

KPMG Japan tax newsletter

International Taxation

Change to the Attributable Income Principle (AOA)



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On 24 October 2013, a report titled 'Tax reform regarding a change from the Entire Income Principle (the Force of Attraction Principle) to the Attributable Income Principle' ('AOA Report') was submitted by the Ministry of Finance ('MOF') to a meeting of the International Taxation Discussion Group of the government's Tax Commission. The AOA Report indicates practical directions on

such tax reform expected to be implemented, after being referenced in the outlines of the annual tax reforms for the last couple of years. We have set out in this newsletter the main points indicated in the AOA Report.

The points raised below could be subject to change since the AOA Report was submitted as a report prepared by the 'Study Group on the Attributable Income Principle' that was set up as a private study group of experts by the Director of the International Tax Policy Division of the MOF. The endorsed outline of the tax reform measures should be announced in the 'Outline of the 2014 Tax Reform' in December after discussion within the government's Tax Commission and the ruling parties' Tax Commission, and then should become definite when a bill to amend the tax law is passed by the Diet in March 2014. The expected timing for which the amendments will become enforced is still unknown.

(Please note that although the tax reform will effect taxation of individuals as well, we will focus on the tax treatment of companies in this newsletter, since individuals rarely carry on business through a permanent establishment ('PE') outside their country of residence.)

I. POINTS OF THE TAX REFORM AND THE EFFECTS THEREOF

1. Points of the Tax Reform

'The tax reform regarding a change from the Entire Income Principle to the Attributable Income Principle' includes the following two aspects:

- Change from the Entire Income Principle to the Attributable Income Principle
- Adoption of the AOA for the calculation of profits attributable to a PE

(1) Change from the Entire Income Principle to the Attributable Income Principle

The change is intended to mitigate double taxation/no taxation in either jurisdiction by adopting the Attributable Income Principle broadly accepted by many countries and to ensure consistency with tax treaties concluded by Japan.

The difference between the two principles is the scope of taxable income of a foreign company with a PE in Japan. Under the Attributable Income Principle, the business income attributable to the PE of such foreign company is subject to corporate tax and the Japanese source income not attributable to the PE is taxed in the same way as Japanese source income earned by a foreign company without a PE in Japan (i.e. in principle, subject to withholding tax only, except for certain capital gains, etc.). On the other hand, under the Entire Income Principle, a foreign company with a PE in Japan is liable for corporate tax on all Japanese source income (in principle) regardless of whether such income is attributable to the PE.

A foreign company of a country concluding a tax treaty with Japan will not be affected by the above change since all tax treaties concluded by Japan have already adopted the Attributable Income Principle, resulting in the Attributable Income Principle being applied to such company in practice even under the current tax law. However, the change will bring benefits to a foreign company of a country that has no tax treaty with Japan in that the scope of taxable income for corporate tax purposes could be narrowed if the foreign company has a PE in Japan. Moreover, for a foreign company of a country that has no tax treaty with Japan which believes it has no PE in Japan, the predictability of the tax treatment of Japanese source income not attributable to a PE in Japan will be improved since assessment of a PE will not affect such tax treatment under the Attributable Income Principle. However, consideration of whether the income is

attributable to the PE will still be required.

(2) Adoption of the AOA for the calculation of profits attributable to a PE

Although Article 7 (Business Profits Provision) of the OECD Model Tax Convention adopts the Attributable Income Principle, there were risks of double taxation/no taxation in either jurisdiction due to the absence of consensus in interpretation and practical application of the article. The OECD worked on the issues and developed the Authorised OECD Approach ('AOA') which was publicized in the 'Report on the Attribution of Profits to Permanent Establishments' released in 2008 and 2010.

The AOA is an approach to calculate income attributable to a PE, under which external transactions, assets, risks and capital attributable to a PE are determined based on functions performed by the PE and other related facts, and internal dealings are recognized at an arm's length price ('ALP').

Note that Article 7 and the Commentary thereon were amended in 2010 to be in line with the AOA. As the majority of the existing tax treaties are based on the previous version of Article 7 ('Old Article 7'), the Old Article 7 and the Commentary thereon (amended in 2008 to adopt the AOA to the extent of not jeopardizing consistency with the Old Article 7) are included in the OECD Model Tax Convention/Commentary as an Annex.

2. Effects of the Tax Reform

The following effects are expected for foreign companies as a result of the tax reform:

	With a PE in Japan	Without a PE in Japan
Foreign company of a country not concluding a tax treaty with Japan	<ul style="list-style-type: none"> Japanese source income not attributable to a PE in Japan will not be aggregated to income attributable to the PE for corporate tax purposes. Calculation of income attributable to a PE will be changed. (Recognition of internal dealings, documentation, etc.) Foreign tax credit will become available. 	<ul style="list-style-type: none"> No effect is expected in principle. (The predictability of tax treatment of Japanese source income not attributable to a PE will be improved since such tax treatment will not be jeopardized by assessment of a PE.)
Foreign company of a country concluding a tax treaty with Japan	<ul style="list-style-type: none"> Calculation of income attributable to a PE will be changed. (Recognition of internal dealings, documentation, etc.) Foreign tax credit will become available. 	<ul style="list-style-type: none"> No effect is expected in principle.

Moreover, the tax reform is expected to bring the following effect for Japanese companies:

	With a PE outside Japan	Without a PE outside Japan
Japanese company	<ul style="list-style-type: none"> Foreign tax credit will be affected since income attributable to a foreign PE will be defined as an item of foreign source income. (Recognition of internal dealings, documentation, etc.) Foreign tax credit on income not attributable to a foreign PE may be affected since the scope of foreign source income will be changed. 	<ul style="list-style-type: none"> Foreign tax credit may be affected since the scope of foreign source income will be changed.

II. OUTLINE OF THE AOA REPORT

We set out below the main points indicated in the AOA Report: (Note that although statements are written as proposals/suggestions in the AOA Report, we have changed such style for the purpose of this newsletter.)

A. TAXATION OF A FOREIGN COMPANY

1. Basic Policy

- The international taxation principle applied to foreign companies under domestic tax laws will be changed from the Entire Income Principle to the Attributable Income Principle.
- The Attributable Income Principle should be, in principle, consistent with Article 7 of the OECD Model Tax Convention amended in 2010 ('New Article 7').

2. Japanese Source Income

(1) Taxation of a foreign company with a PE in Japan

- Income attributable to a PE in Japan will be defined as a type of Japanese source income. (e.g. income derived from investments into a third country by a PE will become taxable in Japan regardless of whether or not such income is taxed in the third country.)
- Income not attributable to a PE in Japan will be taxed separately from income attributable to the PE and taxed, in principle, in the same way as Japanese source income earned by a foreign company without a PE in Japan.

(2) Taxation of a foreign company without a PE in Japan

- There will be no change in principle.

3. Income Attributable to a PE

(1) Basic policy

- Income attributable to a PE will be the income that the PE would have earned under the arm's length principle if it were a distinct and separate enterprise from its head office, based on the functions performed by the PE, the assets used by the PE and the risks assumed by the PE.

(2) Tax exemption regulation of mere purchases

- A provision prescribing that mere purchase by a PE of goods or merchandise for its head office does not generate any profits will be abolished from the perspective of consistency with the arm's length principle. (Although the Old Article 7 includes such provision and its direct application may be possible, a provision to clarify the practical treatment of a mere purchase under Old Article 7 type tax treaties should be prepared under the domestic tax laws.)

(3) Internal dealings

- When a transaction between a PE and its head office requires paying/receiving consideration if it were conducted between unrelated persons, the arm's length principle should be applied to such transaction.
- Neither internal guarantees nor internal reinsurance between a PE and its head office will be recognized in calculating income attributable to the PE.
- In relation to countries concluding New Article 7 type tax treaties with Japan or countries not concluding tax treaties with Japan, all internal dealings including internal royalties and internal interest for non-financial institutions

should be recognized, while internal dealings excluding internal interest for non-financial institutions and internal royalties should be recognized in relation to countries concluding Old Article 7 type tax treaties with Japan.

- Profits/losses incurred from an internal dealing should be recognized when the internal dealing is conducted, not when the external transaction pertaining to the internal dealing is conducted.
- The following aspects will be treated in the same way as those under the transfer pricing rules:
 - ✓ If income attributable to a PE is less than it should be since the price of an internal dealing is not an ALP, the price should be adjusted to the ALP.
 - ✓ Income attributable to a PE could be reduced by Corresponding Adjustments under tax treaties.
 - ✓ Special provision to extend statutory limitation for corrections, rules of inquiry and inspection to third parties engaging in the same activities and application of the estimation clause will be applied to internal dealings in the same way as those under the transfer pricing rules.
- Rules under the Corporation Tax Law and the Special Taxation Measures Law will be applied/not applied to internal dealing as follows:
 - ✓ Provision for bad debts will not be allowed for internal loans within a single enterprise.
 - ✓ The deductibility of an internal transaction will be denied in the same way as a donation to foreign related parties where the transaction would have been treated as a donation from a PE to its head office if it were conducted between unrelated parties.
 - ✓ Neither the foreign dividend exclusion system nor the tax consolidation system will be applicable.
 - ✓ While the thin-capitalization rules will not be applied, the earnings stripping rules will be applied.
- As internal dealings are hypothetical transactions for tax purposes, actual payments/receipts for these transactions should not be required.
- The ALP of internal dealings can be subject to Advance Pricing Arrangements.
- Internal dealings will not be subject to withholding tax.

(4) Cost allocations (Overhead costs allocations)

- Actual costs allocation based on reasonable allocation keys from the head office to a PE will be deductible as currently allowed. When documentation is not sufficient, the deductibility will be denied until the documentation requirement is satisfied.

4. Capital Attributable to a PE/Limitation on Deductibility of Interest Expenses

- The capital needed if a PE were a distinct and separate enterprise from its head office should be allotted to the PE.
- There are basically two approaches to calculate capital attributable to a PE: (Although there will be no priority among them, the chosen approach should be applied consistently.)

- (i) Capital allocation approach (the amount of capital attributable to a PE is calculated by allocating an enterprise's capital to the PE based on certain allocation keys.)
- (ii) Thin-capitalization approach (the same amount of capital as an independent enterprise carrying on the similar activities in the host country of a PE is allotted to the PE.)
- Approaches for allocation of free capital can be subject to Advance Pricing Arrangements.
- When the amount of capital attributable to a PE exceeds the amount of capital recorded in the PE, interest expenses corresponding to such excess portion will not be allowed in calculating income attributable to the PE.
- The amount of capital attributable to a PE will be used for the purpose of calculating the deductible interest only.

5. Foreign Tax Credits

- A foreign tax credit system applicable to a foreign company with a PE in Japan will be newly introduced to avoid double taxation of income derived from investments into a third country that constitutes taxable income in Japan under the new regime.
- Apart from the source rule to determine the scope of taxable Japanese source income, the scope of foreign source income will be defined for the purpose of calculating the creditable amount (i.e. corporation tax liability x foreign source income/all income).
- When income attributable to a PE includes income that would have been treated as being derived from outside of Japan if such income were not attributable to the PE, such portion should be categorized as foreign source income for the purpose of calculating the creditable amount.

6. Documentation

- The following two steps for documentation with respect to income attributable to a PE are expected:
 - Step 1: Documentation to determine internal dealings and external transactions attributable to a PE
 - Step 2: Documentation to determine the ALP of internal dealings
- The following are examples of documents that must be prepared in Step 1:
 - ✓ Documents equivalent to evidence such as contracts, receipts and invoices for internal dealings
 - ✓ Documents describing details of internal dealings
 - ✓ Documents describing functions/risks performed/assumed by the PE and its head office
- As evidence such as contracts, receipts and invoices is usually kept for external transactions, keeping documents equivalent to such evidence for internal dealings should be one of the requirements to be a blue-return filing taxpayer who can enjoy preferential tax treatment.

7. Taxable Base/Tax Losses

- A foreign company with a PE should have two categories of taxable base; income attributable to the PE and income not attributable to the PE. Income

from the two categories will be taxed separately. Tax losses incurred in one category will not be utilized to offset income in the other category.

8. Closure/Transfer/Establishment of a PE

- When a PE is closed, built-in gains/losses in assets attributable to the PE will be taxed by aggregating them to income attributable to the PE.
- When all assets of a PE are sold, capital gains/losses incurred from the sales will be taxed by assuming that the PE itself sold such assets and aggregating them to income attributable to the PE.
- When the head office establishes a PE by transferring its assets, the PE will acquire such assets at the fair market value; i.e. no built-in gains/losses will be assumed by the PE.

9. Other Issues

- An anti-tax avoidance provision similar to the existing anti-tax avoidance provision applied to family companies will be introduced with respect to calculation of income attributable to a PE and taxation thereon.
- Internal dealings are not subject to consumption tax since they are hypothetical transactions required to calculate income attributable to a PE for corporation tax/income tax purposes.
- Tax treatment for local tax/business tax purposes will also be amended in principle, based on the tax reform for (national) corporation tax purposes.

B. TAXATION OF A JAPANESE COMPANY

1. Foreign Tax Credits

- Although foreign source income is defined as income other than Japanese source income under the current tax law, foreign source income will be itemized to clarify the scope of income subject to foreign tax credit.
- Income attributable to a foreign PE will become an item of foreign source income.

2. Income Attributable to a Foreign PE

- In principle, income attributable to a foreign PE should be calculated by applying the arm's length principle to internal dealings between the PE and its head office in the same way that it is applied to the calculation of income attributable to a PE in Japan for a foreign company. In the process of the calculation, the following points should be considered:
 - ✓ Allocation of free capital to a foreign PE will be an option (i.e. excess interest expenses will be added back to income only when certain requirements such as attaching calculation details to a tax return are met). Note that banks/securities companies will be covered by different rules.
 - ✓ Keeping internal dealing documents, equivalent to evidence such as contracts, receipts and invoices for external transactions, should not be one of the requirements to be a blue-return filing taxpayer who can enjoy preferential tax treatment.

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