Japan's International Taxation Law and Hong Kong

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1. The Basic Aim of International Taxation Law

1. Double taxation adjustment
2. Measures against avoidance through the use of national tax burden disparities

Regarding business profits, double taxation at international level can be a problem. For complete coordination between two countries a taxation treaty must be formed. However, there is no such treaty in existence between Japan and Hong Kong. So here just the adjustment steps for Japan will be explained.

2. Internationally Taxed Items

There follows a summary of four items.

1. Amount of Foreign Tax Deduction

Under our corporation tax law, regarding all business profits, it is not important where the profit was made, they will still be included as taxable profit. Japanese businesses with branches or offices established in Hong Kong will be taxed on the profits earned in that location under the Hong Kong corporation tax law, but those profits must also be included in the Japanese businesses' account settlement to be taxed under the Japanese corporation tax law. Profits made in Hong Kong will be eligible for taxation in both countries.

The amount of profit taxed in Hong Kong can be deducted from the amount of Japanese corporation tax.

The method of calculation is as follows:

Amount of Japanese corporation tax ×
(Hong Kong profits/all corporate profits)
= maximum deduction amount

Because the Hong Kong corporate tax rate is lower than the Japanese one, this deduction can be done smoothly.

2. Tax Haven Systems

If you compare the Hong Kong corporate tax rate with the Japanese one, you find that the Hong Kong one is lower. For this reason, many Japanese businesses have established themselves in Hong Kong. If this lack of fairness in regard to the tax burden on domestic profits is left as it is, there are concerns that an exodus of Japanese business may occur.

Therefore, when Japanese company capital is invested in Hong Kong entities known as "Foreign Related Companies," the taxation between the Japanese enterprise and the Hong Kong entity shall be corrected.

A "Foreign Related Company" is one whose majority of capital is held by Japanese enterprise or individual. The investor on the Japanese side is referred to as the "same family group" provided they hold more than 5% of the Foreign Related Company's capital.

The Foreign Related Company's reserved funds (the business year's funds from which the corporate income tax amount and dividends are deducted) are divided according to the proportion of the amount invested by each of the Japanese companies that make up the "same family group" and then added to the Japanese enterprise's income. This is the method for calculating the Japanese corporation tax amount.

This tax haven taxation is applied to Japanese enterprises that have invested in countries, which do not tax corporate income or where the tax rate on income is less than 25%.

3. Transfer Pricing Taxation

This applies when there is an abnormal price in transactions between a domestic tax payer and a foreign corporation in special relation thereto. This is to achieve the proper distribution of taxable income at international level through the revision of the price. Foreign entities in a special relation to a domestic tax payer are the following.

A relationship involving capital, such that either a Japanese or foreign enterprise holds over 50% of the other's capital or when a Japanese investor holds over 50% of the capital in both a Japanese and foreign enterprise.

A close relationship other than that of a capital nature, such as where an executive post is held by the same person in both the Japanese and the foreign corporation, or where there is a form of business dependence (e.g. an exclusive sale contract), or where there is a supply of business funds provided by the Japanese enterprise.

When a transaction price between this type of foreign corporation and a Japanese enterprise does not concur with that of parties not in such a special relation, the correct price is assessed as what would exist between a company without the special relationship, or the independent party price. That is to say, in case of an unjustly low price or of an unjustly high price, it is re-calculated according to the price an independent party would pay. The amount of tax is then revised according to the allocation of taxable income.

4. Domestic Withholding of Income Tax of Foreign Corporations

Foreign corporations with a branch or an office established in Japan are eligible to be taxed on income derived from sources in Japan. They will be taxed under the Corporation Tax Law.

Because of the large difference in the tax rate, the number of Hong Kong businesses settling in Japan is low.