the applicable limitations may be carried over for five years.\textsuperscript{78} Such excess taxes so carried over are credited first against national corporate income and then against the local inhabitants tax liability in accordance with the same procedures and subject to the same limitation.\textsuperscript{79} In Japan there is no carry back of foreign tax credits but approximately the same result is achieved through a carry over of excess limitations. In the event foreign income taxes accrued in any year are less than

\textsuperscript{75} LTL arts. 51(1), 314-6(1).
\textsuperscript{76} CTL Enf. Order art. 144.
\textsuperscript{77} CTL Enf. Order art. 143.
\textsuperscript{78} CTL art. 69(2); CTL Enf. Order art. 144.
\textsuperscript{79} CTL art. 69(2).
the statutory limitations on the credit for both national and local income tax liability, the amount of such deficiency may be carried over and added to the statutory limitations (calculated in the normal way) during the immediately succeeding five years. 80

F. Deduction Instead of Credit: A Japanese corporate taxpayer may elect to deduct its foreign taxes as an expense, instead of crediting them. 81 If this election is made, all foreign taxes, including those deemed paid, which become due within the taxable year may be deducted without regard to the statutory limitation, but the privilege of carrying unused foreign taxes forward to future years and adding the amount of unused past limitations to future limitations is thereby sacrificed. 82

G. Adjustments on Later Distribution of Taxed Undistributed Profits:

(1) Dividends: The tax haven legislation 83 provides that when undistributed profits of a designated tax haven subsidiary, previously taxed to the recipient Japanese shareholder, are distributed in the form of dividends, the Japanese shareholder is able to reduce its current taxable income by the amount of undistributed profits taxed during the previous five years, and the amount of foreign tax which had been taken as a deemed paid credit in those years must be taken back into income during the current year. 84 Although the statutory language is not specific on this point, there are as yet no illuminating regulations. It would appear that the amount of dividends received would be added to taxable income, the grossed-up amount of previously taxed undistributed profits would be deducted, and then, to assure a wash, the deemed paid credit previously taken would be added back. This is illustrated by the following example, which continues the facts of the case mentioned in 4.C.(2) above and assumes that year 1 undistributed profits (37.50). of designated tax haven subsidiary C are distributed as dividends to A in year 2:

80. CTL art. 69(3); CTL Enf. Order art. 145.
81. CTL art. 41.
82. Corporate Tax Law Basic Circular (hojinzei kohon tsutatsu), originally issued May 1, 1969 [hereinafter cited as CTL Basic Circular].
83. Tax haven legislation refers to all of the laws, orders and regulations which implemented the system of taxing profits of tax haven subsidiaries.
84. STML art. 66-67.
Thus for year 2, the calculation should produce the same result as would be produced if only the domestic income realized in year 2 were taxed at 50%.

(2) Sale of Shares and Liquidation: It is as yet unclear how previously taxed undistributed profits will be treated at the time of a sale of the shares or liquidation of a designated tax haven subsidiary. Presumably, such treatment, when clarified, will include some type of adjustment in respect to any deemed paid credit previously taken. If the same treatment is used in these circumstances as is used for dividends, the amount of gain on sale or liquidation should include the portion attributable to previously taxed undistributed profits. The gain should then be reduced by the grossed-up amount of taxable undistributed profits reported during the previous five years, and the amount of deemed paid credit taken in respect to the deducted undistributed profits should be taken back into income.

5. DOMESTIC LAW PROVISIONS AFFECTING FOREIGN INCOME

Japanese domestic corporate income tax law includes provisions which encourage certain types of foreign transactions.

A. Overseas Market Development Reserves: Small Corporations (paid-in capital of ¥100,000,000 or less) and Medium-sized Corporations (paid-in capital of over ¥100,000,000 but less than ¥1,000,000,000) may deduct currently amounts credited to overseas market development reserves for domestic corporate tax purposes.85

85. STML art. 54.
Where the goods to be exported are purchased from others, the maximum amount which may be deducted is 1.7% (for Small Corporations) or 0.85% (for Medium-size Corporations) of the export value of the goods so purchased. Where the goods to be exported are manufactured or processed by the corporate taxpayer, the maximum amounts are 2.3% (for Small Corporations) or 1.15% (for Medium-sized Corporations) of the export value of the goods manufactured or the processing fees realized. The corporate taxpayer need not be the actual exporter in order to deduct amounts credited to an overseas market development reserve account. Sales made to a domestic exporter and manufacturing or processing performed for a domestic exporter will be eligible. In addition, major ship repairs will be eligible if payment therefore is made directly or indirectly in foreign currency. The amounts credited must be taken back into income in equal installments during each of the immediately succeeding five years. Actual losses may be deducted as they are realized.

B. Overseas Investment Loss Reserves: Under certain conditions, a Japanese corporation investing in a domestic or foreign corporation whose activities are related to certain types of business conducted outside Japan, may credit to an overseas investment loss reserve account and deduct currently up to a certain percentage of the investment. The percentages vary according to the nature of the corporation and the nature of the investment, and range from 15% to 100% of the amount invested.

The categories of investment eligible for this credit and deduction are as follows:

(1) Business Investment in Developing Countries: A Japanese corporate taxpayer may credit to this reserve account and deduct currently 15% of its investment in corporations which have their head office in and are engaged primarily in certain activities in developing countries. The eligible activities are agriculture, forestry, fishing, marine products farming, mining, construction and manufacturing. For these purposes, developing countries include all countries of the world except the U.S., Canada, the industrialized European countries, the U.S.S.R., Australia, New Zealand,

86. STML art. 54(6).
87. STML art. 55.
88. Prior to April 1, 1978, the deduction allowed was 30%.
89. Prior to April 1, 1978, all types of business activities were eligible.
90. In Europe, Iceland, Spain, Portugal, Malta, Greece, Turkey and Cyprus are considered developing countries for these purposes.
91. Prior to April 1, 1978, Australia and New Zealand were considered developing countries for these purposes.
and South Africa. For this deduction to be taken, the corporation, together with other Japanese investors, must own in aggregate 10% or more of the relevant developing country corporation. A credit and deduction of 15% may also be taken for investment in Japanese investment companies, which (a) are primarily engaged in investing in qualifying developing country corporations, (b) are not listed on a stock exchange and (c) have been specifically designated as eligible for this credit and deduction by the Ministry of International Trade and Industry (MITI). To take this deduction, a Japanese corporate shareholder must hold 1% or more of the outstanding shares of the designated investment company.

(2) Natural Resource Exploration and Development: Investments in Japanese and foreign corporations which are engaged exclusively in exploration for or the development and extraction of natural resources outside Japan, and in investment companies designated by MITI which invest exclusively in such natural resource corporations, are eligible for this credit and deduction. In the case of petroleum only such corporations may be engaged in exploration, development, or extraction within as well as outside Japan. Where the investment is in companies engaged exclusively in exploration, the Japanese corporate shareholder may credit and deduct currently 100% of the investment. For investment in companies engaged in development and/or extraction, the current credit and deduction is limited to 40% of the investment.

The investments eligible for the credit and deduction in (1) and (2) above are share acquisitions at the time of incorporation, capital increases, share dividends or purchase from a nonresident individual or foreign corporation, and certain debentures and loans approved by MITI. The amount of investment for these purposes will be the acquisition cost of the shares and debentures or the amount of the loans.

(3) Nuclear Fuel Reprocessing: Japanese corporate taxpayers may credit and deduct currently 40% of loans made to foreign corporations, if the loans will be used exclusively for nuclear fuel reprocessing.

(4) Specified Overseas Construction Projects: A Japanese cor-

92. STML art. 55; this provision was effective as of April 1, 1978.
93. Id.
94. Id.
95. Id.
96. Id.
97. Id.
98. Id.
corporation acquiring assets or making expenditures for construction with respect to certain specified large projects outside Japan may credit 7% of the expenditures to overseas investment loss reserves. The projects specified as eligible are almost all in developing countries.

Amounts credited to an overseas investment loss reserve account and deducted currently must be taken back into income in equal installments over five years starting from the sixth year after the year when the credit and deduction were made. Any amounts not already taken back into income in accordance with this schedule must be taken back at the time an eligible overseas investment is wound up, liquidated, sold, or devalued on the books of the investor (in which case a deduction may be taken in the amount of devaluation). In the case of business investment in developing countries, they must be taken back at the time the percentage of ownership is reduced to below the relevant minimums. In the case of specified overseas construction projects, this must be done on completion of the project. Any actual losses incurred may be deducted when they are realized.

C. Special Deduction for Foreign Technological Transactions: A Japanese corporation supplying technical information and industrial property rights which it has developed itself to a foreign purchaser or licensee in the form of a sale or license of patents, know-how, trademarks, etc. may deduct 35% of the gross proceeds received in respect to such sales or licenses. Japanese corporations selling or licensing copyrights to foreign purchasers and receiving payment in foreign currency may deduct 20% of the gross proceeds received from such transactions. Japanese corporations providing technical services to foreign parties in the form of research or certain kinds of technical supervision and inspection may deduct 20% of the gross proceeds from such services. The aggregate deduction for all of the above in any one taxable year may not exceed 50% of the corporation’s net taxable income before the deduction. This special deduction may be taken in addition to ordinary business expenses relating to these activities. Unlike a reserve account, where credits must ultimately be taken back into income and which, consequently, results only in tax deferral or averaging or both, this special

99. STML art. 75(4).
100. Prior to April 1, 1978, the deduction allowed was 55%.
101. STML art. 58.
102. Id.
103. Id.
deduction need not be taken back into income. The result is complete exemption from taxation to the extent of the deduction taken.

6. NEUTRALITY

A common standard used in the evaluation of systems for the taxation of foreign income is whether those systems are "neutral" as to the location of business activities and investment, i.e., whether the same domestic tax consequences will result for a resident taxpayer regardless of whether its business activities and investments are located at home or abroad. Neutrality is considered desirable because presumably it will tend to encourage the most efficient allocation of economic resources on a world-wide basis. Several aspects of tax neutrality should be considered. To maintain neutrality between domestic and foreign investment, a tax system should allow a full credit of foreign taxes paid on foreign income at least up to the amount of tax which would be imposed on the same income if earned domestically. If a tax system is to be neutral as between different foreign jurisdictions and different lines of business, there should be no special incentives granted or penalties assessed on investments in specific foreign jurisdictions or in specific lines of business. In respect to domestic business activities, exports and other transactions with foreign parties should be neither encouraged nor discouraged, at least as far as domestic tax consequences are concerned.

How neutral, then is Japanese taxation of the foreign income of Japanese corporations?

In general, Japanese law appears to be quite generous, and more liberal than the equivalent U.S. law in allowing the credit for foreign taxes paid. Foreign source income is broadly defined, the calculation of the limitation fraction may in some cases actually allow a credit in excess of the Japanese tax liability on the same income,\(^\text{104}\) and Japanese corporate taxpayers may at the same time receive the benefit of both the overall and per country methods of calculating the limitation. On the other hand, no foreign tax credit may be taken against enterprise tax liability, which amounts to about 23% of all Japanese corporate income tax revenues, even though certain (but not all) types of foreign income are subject to

\(^{104}\) For example, the exclusion of foreign losses from the numerator and the inclusion of untaxed foreign income in the numerator of the limitation fraction substantially increases the opportunities to average the rates of high and low tax jurisdictions. Such averaging may allow the full credit of income taxes from a foreign jurisdiction where the effective rate of tax is higher than the effective rate in Japan.
this tax. Also, the limitation of the deemed paid credit to subsidiaries in which at least 25% of the shares are held seems less liberal than U.S. law. Although, as one MOF official has noted, there are a whole range of special tax incentives in Japanese corporate tax law which favor domestic investment, such as those encouraging energy conservation, the use of pollution control equipment, the transfer of industry to certain favored geographic areas, such as Okinawa, and the development of residential housing, all within Japan. These are, to some extent, offset by direct incentives to foreign investment, notably the deduction of certain overseas investment loss reserves. 

On the whole, it would appear that Japanese income tax law, although not perfectly neutral, probably comes as close to neutrality as the law of most other major industrialized nations, at least as between foreign or domestic investment in general.

Japanese income tax law seems less neutral, however, as between foreign jurisdictions and in respect to certain lines of business. Although the new tax haven legislation should reduce the incentive for investing in low tax jurisdictions, it appears that Japanese rules may be less strict than those in, for example, the U.S. Carefully structured Japanese investment may still flow to those areas. The tax haven rules, however, may be tightened as implementing regulations are issued, or as the need arises. The incentives for investment in developing countries, although reduced significantly by the 1978 tax law amendments, remain very substantial. Exploration for and development of natural resources continues to be highly favored over other types of foreign investment. Nevertheless, the question remains whether Japanese income tax law is less neutral than the laws of other major countries in directing investment to specific places and to certain types of resources considered essential for the national welfare.

Two features of Japanese corporate income tax law appear to favor exports over domestic sales. First, the deduction allowed for overseas market development loss reserves, although called “minor” by an MOF official, is available to corporations capitalized at up to one billion yen, or more than US$5 million at present exchange rates. It would appear that quite a few Japanese exporters are eligible to take advantage of this incentive. Second, the much larger

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107. Sato, supra note 85, at 256.
incentive deduction allowed for foreign technology transactions, although reduced in 1978, continues to encourage the export of technology.

Of course, taxes on income are not the only taxes which affect foreign investment or foreign business transactions. The neutrality of overall tax policy may be judged only by examining the effect of all taxes, including excise taxes such as the Japanese commodity tax which is imposed on domestic but not export sales. The commodity tax, however, is not a tax on income and is beyond the scope of this paper.

**CONCLUSION**

Japanese corporations are taxed in Japan on worldwide income. In general, income of foreign subsidiaries is taxed to the Japanese parent when received in the form of dividends or otherwise, except that deferral of the tax on undistributed profits of designated tax haven subsidiaries has been eliminated by the 1978 amendments to the Special Tax Measures Law. The rules allowing foreign tax credits against national corporate income tax liability are quite liberal. In addition, various provisions of domestic Japanese corporate tax law affect the taxation of foreign income as well by encouraging certain types of foreign transactions. On the whole, Japanese corporate taxation appears fairly neutral in its treatment of domestic and foreign activities and investments.