COMPARATIVE CONTROLLED FOREIGN CORPORATION QUESTIONS FOR MSSRS. THOMAS, EDGE, MENGER, AND SCHOON

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How would the following situations be treated under your controlled foreign corporation (CFC) rules in Japan, the Netherlands, the United Kingdom, and Germany?

Responses Concerning Japan from Gary M. Thomas

a. P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply to attribute all of its profits (on a company basis) currently to its Japanese resident shareholders who either own, or belong to a single shareholding group that owns, directly or indirectly, 10% or more of its shares (hereafter referred to as "Japanese shareholders").

If all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders but, as described below, certain asset income may be attributable nevertheless.

The four tests are (1) the business activity test, (2) the physical facility test, (3) the management and control test, and (4) the unrelated person test (if the CFC is engaged in a prescribed business activity) or, alternatively, the location test.

A brief summary of the four tests is presented below:

- <u>Business activity test</u>: The CFC must not have as its principal business activity (i) the holding of shares, investments or debt securities, (ii) the provision of industrial property rights or copyrights, or (iii) the leasing of ships or aircraft.

- <u>Physical facility test</u>: The CFC must have a physical facility in its country of residence that is recognized to be necessary for the conduct of its principal business activity.

- <u>Management and control test</u>: The CFC's management and control must be conducted locally.

- <u>Unrelated persons test</u>: The CFC must engage in its principal business activity principally with unrelated persons, if its principal business activity is wholesaling, banking, trust management, securities, insurance, or sea or air transportation

- Location test: The CFC must engage in its principal business activity principally in its country of residence, if its principal business activity is one that is not listed under the unrelated persons test.

For reference, CFCs which are holding companies nevertheless are exempted from the CFC tax regime provided that the following criteria are met:

- The holding company must be owned 100% directly or indirectly by a Japanese corporation.

- The holding company must hold two or more controlled companies and conduct operations to control the business activities of the controlled companies. (A "controlled company" is a company which is owned 25% or more directly by the controlling company (the holding company) and carries out business activities having substance.

- The holding company must have fixed facilities and employees necessary to carry out the control activities.

It is noted that, in Case a, because the CFC is engaged in manufacturing, the location test (rather than the unrelated person test) would have to be applied.

b. Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Nevertheless, even if the CFC satisfies all of the four above-mentioned tests and avoids application of the CFC rules on an overall company basis, in the event that it has certain prescribed passive income, a special look-through rule for specified "asset income" would apply to attribute that income back to the Japanese shareholders.

Specified asset income consists of the following:

(i) Dividends from corporations in which the shareholding is less than 10% of the outstanding shares

(ii) Interest on debt instruments

(iii) Income from the redemption of debt instruments

(iv) Gains from the sale of shares of corporations in which the shareholding is less than 10% of the outstanding shares (limited to transfers on securities exchanges or over the counter)

(v) Gains from the sale of debt instruments

(vi) Income from the provision of patents, utility model rights, design rights, trademarks and copyrights (excluding income arising from property that was developed by the CFC itself, property purchased by the CFC and used in its business, and property licensed by the CFC and used in its business)

(vii) Income from the leasing of ships or aircraft

For purposes of computing the amount of profits attributable to shareholders, certain expenses related to the above income may be deducted.

For reference, income in categories (i) through (v) above arising from operations which are "basic, important and unavoidable based on the characteristics of the business carried out" by the CFC, except for specified businesses (i.e., holding of shares or debt securities or provision of industrial property rights, etc.), is excluded from this attribution rule.

With regard to Case b, interest income from lending funds to unrelated persons outside X would not fall within the specified interest described above that is subject to the asset income attribution rules.

For reference, the larger of the following de minimus amounts is also excluded from this asset income attribution rule:

- revenue amounts pertaining to asset income attributable from the CFC which is 10,000,000 yen or less

- revenue amounts pertaining to the asset income attributable from the CFC which is 5% or less of its book profits

c. Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.

Response:

Japan's CFC rules apply a trigger rate of 20% in determining whether profits are to be attributed to Japanese shareholders in the case that CFC fails any one of the four prescribed tests described above. This 20% rate is computed based on the "effective" tax rate, not the statutory tax rate. In addition, the effective tax rates are to be calculated pursuant to Japanese domestic tax law. Effective tax rates of 20% or less are considered to constitute an extremely low tax burden as compared to the taxes on corporate income in Japan.

Consequently, even if the statutory tax rate in the CFC's country is 25%, a tax holiday would reduce the effective tax rate to zero, in which case the 20% trigger would apply.

d. **Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.**

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC would not be attributed back to the Japanese shareholders.

Nevertheless, the royalty income from the provision of industrial property rights and copyrights would be includable in specified asset income and subject to attribution <u>unless</u> this royalty income arises from property that was developed by the CFC itself, property purchased by the CFC and used in its business, or property licensed by the CFC and used in its business.

e. **Same as (a), except that the CFC earns interest derived from another CFC controlled by P.**

Response:

In the case that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company-wide basis would not be attributed back to the Japanese shareholders.

Nevertheless, if the interest derived from another CFC controlled by P is includable in specified asset income, it would be subject to attribution under the asset income attribution rule. In order to be subject to attribution, it would have to be interest on debt instruments, not merely interest on a loan.

f. **Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.**

Response:

In the case that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC would not be attributed back to the Japanese shareholders.

In Case f, if the CFC is engaged in purchasing and selling as its "principal business activity," the unrelated person test would have to be applied.

g. **Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.**

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Because the CFC is predominantly engaged in the banking business, it would be subject to the unrelated persons test and would satisfy that test.

As the CFC conducts a substantial activity with respect to such business, it is likely to satisfy the physical facility test and probably the management and control test.

Since it is not engaged in a business described under the business activities test, the CFC satisfies that test.

As a result, the CFC would not be subject to the attribution rules on a company basis.

However, if the CFC has income that qualifies as specified asset income, it would be subject to the asset income attribution rules.

h. Same as (a), except that the CFC is an insurance company.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Nevertheless, even if the CFC satisfies the four tests, if it has income that qualifies as specified asset income, it would be subject to the asset income attribution rules.

i. Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Nevertheless, even if the CFC satisfies the four tests, in the event that it has income that qualifies as specified asset income, it would be subject to the asset income attribution rules.

Interest earned from lending to P would not fall within income subject to the asset income attribution rules.

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