Singapore and the Japanese Anti-Tax-Haven Tax Regime

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Singapore escaped the OECD blacklist, but became a Japanese tax haven when it lowered its corporate tax rate below 25 percent, effective from year of assessment 2002. Despite heavy lobbying by the Japanese business community with the support of the Singapore government, Japan has refused to amend its tax laws to create a special exception for Singapore. Consequently, some Japanese shareholders of Singapore companies now face the uneasy task of finding a way to circumvent Japan’s controlled foreign corporation (CFC) regime — also popularly known as the anti-tax-haven tax regime — or learning to cope with it.

Japan’s anti-tax-haven regime may also be of interest to a wider international audience, from traditional tax havens such as the Cayman Islands and Hong Kong to the OECD, for several reasons. The Japanese tax authorities routinely scrutinize corporations closely in tax examinations for violations of the anti-tax-haven rules. According to the latest data published by the Japanese National Tax Agency (NTA), there were a record number of cases involving a record amount of unreported taxable retained earnings in tax havens in 2000. Furthermore, the OECD’s current crackdown on harmful tax practices, reports of the extensive use of tax havens by Enron and other multinationals, and the need to counter money laundering and the financing of terrorist networks especially after 11 September have focused international attention on countermeasures against tax havens.

1 Although the regime has long been referred to by the Japanese government and practitioners by its popular nickname “Takkusu Heiben Taisaku Zeisei” (the anti-tax-haven tax regime), the nickname in fact does not appear anywhere in the legislation or related tax circulars. Recently, the Japanese Ministry of Finance began referring to the regime as “Tokutei Gaikoku Kogaisha Gassan Kazei Seido (CFC Zeisei),” possibly to avoid confusion with the OECD countermeasures against harmful tax practices. See http://www.mof.go.jp/jouhou/syuzei/siryou/ kokusai.htm.

2 In the NTA’s 2000 administrative year, there were 78 cases under the anti-tax-haven regime involving a total amount of ¥10.4 billion of unreported taxable retained earnings. This was a 205.3 percent increase in the number of cases and 358.6 percent increase in the amount of unreported taxable retained earnings over the previous year. See “Heisei 12 Jimu Nendo Chousaka Shokan Houjin Ni Kakaru Kazei Jisseki,” Shukan Zeimu Tsushin No. 2697 (12 Nov. 2001); NTA, “Heisei 12 Jimu Nendo Ni Okeru Chousaka Shokan Houjin Ni Kakaru Houjinzei No Kazei Jisseki Ni Tsuite,” October 2001, keihyou 4(2), available at http://www.nta.go.jp/category/press/press/91/01.htm.


This article explores the following issues:

I. What is the background of Singapore's corporate tax cuts?

II. How does the Japanese anti-tax-haven regime operate?

III. What tax planning methods are available?

IV. How is the Japanese anti-tax-haven regime different from the U.S. subpart F regime and the OECD's countermeasures against harmful tax practices?

V. What is the future of the Japanese anti-tax-haven regime?

I. Background

A. Singapore's New Corporate Tax Regime

Singapore lowered its corporate tax rate to 24.5 percent from 25.5 percent, effective from year of assessment 2002. In addition, under the new corporate tax regime, three-quarters of the first SG $10,000 of a company's chargeable income (other than Singapore dividends) and one-half of the next SG $90,000 of chargeable income are exempt from tax. Furthermore, in the fiscal year 2002 budget statement on 3 May, Singapore's deputy prime minister and finance minister Lee Hsien Loong announced that Singapore will lower its corporate tax rate again — to 22 percent effective from year of assessment 2003, and to 20 percent by the fiscal year 2004 budget — barring any major change in the economic and political climate.

As Lee's predecessor explained in the fiscal year 2001 budget statement, the government's aim is to create optimal conditions for private enterprise by keeping business costs down and maintaining a globally competitive corporate tax rate. In recent years, Germany, the United Kingdom, Australia, Ireland, and other developed countries have lowered their corporate tax rates to stimulate growth and attract investments, and Singapore needs to keep pace. Moreover, the new tax exemption scheme will help many small, medium-size, and start-up enterprises by cutting their taxes by more than half. As a result, the effective corporate tax rate for a company with SG $100,000 of income for year of assessment 2002 is only 11.6 percent, which is even lower than Hong Kong's corporate tax rate of 16 percent (currently the lowest in Asia). From year of assessment 2003, small and medium-size enterprises will pay effective corporate tax rates of between 5.5 percent and 10 percent.

B. Reactions to the Singapore Corporate Tax Cut

The Singapore corporate tax cut came as a surprise to many Japanese corporations that had set up regional headquarters, sales, trading, and other functions in Singapore with the long-term expectation that they would be able to defer Japanese taxation of their offshore retained earnings.
When Singapore’s corporate tax rate dipped below 25 percent, Singapore became a tax haven for purposes of the Japanese anti-tax-haven regime. Consequently, existing Japanese shareholders of Singapore companies and prospective Japanese investors may need to review and amend their international tax planning strategy accordingly.

In March 2001, the Japanese Chamber of Commerce & Industry in Singapore (JCCI) conducted a survey of its local corporate members regarding the potential impact of the corporate tax cut. Seventeen companies (7 percent) of the 242 respondents said they were affected by the anti-tax-haven regime. Another nine companies (4 percent) said they did not know whether they were affected. In addition, a significant number of companies said they would consider downsizing their operations or withdrawing completely from Singapore, depending on the circumstances, and that the Japanese anti-tax-haven regime constituted an obstacle to future expansion.11

The Singapore government was aware of the potential downside of reducing the corporate tax rate, but it decided to implement the tax cut anyway. The government weighed the potential loss of foreign investments against the importance of maintaining Singapore’s global competitiveness, and concluded that there was no need to be overly concerned about foreign anti-tax-haven measures because most measures apply against passive income only, not active income. Former Finance Minister Richard Hu explained that Singapore has always encouraged foreign companies “to set up operations in Singapore with substantial real activities in Singapore and not just use Singapore as a base for booking activities.”12

Nevertheless, the government cannot afford to ignore the shrinking number of Japanese companies in Singapore, in light of Singapore’s heavy dependence on foreign direct investment13 and the fact that the country is struggling to recover from its worst recession in four decades. There are currently about 1,600 Japanese companies in Singapore, down from more than 2,000 companies in the early 1990s. They comprise about one-quarter of the 6,000 international companies operating in Singapore. Some companies have already moved their operations to neighboring countries. According to a Waseda University survey, China has become the top destination for future investments by Japanese companies (82 percent),14 while Singapore ranks a distant 10th (6 percent).15

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C. Lobbying

The classification of Singapore as a Japanese tax haven prompted several leading Japanese business organizations, including the JCCI, the Japanese Business Federation (Keidanren), and the Japan Foreign Trade Council, Inc., to call for reform of the Japanese anti-tax-haven regime. (For prior coverage, see Tax Notes Intl’, 12 Mar. 2001, p. 1213, 2001 WTD 42-7, or Doc 2001-6267 (2 original pages).)

Specifically, some Japanese corporations would like the Japanese government to amend the “active business” exception to the anti-tax-haven regime so that Singapore subsidiaries (especially operational headquarters) can qualify under the exception. They say the purpose of the anti-tax-haven regime is to prevent tax avoidance through the establishment of a foreign subsidiary that does not conduct any substantive business activity in a low-tax jurisdiction; the regime should not apply to continuing substantive business operations that subsequently become subject to the anti-tax-haven regime merely because of a reduction of the local corporate tax rate.16 The Singapore govern-

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14Japanese companies are attracted by China’s lower costs and consumer market. The other top destinations are the United States (32 percent), Thailand (25 percent), Indonesia (14 percent), and India (13 percent).
ment pledged to provide its support by explaining the reasons for the reduction of the Singapore corporate tax rate and why this should not trigger the anti-tax-haven rules to the relevant Japanese authorities, through the Keidanren.17

Alternatively, Japanese corporations would like the Japanese government to lower the “25 percent or lower tax rate” standard for determining tax-haven status to 20 percent, so that Singapore will no longer be classified as a tax haven. They point out that the 25 percent threshold was established at a time when the effective Japanese corporate tax rate was 50 percent (1/2 x 50 percent = 25 percent). They argue that the threshold should be reduced to 20 percent now that the effective Japanese corporate tax rate has fallen close to 40 percent (1/2 x 40 percent = 20 percent), taking into consideration the downward trend in corporate tax rates around the world. Otherwise, countries such as Singapore, Switzerland, and Taiwan that are not actually tax havens could be treated as tax havens for Japanese purposes, and that is not consistent with the intention behind the anti-tax-haven regime.18 However, this proposal would provide only temporary relief, as the Singapore corporate tax rate is due to fall to 20 percent by the fiscal year 2004 budget.

Japanese corporations would also like the anti-tax-haven law to be amended to allow designated foreign subsidiaries to deduct losses that they incur for purposes of computing retained earnings, similar to the Japanese tax treatment of losses of foreign branches of Japanese corporations. They argue that the anti-tax-haven regime is, in essence, a type of consolidated tax system and, thus, it is inconsistent not to allow the losses of subsidiaries.19

The Japanese government, however, has not acceded to the above requests. Accordingly, the fiscal year 2002 Japanese tax reform does not include any amendment to the anti-tax-haven tax regime.20

II. Overview of the Japanese Anti-Tax-Haven Tax Regime

A. General Rule

Before Japan introduced an anti-tax-haven tax regime, Japanese individuals and corporations could defer or avoid Japanese tax on offshore income quite simply21 by establishing a corporation in a tax haven and diverting income to it. Japanese shareholders did not have to pay Japanese tax on income earned by the tax-haven subsidiary as long as the subsidiary did not distribute dividends to its Japanese shareholders, the subsidiary was not liquidated, and the Japanese shareholders did not sell or otherwise dispose of their shares in the subsidiary. To curb tax abuse, Japan enacted anti-tax-haven legislation effective for fiscal years beginning on or after 1 April 1978.22

The Japanese anti-tax-haven tax regime applies to a Japanese resident individual or a Japanese corporation that either: (1) owns directly or indirectly 5 percent or more of the stock of a designated foreign subsidiary (tokutei gaikoku kogaisha tou); or (2) is a member of an affiliated shareholder group that owns directly or indirectly 5 percent or more of the stock of a designated foreign subsidiary (5-percent shareholder).23 If the designated foreign subsidiary has undistributed income in any fiscal year, each 5-percent shareholder is required to include its pro rata share of the taxable retained earnings (tekiyou taishou ryuuho kingaku) in its income for Japanese tax purposes. The 5-percent shareholders must report the income on their respective Japanese tax returns for the fiscal year that includes the last day of the two-month period after the fiscal year-end of the designated foreign subsidiary.24

17See JCCI, “A Brief Outline, Outcome”; JCCI, “Takkusu Heiben Zeisei.”
21See JCCI, “A Brief Outline, Outcome”; JCCI, “Takkusu Heiben Zeisei.”
23Stock that does not carry, or is deemed not to substantially carry, a right of claim to dividends, distributions of assets, or other economic benefits (shares without claim rights) is excluded for this purpose.
A designated foreign subsidiary is a company that meets the following two conditions:

- It is a foreign related company (gaikoku kankei kaisha), that is, it is a foreign company and more than 50 percent of the total number of its issued shares or the amount of its contributed capital is owned directly or indirectly by Japanese residents.26
- It is located in a jurisdiction that imposes a substantially lower corporate income tax burden than the corporate income tax burden in Japan. This condition is met if the foreign related company either: (a) has its head office or main office in a country or territory where there is no corporate income tax; or (b) the rate of tax on the income of the foreign related company in any fiscal year is 25 percent or less.27 It is interesting to note that although this 25 percent criterion for determining what constitutes a low-tax jurisdiction was established when Japan’s effective corporate tax rate (national and local taxes combined) was about 50 percent (1/2 x 50 percent = 25 percent), the percentage has remained unchanged, even though Japan’s effective corporate tax rate is now approximately 40 percent.

The 25 percent test for determining tax-haven status in condition (b) above is met if the total amount of foreign corporate income taxes imposed on the income of the foreign related company for the fiscal year divided by the adjusted income of the foreign related company for the fiscal year is equal to or less than 25 percent.28

Under a special rule, if the country or territory where the head office or main office of the foreign related company is located (the home jurisdiction of the foreign related company) provides progressive corporate income tax rates, the taxpayer can use the highest marginal tax rate for purposes of calculating the amount of taxes in the numerator of the above formula.29

To avoid double taxation, a corporate 5-percent shareholder can claim a Japanese tax credit for foreign taxes that it is deemed to have paid as a result of any foreign corporate income tax imposed on the foreign designated subsidiary.30

B. ‘Active Business’ Exception

1. Conditions

Since the purpose of the anti-tax-haven regime is to prevent Japanese tax evasion by the artificial diversion of income to low-tax jurisdictions, there is a special exception for foreign designated subsidiaries that carry on bona fide active business activities. If a foreign designated subsidiary meets all of the conditions below for any fiscal year, Japanese 5-percent shareholders of the subsidiary will not be taxed currently on their pro rata shares of the subsidiary’s taxable retained earnings in that fiscal year.31

- Active Business. The main business of the designated foreign subsidiary is not the holding of shares or debt securities; the licensing of industrial property rights, other technical rights, manufacturing methods using special technology and similar things, or copyrights; or the leasing of ships or aircraft.

- Substance. The designated foreign subsidiary has an office, store, factory, or other fixed facility in its home jurisdiction, which is deemed to be necessary for it to conduct its main business there.

- Local Management and Control. The designated foreign subsidiary itself manages, controls, and operates its main business in its home jurisdiction.

- Business With Unrelated Persons or Local Business. If the main business of the designated foreign subsidiary is a wholesale, banking, trust company, securities, insurance, shipping, or air-freight business, more than 50 percent of the business must be

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25(a) If a company issues nonvoting shares, the nonvoting shares are excluded for purposes of calculating the ratio. (b) If the company issues shares without claim rights, they are excluded for purposes of calculating the ratio. (c) If the company issues both nonvoting shares and shares without claim rights, the ratio described in (a) or (b), whichever is higher, applies.

28STML arts. 40-4(2)(i), 66-6(2)(i)
29STML arts. 40-4(1), 66-6(1); STML Enforcement Order (Enf. Order) arts. 25-19(1), 39-14(1). The Japanese Ministry of Finance stopped maintaining a list of low-tax jurisdictions effective 1 Apr. 1992, because it is administratively too burdensome and to prevent unfair treatment. See “Heisei 4 Nen, Kaisei Zeihou No Subete,” at 203.
30STML arts. 40-4(2), 66-6(3).
31STML art. 66-7(1); STML Enf. Order art 39-18(1).
Flowchart for Determining Whether the Active-Business Exception Applies

1. Active Business
   - Yes
   - No

2. Substance
   - Yes
   - No

3. Local Mgt. and Control
   - Yes
   - No

4. Unrelated Persons I
   - Yes
   - No

5. Unrelated Persons II
   - Yes
   - No

6. Local Business
   - Yes
   - No

CRITERIA

1. Is the subsidiary's main business other than one of the following?
   - Holding stocks or debt securities
   - Licensing industrial property rights or other prescribed rights
   - Licensing copyrights or other prescribed rights
   - Leasing ships or aircraft

2. Does the subsidiary have an office, store, factory, or other fixed facility in its home jurisdiction, which is deemed necessary for it to conduct its main business there?

3. Does the subsidiary itself manage, control, and operate its main business in its home jurisdiction?

4. Is the main business of the subsidiary one of the following?
   - Wholesale
   - Banking
   - Trust Company
   - Securities
   - Insurance
   - Shipping
   - Air-freight

5. Do transactions with unrelated persons account for more than 50 percent of the amount of revenues or purchases of the subsidiary?

6. If the subsidiary's main business is other than a business specified in item 4, does the subsidiary conduct its business mainly in its home jurisdiction?
conducted with unrelated persons. If the main business of the designated foreign subsidiary is a business other than a business specified in the preceding sentence, the designated foreign subsidiary must conduct its business mainly in its home jurisdiction.

C. Points to Note

1. Foreign Related Company

As discussed above, a foreign company is a foreign related company (gaikoku kankei kaisha) if Japanese residents directly or indirectly own more than 50 percent of the total number of issued shares or the amount of contributed capital of the foreign company. In making their determination, the Japanese tax authorities and the courts will look not only at the form, but also at the substance, of the shareholding ratio.

For example, in the case of a joint venture, the facts may be examined to see if other shareholders are holding shares of the foreign company as nominees for the Japanese residents, especially if the Japanese residents own 50 percent or slightly less than 50 percent of the shares or the contributed capital of the foreign company. In a 1993 Osaka High Court case, an officer of a Japanese corporation (J Co) contributed capital to establish a company in Panama (P Co). The court considered all the facts and circumstances concerning the incorporation and operation of P Co, including details of the establishment of P Co, the actual management and control of P Co, the party that paid the expenses with respect to P Co, and the perception of counterparties in transactions. The court found that the officer had, in fact, made the capital contribution to P Co on behalf of J Co. Thus, the court held that P Co was a designated foreign subsidiary of J Co.

The Japanese tax authorities are also likely to scrutinize the share ownership structure in cases where the local jurisdiction of the foreign subsidiary regulates capital investments from other countries or where there is a decrease in the shareholding ratio of Japanese residents when the corporate tax rate in the local jurisdiction is reduced below 25 percent.

2. Active Business

One of the main conditions for qualifying under the “active business” exception is that the main business of the designated foreign subsidiary is not the holding of shares or debt securities or other prescribed passive activity.

The burden of proof is on the taxpayer to establish that it meets all the conditions for the ‘active business’ exception to apply.

In Yaohan Finance K.K. v. District Director, Numazu Tax Office, the plaintiff (P Co) established a subsidiary (S Co) in Hong Kong. During its first fiscal year ended March 1989, S Co was engaged in the business of holding shares for investment purposes. Its revenue consisted of interest received on loans to group companies, interest on bank deposits, gains from the sale of securities held for investment purposes, and interest on bank deposits. Ninety-six percent of its revenues consisted of interest received on loans to group companies.

The court held that the main business of the designated foreign subsidiary should be determined based on specific and objective facts concerning the business activities of the designated foreign subsidiary for each fiscal year. In other words, a determination should be made based on an overall consideration of objective business results such as revenue or income received, the number of employees, fixed facilities, and other relevant facts on a fiscal year-by-fiscal year basis. Facts arising after the end of the fiscal year at issue should not be taken into account. Thus, the court held that S Co’s main business until the fiscal year ended March 1990 was the holding of shares.

33Isshin (court of first instance), Kobe District Court decision, 13 Mar. 1991; Kousoshin (on appeal), Osaka High Court decision, 22 July 1992.
34Isshin (court of first instance), Shizuoka District Court decision, 9 Nov. 1995; Kousoshin (on appeal), Tokyo High Court decision, 19 June 1996; Supreme Court (Dai-ni Shouhoutei) decision, 12 Sept. 1997.
35STML Basic Circular 66-6-8.
The burden of proof is on the taxpayer to establish that it meets all the conditions for the “active business” exception to apply. Therefore, it would be prudent for the taxpayer to prepare and maintain records that can objectively show that the designated foreign subsidiary’s main business is an active business (for example, information concerning the designated foreign subsidiary’s revenue and income, number of employees, and fixed facilities).

3. Substance

Japanese corporations often use designated foreign subsidiaries to avoid business restrictions imposed by special Japanese industrial regulations, laws, administrative guidelines, or industrial practices. For example, in the case cited in C.1 above, a Japanese corporation established a paper subsidiary in Panama for owning ships, to circumvent a labor-union agreement in the Japanese shipping industry that required Japanese sailors to be employed on ships registered in Japan. Foreign designated subsidiaries are also often used for purposes of obtaining financing and asset management. In such cases, the Japanese tax authorities are likely to check whether the foreign designated subsidiary in question has an office or other fixed facility in its home jurisdiction necessary for it to conduct its main business there.

Even if the foreign designated subsidiary has an office or other fixed facility in its home jurisdiction, if the foreign designated subsidiary has no directors or officers working exclusively for it or if it has only a few employees, the Japanese tax authorities may look closely to see if the office or other fixed facility has any actual substance.

Consequently, foreign designated subsidiaries should maintain documentation that can objectively prove that they, in substance, have an office or other fixed facility in their home countries, such as title deeds, lease agreements, correspondence, and financial statements.

D. Local Management and Control

Whether a designated foreign subsidiary exercises management and control in its home jurisdiction can sometimes be difficult to determine. A tax circular states that factors to be considered include where the subsidiary’s general shareholders meetings and board of directors meetings are held, where executive duties are carried out, and where the subsidiary’s accounting records are prepared and maintained. The tax circular also states that a subsidiary that performs its business planning and decision-making in its home jurisdiction, but discusses and seeks the views of its parent company and holds its general shareholders meetings outside its local jurisdiction, will not necessarily fail the “local management and control” test.

The Japanese courts have considered the “local management and control” test in at least two cases. In one case, a designated foreign subsidiary that had its head office in Hong Kong (S Co) held all its general shareholders meetings and board of directors meetings in Japan. All of S Co’s executives also served as executives of S Co’s Japanese parent company (P Co), and S Co had only one full-time employee. S Co needed P Co’s final approval or decision on business and administrative matters, and did not have authority to make independent decisions. The Supreme Court held that S Co did not manage, control, and operate its main business in its home jurisdiction by itself as an independent entity. Instead, P Co exercised management and control of S Co in Japan.

The second case involved another designated foreign subsidiary with its head office in Hong Kong (H Co). H Co’s representative director and officers were also executives at H Co’s Japanese parent company (J Co). During the year at issue, H Co’s representative director spent only 15 days in Hong Kong and the other directors did not work in Hong Kong at all. H Co held all board of directors meetings in Japan. General shareholders meetings were held in Hong Kong in form only. H Co engaged a Hong Kong leasing agent to operate its real estate leasing business, while H Co’s staff performed administrative, accounting, and janitorial work. J Co made the decision to acquire H Co’s sole asset, a building, as well as the decision to transfer a portion of the building from H Co to J Co. After the transfer, H Co’s business consisted of managing the building for J Co, and H Co made all important decisions.

37STML art. 66-6(5).
38STML Basic Circular 66-6-16.
40Kumamoto District Court decision, 27 July 2000.
subject to J Co’s approval. The Kumamoto District Court held that H Co did not manage, control, and operate its main business in its home jurisdiction by itself as an independent entity. J Co exercised almost total control of H Co in Japan.

III. Tax Planning

Japanese shareholders subject to the anti-tax-haven regime may have several tax planning options.41

A. Distribute All of the Singapore Subsidiary’s Income

A Japanese 5-percent shareholder is subject to Japanese tax on its pro rata share of the taxable retained earnings of a designated foreign subsidiary. Therefore, if the subsidiary distributes all of its income to its shareholders, leaving behind no retained earnings in the subsidiary, the anti-tax-haven regime will not impose additional tax on the Japanese shareholders.

Of course, the Japanese shareholders must pay Japanese tax on the dividends they actually receive from the subsidiary. The amount of Japanese tax on the dividends received would be about the same as the amount of Japanese tax that the Japanese shareholders would be required to pay with respect to the taxable retained earnings of the subsidiary if the subsidiary does not distribute dividends. In other words, regardless of whether dividends are distributed, the Japanese shareholders will not be able to defer Japanese tax on the subsidiary’s income. Nevertheless, this tax planning method may be useful because it avoids a cash-flow problem for Japanese shareholders, whereby the Japanese shareholders are taxed currently in Japan on the subsidiary’s taxable retained earnings, even though the Japanese shareholders have not actually received dividends from the subsidiary and may not have the cash to pay the Japanese tax.

In practice, it may be difficult for management to ensure that a designated foreign subsidiary has absolutely no taxable retained earnings, because the amount of “retained earnings” for accounting and financial-reporting purposes is not necessarily the same as the amount of “taxable retained earnings” for purposes of the anti-tax-haven regime.42

B. Restructure to Qualify Under the ‘Active Business’ Exception

If a Singapore designated foreign subsidiary does not qualify under the “active business” exception, it is likely to meet another requirement, also subject to J Co’s approval. The Kumamoto District Court held that H Co did not manage, control, and operate its main business in its home jurisdiction by itself as an independent entity. J Co exercised almost total control of H Co in Japan.

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exception because it fails to meet one or more of the technical requirements, it may be possible to restructure the subsidiary’s operations to qualify under the exception.

A holding company can meet the “active business” requirement by starting up or acquiring an active business. For example, the trend is for Japanese-owned operations in Singapore to move toward providing services, including regional-headquarters and sales and marketing services.44 Typical headquarters activities include business planning, logistics, sourcing raw materials and components, research and development, technical services, marketing and sales promotion, personnel management, and treasury functions.45 Such services are likely to qualify as an active business.

A subsidiary can meet the substance requirement by establishing an office or other fixed facility in Singapore that is necessary for it to conduct its main business in Singapore.

If a subsidiary is unable to meet the “local management and control” test because it is being managed and controlled by its parent company in Japan, the subsidiary should hold all general shareholders meetings and board of directors meetings in Singapore, make and carry out all important business and administrative decisions in Singapore, and prepare and maintain its accounting records in Singapore.

If the main business of the Singapore subsidiary is a wholesale or other prescribed business that is conducted mostly with affiliated companies in the region, the subsidiary may be able to restructure its business so that more than 50 percent of its

41See Momozaki, supra n. 11, at 176-178; J. Darcy, Japan-U.S. International Tax Transactions (CCH) (Darcy), para. 755.


43According to the Singapore Economic Development Board (EDB), at the end of 2000, about half of the 6,000 international companies in Singapore had regional operations and headquarters-related functions. The EDB has awarded operational-headquarters and business-headquarters tax incentives to more than 200 multinationals, of which 11 percent are Japanese.

44See A. Teo, “Japanese Companies Here Slip to 1,600,” supra n. 11.

business is conducted directly with unrelated customers instead of indirectly through local affiliates. For example, a Singapore sales subsidiary may directly sell electronic components to unrelated customers in Thailand, with a Thai affiliate providing local marketing and technical-support services. Alternatively, the Singapore subsidiary may be able to change its business to one other than a wholesale or other prescribed business and take advantage of the local-business exception, as discussed below.

If the main business of the subsidiary is not a wholesale or other prescribed business, the subsidiary should conduct its business mainly in Singapore. Business in other countries should be conducted by non-Singapore affiliates.

C. Convert Holding Company’s Subsidiaries to Branches

A Singapore holding company that holds stock of subsidiaries in other countries that have higher corporate tax rates may be able to convert the non-Singapore subsidiaries into branches. If the Singapore holding company can thereby increase the effective tax rate on its income above 25 percent, it will not be classified as a designated foreign subsidiary and will not be subject to the anti-tax-haven regime.

The foreign branches, however, are likely to be considered permanent establishments of the Singapore company in the countries where the branches are located. Therefore, the Singapore company needs to assess carefully whether there is a risk that more of its income may be attributable to those permanent establishments, and thus subject to tax by the other countries, than the amount of income that would be taxed in those countries under the holding company/subsidiary structure. Furthermore, some countries require a branch to file not only the branch’s financial statements and other information, but also financial statements and other information for the entire company, with the local registrar of companies, who may make the records available for public inspection. Some companies may find this unacceptable because they prefer to keep their companywide data confidential.

D. Form a Joint Venture With Nonresidents of Japan

The anti-tax-haven regime will not apply to a foreign subsidiary if Japanese residents own directly or indirectly 50 percent or less of the shares or contributed capital of the Singapore subsidiary to, or just below, the 50 percent threshold, especially during the period immediately before or after Singapore’s classification as a tax haven. In determining whether the Singapore subsidiary is a foreign designated subsidiary, the tax authorities will look at not only the form, but also the substance, of the transaction. In particular, they may examine whether non-Japanese resident shareholders are holding shares of the Singapore subsidiary as nominees for the Japanese shareholders.

E. Relocate to Another Low-Tax Jurisdiction

Japanese shareholders of a Singapore designated foreign subsidiary could consider establishing a new subsidiary in a low-tax jurisdiction with a corporate tax rate higher than 25 percent and transfer the business of the Singapore subsidiary to the new subsidiary. However, relocation to another low-tax jurisdiction may only be a short-term solution, because that jurisdiction may also lower its corporate tax rate to meet international competition and become a tax haven in the future. It is also possible that Japan may amend its anti-tax-haven regime in the future to raise the threshold for non-tax-haven status above 25 percent (see discussion in section V, below).

F. Relocate to Special Zones in Okinawa, Japan

Alternatively, Japanese financial-services businesses and

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46For example, the United Kingdom.

47For example, Malaysia, which has a 28 percent corporate tax rate.

information-technology businesses could consider relocating to one of the special zones in Okinawa in the south of Japan, which provides tax breaks that effectively lower the corporate tax rate to 26 percent.

Under the Special Measures Law for the Development of Okinawa, which is part of the 2002 tax reform,49 the Japanese government set up a special financial operation zone (named kinyuu gyoumu tokubetsu chiku) in Okinawa.50 An approved corporation that is newly established in the zone and that meets the prescribed conditions will be granted a special 35 percent income deduction51 against the income from its business for Japanese tax purposes, for 10 years from the date of its establishment. The conditions include conducting a financial business or a finance-related business in the zone as the corporation’s main business, and regularly employing 20 or more employees52 in the zone. The amount of the special income deduction is limited to 20 percent of the total amount of personnel costs incurred in the zone.

The government established a similar zone in Okinawa for developing designated key information functions (named jouhou tsuushin sangyuu tokubetsu chiku). An approved corporation that is newly established in the zone, conducts a designated key information business in the zone as the corporation’s main business, regularly employs 20 or more employees53 in the zone, and meets other prescribed conditions will be granted a special 35 percent income deduction against the income from its business for Japanese tax purposes for 10 years, from the date of its establishment. The amount of the special income deduction cannot exceed the amount of the corporation’s income for the business year.54

Japan’s general effective corporate tax rate is 40.87 percent. Thus, a 35 percent income deduction will result in an effective corporate tax rate of 26.6 percent for approved corporations operating in the special zones, calculated as follows:

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40.87\% \times (1 - 0.35) = 26.6\%
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Perhaps not coincidentally, the 26.6 percent effective corporate tax rate is slightly higher than the threshold for non-tax-haven status. In any case, the anti-tax-haven regime applies to foreign subsidiaries only, not to companies established in Japan.

The Japanese anti-tax-haven regime is actually a form of CFC regime, similar to the CFC regime under subpart F of the U.S. Internal Revenue Code.

IV. Comparison With U.S. Subpart F and OECD Countermeasures

A. U.S. Subpart F Regime

Despite its popular nickname,55 the Japanese anti-tax-haven regime is actually a form of CFC regime, similar to the CFC regime under subpart F of the U.S. Internal Revenue Code (IRC).56 Both the Japanese and the U.S. regimes curtail the deferral of domestic taxation by accumulating foreign-source income in a foreign subsidiary established in a low-tax jurisdiction. They deter the improper shifting of income to the foreign subsidiary by means of “tax-haven devices” such as artificial intercompany pricing,57 transfers of patent rights, and management fees.58 Subpart F is also intended to ensure that all


51STML, article 59. Alternatively, the corporation can elect to receive other benefits.

52Okinawa Shinkou Tokubetsu Sochi Hou, Enf. Order art. 27(1).

53Okinawa Shinkou Tokubetsu Sochi Hou, Enf. Order art. 11(1).

54Okinawa Shinkou Tokubetsu Sochi Hou, articles 28, 31; STML, article 59; STML Enf. Order art. 35(4).

55See supra n.1.

56The United States was the first country to enact legislation dealing with CFCs, in 1962. See OECD, “Controlled Foreign Company Legislation” (1996) (OECD CFC Report), at 21. The United States has other anti-tax-deferral regimes, including provisions governing foreign personal holding companies, foreign investment companies, and passive foreign investment companies. IRC sections 551-558, 1246, 1247, and 1291-1298. See also Office of Tax Policy, Department of the Treasury, “Corporate Inversion Transactions: Tax Policy Implications,” May 2002, 2002 WTD 103-38 or Doc 2002-12218 (31 original pages), which concludes that “[c]hanges to the applicable statutory and regulatory rules are needed to ensure that any transaction that results in a new foreign parent of a corporate group with U.S. operations does not serve to facilitate an inappropriate decrease in tax on the U.S. income of the U.S. operations.”

57As Kuntz & Peroni note, in theory, transfer pricing legislation such as IRC section 482 prevents the shifting of income between related persons through improper pricing or fees. However, section 482 is not self-implementing and is difficult for the U.S. Internal Revenue Service to police. See J. Kuntz & R. Peroni, U.S. International Taxation (Warren Gorham Lamont) (Kuntz & Peroni), at B3-6, n. 5.

58See Darcy, paragraph 700; Office of Tax Policy, Department of the Treasury, “The Deferral of Income Earned Through U.S. Controlled Foreign Corporations,” December 2000 (U.S. Treasury’s Subpart F Report), Chapter 1 and Chapter 2, Section II.A; Kuntz & Peroni, paragraph B3.01.
passive income earned by U.S.-owned foreign corporations is subject to current U.S. tax, to promote equity among U.S. taxpayers, and to encourage economic efficiency based on the concept of tax neutrality without unduly harming the competitiveness of U.S. multinationals. It reinforces the principle of worldwide taxation of U.S. taxpayers.

Under subpart F, a foreign corporation is considered a CFC if “United States shareholders” directly, indirectly, or constructively own more than 50 percent of the total combined voting power or total value of the stock of the corporation on any day during the taxable year of the corporation. For this purpose, any U.S. person who owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation is treated as a “United States shareholder.”

If a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every United States shareholder who owns stock in the corporation on the last day, in such year, on which the corporation is a CFC must include the sum of the shareholder’s pro rata share of the following four kinds of income in the shareholder’s current gross income, even though the CFC has not distributed the amounts: (a) the CFC’s subpart F income for the taxable year; (b) the CFC’s previously excluded subpart F income withdrawn from investment in less-developed countries for the taxable year; (c) the CFC’s previously excluded subpart F income withdrawn from foreign base company shipping operations for the taxable year; and (d) the CFC’s increase in earnings invested in U.S. property for the taxable year.

Subpart F income generally consists of the sum of the following: (a) prescribed insurance income; (b) foreign base company income, including subpart F foreign personal holding company income such as dividends, interest, royalties, rents, and annuities; income deemed connected with an international boycott; (d) illegal bribes, kickbacks, or other payments paid by or on behalf of the corporation directly or indirectly to an official, employee, or agent in fact of a government; and (e) income derived from a foreign country while it is “blacklisted” under IRC section 901(j).

Under the high-tax exception, a United States shareholder can elect to exclude from income any item of income received by a CFC that would otherwise constitute foreign base company income or insurance income if the shareholder can establish that the item of income received by a CFC was subject to current U.S. tax, to promote equity among U.S. taxpayers, and to encourage economic efficiency based on the concept of tax neutrality without unduly harming the competitiveness of U.S. multinationals. It reinforces the principle of worldwide taxation of U.S. taxpayers.

Generally, countries that have enacted CFC laws take either one of two basic approaches. The United States uses a transactional approach targeting specific types of income. Japan adopts the other approach — the entity approach, which ends deferral for all of the income of a designated foreign subsidiary if certain conditions are present.

The U.S. subpart F regime differs from the Japanese anti-tax-haven regime in other ways. For example, under the U.S. regime, U.S. 10 percent shareholders must own more than 50 percent of a CFC. In contrast, if Japanese residents own more than 50 percent of a foreign subsidiary, it will be considered a designated foreign subsidiary; Japanese 5 percent shareholders of a foreign designated subsidiary are subject to the Japanese regime. The U.S. rules for determining ownership...
are different from the Japanese rules. Under the U.S. regime, the high-tax exception is available for an item of income that would otherwise constitute foreign base company income or insurance income if it is subject to foreign corporate income tax at an effective rate greater than 31.5%, whereas the general rule under the Japanese regime applies only if the foreign corporate income tax burden on a designated foreign subsidiary’s income is 25 percent or less.

B. OECD’s Project on Harmful Tax Practices

OECD Head of Fiscal Affairs Jeffery Owens noted in an interview in 2000 that the tax-haven problem is “big and getting bigger.” While it is difficult to estimate accurately the magnitude of the problem because it involves unreported income, it is known, for example, that more than US $1 trillion is invested in offshore funds and the number of funds has increased by more than 1,400 percent over the last 15 years, Owens said.72 The IMF estimated that deposits in legal entities such as international business corporations and offshore trusts exceed US $5 trillion.73

In a rapidly globalizing world, the OECD plays an essential role in promoting tax competition to foster growth and development worldwide. In recent years, it has been spearheading international efforts to crack down on the harmful tax practices of tax havens and preferential tax regimes that offer zero or low effective tax rates. Harmful tax practices erode the national tax bases of other countries, divert geographically mobile capital flows, distort trade and investment patterns, and reduce global welfare. Moreover, they increase administrative costs and compliance burdens and undermine the integrity and fairness of other countries’ tax systems.74

The OECD issued a series of reports in 1998, 2000, and 200175 that focused on geographically mobile activities such as financial and other service activities, including the provision of intangibles.

The 1998 Report set out four key factors76 for identifying tax havens, as follows:

- No or nominal taxes. The starting point is to ask whether a jurisdiction imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by nonresidents to escape tax in their country of residence. This is a gateway criterion for determining whether an analysis of the other criteria is necessary. It is a necessary, but not sufficient, condition for a jurisdiction to be considered a tax haven.77

- Lack of effective exchange of information. Tax havens typically have laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities, thereby preventing the effective exchange of information on taxpayers benefiting from the low-tax jurisdiction.

- Lack of transparency. A lack of transparency in a jurisdiction’s operation of its legislative, legal, or administrative provisions is another factor.

- No substantial activities. The 1998 Report also listed as a factor the absence of a requirement that the activity in a jurisdiction be substantial, because that suggests that a jurisdiction may be attempting to attract investment or transactions that are purely tax-driven. In other words, the jurisdiction is essentially a “booking center” for tax-driven transactions, without any value being added locally so that there is little real activity. However, in 2001, the OECD ultimately decided not to use this method to determine

Harmful tax practices erode the national tax bases of other countries, divert geographically mobile capital flows, distort trade and investment patterns, and reduce global welfare.
whether or not a tax haven is uncooperative.\textsuperscript{78}

In June 2000, the OECD published a list of 35 jurisdictions that were found to meet the above criteria for constituting tax havens.\textsuperscript{79} The list did not include Singapore. Thirty-one jurisdictions on the list subsequently made commitments to transparency and effective exchange of information and are considered cooperative jurisdictions by the OECD’s Committee on Fiscal Affairs. As a result, the final list of uncooperative tax havens published by the OECD on 18 April 2002 contains only seven jurisdictions.\textsuperscript{80} OECD member countries will use this list as a basis for the framework of coordinated defensive measures now being developed, which the OECD has pledged not to implement before April 2003.\textsuperscript{81}

Currently, OECD member countries and non-member countries use various countermeasures to mitigate the impact of harmful tax practices, but these measures have limited effectiveness when they are applied on a unilateral or bilateral basis to a problem that is inherently global in nature. Hence, the OECD provides a framework within which both OECD member countries and non-member countries can coordinate and support each other’s efforts to protect themselves from harmful tax practices. However, the actual adoption of defensive measures is at the discretion of individual countries, and it is the OECD member countries themselves — not the OECD — that will enforce the measures against the uncooperative tax havens.\textsuperscript{82}

The 1998 Report made three types of recommendations and guidelines for dealing with harmful tax practices,\textsuperscript{83} as follows:

- \textit{Recommendations concerning domestic legislation and practices}. For example, countries that do not have rules concerning CFCs, foreign investment funds, and reporting of international transactions and foreign operations of resident taxpayers should consider adopting them, and countries that have such rules should ensure that they apply in a manner consistent with curbing harmful tax practices; they should exchange information; and they should remove impediments to access to banking information by tax authorities.

- \textit{Recommendations concerning tax treaties}. For example, countries should undertake programs to intensify exchange of information on transactions in tax havens; they should consider terminating their tax treaties with tax havens, if any; and they should consider undertaking coordinated enforcement programs such as simultaneous examinations, specific exchange-of-information projects, or joint training activities.

- \textit{Recommendations for intensification of international cooperation}. For example, the Forum on Harmful Tax Practices should establish a list of tax havens;\textsuperscript{84} countries that have particular political, economic, or other links with tax havens should ensure that these links do not contribute to harmful tax competition; and the Forum should engage in a dialogue with non-member countries with the aim of promoting the recommendations and guidelines in the 1998 Report.

The Japanese anti-tax-haven regime uses only the first OECD criterion — no or nominal taxation — for purposes of determining whether a country falls within the ambit of the Japanese anti-tax-haven regime. It does not use the other OECD criteria discussed above, that is, lack of effective exchange of information, lack of transparency, or lack of substantial activities.

As noted above, the Japanese anti-tax-haven regime is a form of CFC legislation, which is one of the domestic legislative countermeasures that the OECD specifically recommended that countries adopt. In fact, the Japanese government recently began referring

\begin{itemize}
\item \textsuperscript{78}See the 2001 Report, \textit{supra} n. 75, paragraph 27.
\item \textsuperscript{79}See the 2000 Report, \textit{supra} n. 75, paragraph 17.
\item \textsuperscript{82}See 1998 Report, \textit{supra} n. 74, chapter 3; 2001 Report, paragraphs 47-49.
\item \textsuperscript{83}See 1998 Report, \textit{supra} n. 74, chapter 3 and appendix.
\item \textsuperscript{84}The OECD published a list of tax havens in June 2000 and a list of uncooperative tax havens on 18 April. The OECD will continue to monitor carefully the emergence of any new tax havens. See “The OECD List of Unco-operative Tax Havens — A statement by the Chair of the OECD’s Committee on Fiscal Affairs, Gabriel Makhlouf,” \textit{supra} n. 81.
\end{itemize}
to the anti-tax-haven regime as the CFC tax regime, possibly to avoid confusion with the OECD’s countermeasures against harmful tax practices.85

V. Future of the Japanese Anti-Tax-Haven Regime

In the 2000 Government Tax Commission’s report, the Japanese Ministry of Finance stated that the government has been reviewing, and will continue to review and amend, the anti-tax-haven regime to prevent erosion of the Japanese tax base and for other purposes, taking into account the actual circumstances of Japanese enterprises expanding overseas, the need for the OECD to take appropriate countermeasures against harmful tax competition, countermeasures taken by various foreign countries, and other factors.86

There is no indication, however, that the Japanese government has any intention of acceding to the demands of the Japanese business community discussed in section I.C in the future. Politically, it would be difficult for the government to justify the creation of a special exception to the Japanese anti-tax-haven regime for Singapore subsidiaries, because that would mean favoring one country over others. In addition, from a fiscal viewpoint, it would be difficult to garner support for a revenue-losing measure in the current era of large Japanese budget deficits.

There is also no sign that the Japanese government will lower the 25 percent threshold for non-tax-haven status to 20 percent or allow designated foreign subsidiaries to deduct losses for purposes of computing retained earnings in the future. Even if the government were to adopt a 20 percent threshold, it would provide only temporary respite for Japanese resident shareholders of Singapore companies, because Singapore plans to lower its corporate tax rate to 20 percent by the fiscal year 2004 budget.87 Moreover, it is noted that a 20 percent threshold would be lower than the CFC thresholds of other major OECD countries such as the United States,88 the United Kingdom,89 and Germany.90 One commentator has even suggested that there may be a contrary trend.91 Therefore, the possibility of the Japanese threshold being raised above 25 percent in the future cannot be ruled out entirely.

VI. Conclusion

Singapore joined the league of Japanese tax havens from year of assessment 2002. Nevertheless, there are still tax planning opportunities for avoiding the Japanese anti-tax-haven regime.

Larger problems loom on the macro level. Not only is Singapore struggling to recover from its worst recession in four decades, it is also entering a very different world, where conditions are uncertain and volatile, competition is intense, and change is faster than ever.92 A government-appointed tax subcommittee recently recommended corporate and individual income tax cuts and other bold measures, as part of a blueprint to restructure and revitalize the Singapore economy.93 However, it remains to be seen whether those measures will prove to be adequate.

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85See supra n. 1.
87See Fiscal Year 2002 Budget Statement, supra n. 7, paragraph 1.34.
8831.5 percent (maximum U.S. corporate tax rate of 35 percent x 90 percent) or less. IRC sections 11(b)(1)(D), 954(b)(4); Treas. reg. section 1.954-1(d).
89Less than 22.5 percent (U.K. company tax rate of 30 percent x 0.75). Income and Corporation Taxes Act 1988, as amended, section 750(1).
90Less than 25 percent. Gesetz über die Besteuerung bei Auslandsbeziehungen (Aussensteuergesetz) 1972, as amended, section 8(3).
92See Fiscal Year 2002 Budget Statement, supra n. 7, paragraph 1.5.