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# Japan: Inbound Tax Alert

## 2015 Tax Reform Proposals - Announced

**January 2015, No.10**

On 30 December 2014, the ruling coalition parties of Japan released the Outline of the 2015 Tax Reform Proposals (the, "Proposal"). The main focus of the Proposal from a corporate tax perspective is to promote growth by reducing the effective corporate tax rate and incentivizing companies to increase wages for their employees. At the same time, in order to secure sufficient tax revenue, amendments aimed at expanding the corporate tax base and increasing non-income based taxes are proposed. Other notable proposals include provisions to align with the BEPS[1] projects promoted by the G20 and OECD, and the expected changes to the treatment of digital services for Japanese consumption tax ("JCT") purposes.

This alert highlights several of the significant proposals that may affect foreign companies doing business and foreign nationals working in Japan. It should be emphasized that these tax proposals have not been enacted yet and could change prior to becoming law.

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1 An initiative lead by the Organization for Economic Development and Cooperation (OECD) to combat Base Erosion and Profit Shifting (BEPS) tax planning strategies that exploit gaps and mismatches in tax rules to reduce taxes.

## Corporate Tax

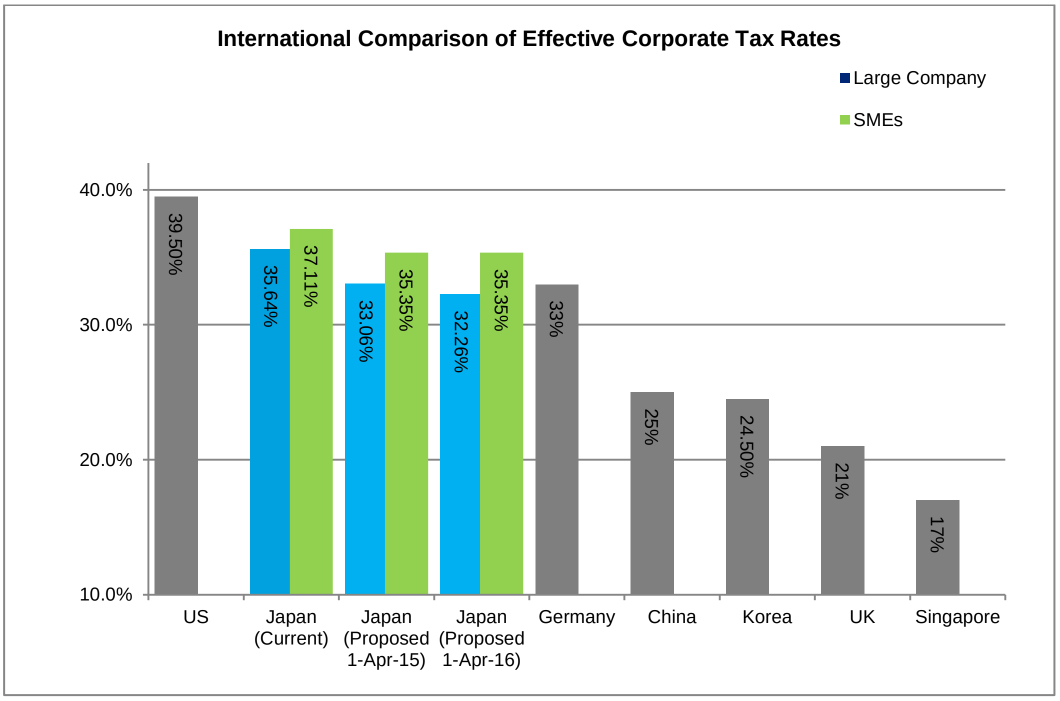
### 1) Reduction in the effective corporate tax rate

As the first step in the government's plan to reduce the effective corporate tax rate to below 30% over the next several years, the national corporate tax rate and the income levy of the factor-based enterprise tax (which is imposed on companies with stated capital of over JPY 100 million) shall be reduced as follows starting with tax years beginning on or after 1 April 2015.

| | Current | Proposed | |
|---|---|---|---|
| | | 1-Apr-2015* | 1-Apr-2016* |
| National Corporate Tax** | 25.50% | 23.90% | 23.90% |
| Factor Based Enterprise Tax Income Levy*** (standard rate) | 7.2% | 6.0% | 4.8% |

* For tax years beginning on or after such date.
** Reduced rate is applicable for SMEs on the first JPY 8 million of taxable income.
*** Does not apply to Small and Medium size Enterprises ("SMEs"), which are defined as companies with stated capital of JPY 100 million or less.Reduced rate is applicable on first JPY 8 million of SME taxable income.

The following graph shows Japan's current and proposed effective tax rates of corporate and local income tax for companies based in Tokyo compared to the effective tax rates of neighboring and other countries around the world. Japan continues to have one of the highest effective corporate tax rates in the world, but further rate cuts are expected in the future.

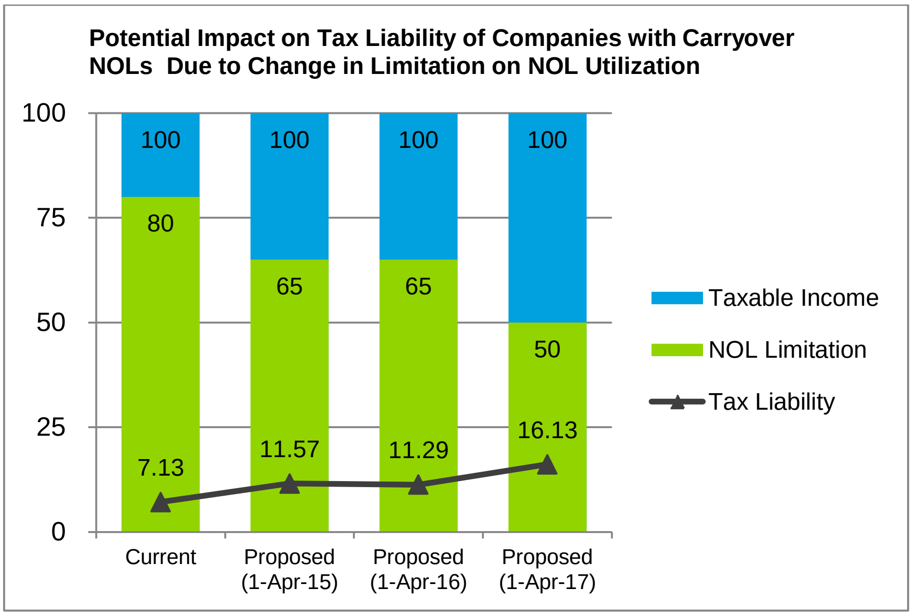



Note: Effective corporate tax rates for Japan assumes that Tokyo continues to impose the same percentage increase over the standard rate for factor-based enterprise tax – income levy.

## 2) Limitations on utilization of NOLs and expansion of NOL carryforward period

The limitation on the utilization of carried forward net operating losses (“NOLs”) of companies filing blue form tax returns shall be reduced in stages with a reduction from the current 80% (of income before the utilization of NOLs) to 65% for tax years beginning on or after 1 April 2015, and to 50% for tax years beginning on or after 1 April 2017. There will continue to be no limitation on the utilization of NOLs by SMEs, whose shares are not wholly directly or indirectly held by a Large Company (defined as a company with stated capital of JPY500 million or more) nor held by two or more Large Companies that are part of a 100% group.

The following graph shows the potential impact to a company’s tax liability as a result of these changes taking into account the proposed reduction to the effective corporate tax rates. Profitable companies with significant carryover NOLs may see their tax liability more than double as a result of these changes despite the reduction in the effective corporate tax rate.




Note: The tax liabilities above are estimated using the effective corporate tax rates shown in the graph in section 1 for companies with stated capital of over JPY 100 million based in Tokyo.

The carry forward period for NOLs incurred for the tax years beginning on or after 1 April 2017 shall be extended from the current 9 years to 10 years. In line with this revision, the following will also be extended from 9 year to 10 years:

- the book retention period;
- the statute of limitations for the tax authorities to correct NOLs; and
- the statute of limitations for taxpayers to file a request for correction of NOLs.

## 3) Increase to the factor-based enterprise tax (Value Added and Capital levies)

The Value Added and Capital levies of the factor-based enterprise tax (which is imposed on companies with stated capital of over JPY 100 million) shall be increased as follows starting with tax years beginning on or after 1 April 2015.

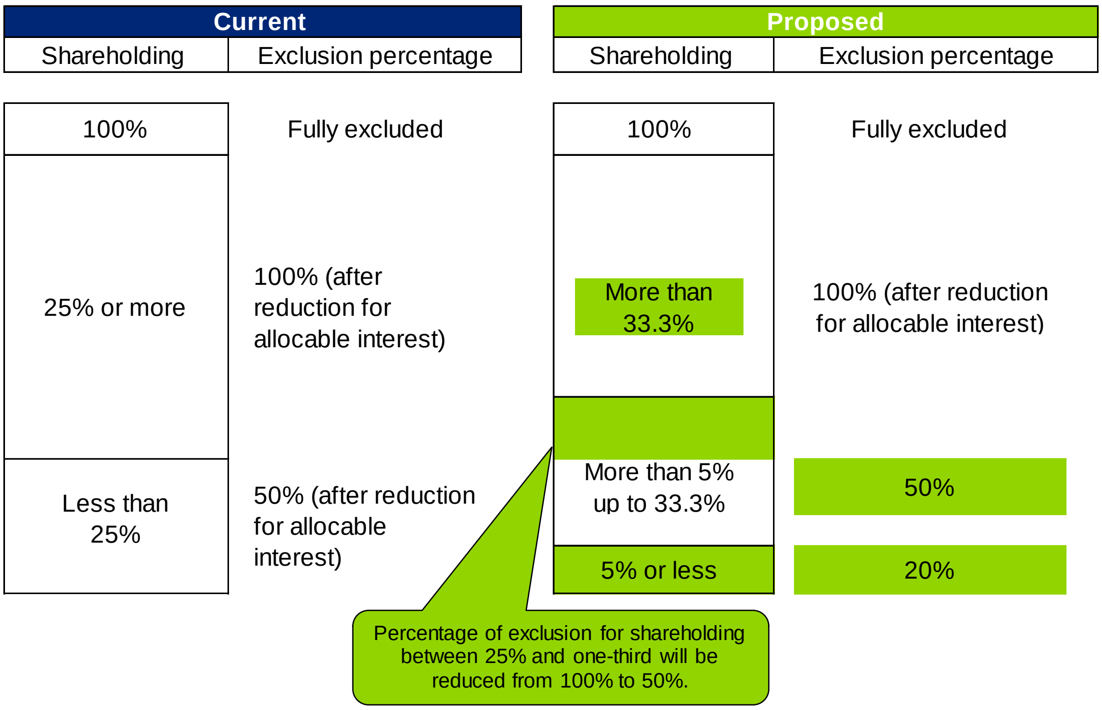
| | Current | Proposed | |
|---|---|---|---|
| | | 1-Apr-2015* | 1-Apr-2016* |
| Value Added levy | 0.48% | 0.72% | 0.96% |
| Capital levy | 0.2% | 0.3% | 0.4% |

* For tax years beginning on or after such date.

In addition to the increase in the rate of the Capital levy, the taxable basis to which the Capital levy (and per capita inhabitance tax) is applied will be changed to the greater of: capital amount for tax purposes, and capital amount for accounting purposes. As an incentive to increase wages, companies that increases wages for any of the fiscal years beginning between 1 April 2015 and 31 March 2018 and which meet conditions similar to those required to obtain a tax credit for wage increase (see section 6 below), may deduct the increased wage payments from the tax base of the Value Added levy.

## 4) Revision of the dividend exclusion system

The percentage of domestic dividends excluded from taxable income and the corresponding shareholding ratio shall be revised as follows.



## 5) Revision of the R&D tax credit

An overview of the current and the Proposed R&D tax credit measures is as follows:

| Current | Proposed |
|---|---|
| (1) General R&D costs<br>Credit limit (%): 8 to 10% (12% for SMEs) of R&D costs<br>Limit amount: 30% of corporate tax (20% for tax years beginning on or after 1 April 2015)<br>Excess credit: Carryforward for one year | (1) General R&D costs<br>Credit limit (%): 8 to 10% (12% for SMEs) of R&D costs<br>Limit amount: **25% of corporate tax**<br>Excess credit: **No carryforward available** |
| (2) Special R&D costs<br>Scope: R&D costs related to joint research with, and contract research performed by, governmental R&D institutions or universities<br>Credit Limit (%): 12%<br>Limit amount: same as (1) above (in aggregate with general R&D credit) | (2) Special R&D costs<br>Scope: **Expanded as follows:**<br>- **Definition of eligible SME contractors revised to include public interest corporations, organizations of local governments and local independent administrative agencies, etc.**<br>- **Royalties for the use of intellectual property paid to SMEs shall be included.**<br>Credit Limit (%): **20% or 30%**<br>Limit amount: **5% of corporate tax (in addition to (1) above)** |
| (3) Incremental/excess type tax credit (expires 31 March 2017)<br>Credit Limit (%): 5% of incremental R&D costs or a certain % of R&D costs in excess of 10% of the average sales<br>Limit amount: 10% of corporate tax | (3) No change |

## 6) Relaxation of requirements for wage increase tax credit

This measure was implemented under the 2013 tax reform and the requirements were relaxed under the 2014 tax reform. In the Proposal, the qualifying requirements have been relaxed in order to make the incentive more accessible.

An overview of this credit and revisions under the Proposal is as follows:

**Tax relief for the promotion of wage increases**

If the following conditions are met, a tax credit equal to 10% of an increase in wages paid to domestic employees may be applied (up to 10% of corporate tax (20% for SMEs))

Requirements

(1) Wage payments have increased compared to the base year* by at least the following percentage

| Current: Tax year beginning on or after | Current | Proposed: Tax year beginning on or after | Proposed: Large company | Proposed: SME |
|---|---|---|---|---|
| 1-Apr-2013 | 2% | 1-Apr-2013 | 2% | 2% |
| 1-Apr-2014 | 2% | 1-Apr-2014 | 2% | 2% |
| 1-Apr-2015 | 3% | 1-Apr-2015 | 3% | 3% |
| 1-Apr-2016 | 5% | 1-Apr-2016 | **4%** | **3%** |
| 1-Apr-2017 | 5% | 1-Apr-2017 | 5% | **3%** |

(2) Current year wage payments ≥ prior year wage payments

(3) Average wage payments per employee in current year > Average wage payments per employee in prior year

* The year prior to the first taxable year beginning on or after 1 April 2013

## 7) Establishment of tax incentives for relocation/expansion in local areas

Tax incentives shall be provided to companies which relocate their headquarter functions from major cities to local areas or expand their headquarter functions already existing in local areas. Specifically, if a company which files blue form tax returns and acquires buildings or structures or hires employees in a designated local area under a certified local revitalization plan pursuant to the Local Revitalization Act ("the Act"), such company may be entitled to the following incentives.

| Tax Incentive | | | | Other Conditions |
|---|---|---|---|---|
| **Building/Structure Acquisition** | | **Relocation** | **Expansion** | |
| Special Depreciation (Percent of acquisition value deductible in acquisition year) | | 25% | 15% | - Minimum cost - JPY 20 million (JPY 10 million for SMEs)<br>- Used in a business |
| Tax Credit (Percent of acquisition value creditable up to 20% of corporate tax liability) | Plan approved by 31 March 2017 | 7% | 4% | |
| | Other | 4% | 2% | |
| **Job Creation** | | | | |
| Tax Credit (Credit allowable up to 30% of corporate tax liability after aggregating with Building/Structure Acquisition tax credit and Job Creation credit under current law) | | JPY 200,000 or JPY 500,000 X increased number of employees (depending on conditions satisfied) | | - No lay offs in C/Y and P/Y.<br>- Minimum 5 (2 for SMEs) new employees in C/Y over P/Y<br>- 10% or more increase in employees in C/Y over P/Y<br>- C/Y total salary > P/Y total salary (with certain adjustments) |

These incentives will apply to assets acquired and jobs created under plans certified after the date the Act is enacted.

## 8) Measures supporting a shift to the attribution principle regarding PE taxation

The following measures, among others, shall be implemented to support the shift to the attribution principle regarding permanent establishment ("PE") taxation, a revision included in the 2014 tax reform and effective for tax years beginning on or after 1 April 2016:

- Interest on accounts receivable with the term of less than six months held by foreign companies shall not be considered domestic source income.
- If an internal dealing between a foreign company and its Japan PE constitutes the transfer or acquisition by the PE of an asset which would produce Japanese source income, even if the income is not attributable to the PE (e.g., gains or rental income from real property in Japan), then the transfer shall be deemed to be performed at the book value and the income attributable to the PE calculated accordingly.

These revisions shall be applicable to corporate tax for the tax years beginning on or after 1 April 2016 and individual income tax for the calendar year of 2017 and the subsequent years.

## 9) Disallowance of foreign dividend exclusion

In response to BEPS Action 2, dealing with hybrid mismatch arrangements[2], the foreign dividend exclusion shall no longer be applicable to foreign dividends which are deductible in the source country.

A foreign tax credit may be taken for foreign withholding tax on dividends to which the exclusion will no longer be applicable.

2 BEPS Action 2 (Neutralise the Effects of Hybrid Mismatch Arrangements) intends to prevent abusive arrangements that exploit the differences in the tax treatment of entities and financial instruments in different countries (e.g. payments that are deductible in the source country, but not taxable in the recipient country).

These proposed revisions shall be applicable to dividends received by Japanese companies from their foreign subsidiaries for tax years beginning on or after 1 April 2016. However, if dividends are received from shares held prior to 1 April 2016, the revision shall not apply to such dividends until tax years beginning on or after 1 April 2018.

### 10) Revision of the anti-tax haven rules

- The threshold effective tax rate that triggers the application of the anti-tax haven rules with respect to foreign subsidiaries shall be revised from “20% or lower” to “less than 20%”. This is significant as several jurisdictions, such as the UK and Vietnam, in which Japanese companies make strategic investments, intend to lower their corporate tax rate to 20%. This revision is applicable for tax years of the CFC beginning on or after 1 April 2015.
- Rules related to applying the regional headquarters exemption will be relaxed. This revision is applicable for tax years of the CFC beginning on or after 1 April 2015.
- Currently, in order to satisfy the exemption tests, various required documents must be attached to final tax returns. Under the Proposal, failure to file the various documents by the return filing deadline will not exclude a taxpayer from utilizing the exemption, provided the tax office agrees that there is a valid reason for the delay and that the documents are later submitted. This revision is applicable for tax years of the CFC beginning on or after 1 April 2015.
- In line with the revision of the foreign dividend exclusion system, a CFC, which receives dividends from a 25% or more shareholding that were deductible in the source country, may no longer exclude such dividend from its income when calculating the amount to be included in a Japanese shareholder’s taxable income under the anti-tax haven rules. This revision is applicable starting in the first tax year in which the CFC’s income may be included in a Japanese shareholder’s taxable income for tax years beginning on or after 1 April 2016.

**Deloitte’s view**

The overall impact of the Proposal on a corporate taxpayer will depend on that company’s specific tax position. Most will welcome the reduced corporate income tax rates, but may find some of the benefit eroded by an increase in higher non-income based taxes. Companies with carried forward NOLs will find it harder to recoup these losses and may face higher than forecasted cash tax liabilities. In light of these proposals, companies may want to start considering the following:

- Re-examine their capital structure and understand the impact that it has on overall cash taxes (including non-income based taxes) and NOL utilization.
- Recalculate deferred tax assets (“DTA”) using amended tax rates, and consider the impact of NOL restrictions on DTA recognition.
- For certain companies subject to NOLs limitations, it may make sense to consider accelerating income in order to utilize more NOLs to offset such income.

The Proposal may be the first of several proposals in the coming years that will focus on reducing the effective corporate income tax rate while broadening the tax base and increasing non-income based taxation. While the specific extent and timing of further rate reductions and base broadening measures is unknown, the government is aiming for an effective corporate income tax rate in the “twenties” within the next several years and has indicated it will investigate imposing further restrictions on, or eliminating certain incentives. These might include certain special depreciation allowances and tax credits under certain regimes, accelerated depreciation, SME NOL carryover rules, and imposing the factor-based enterprise tax regime on a broader range of companies. In addition, the government has clearly set out its commitment to the G20/OECD BEPS project. As a result, we expect the debate on the detail of future corporate tax reforms to continue strongly in 2015.

## Consumption Tax

### 1) Revision affecting cross-border digital services

Currently, the question of whether the supply of digital services is subject to JCT is determined by whether the office of the supplier is located in Japan. As a result, foreign suppliers may provide digital services without charging JCT, while the same services are subject to JCT when provided by Japanese suppliers. From 1 October 2015, digital services will be treated as provided at the office or domicile of the recipient, and as a result, supplies of such services by foreign suppliers to Japanese customers will also be subject to JCT putting foreign and Japanese suppliers on an even playing field. The following table compares the current and proposed rules:

| | Current | Proposed |
|---|---|---|
| Definition of digital services | Not clear whether the supply of digital content is provision of services or lease of copyrights | - Define as "provision of services provided via telecommunications networks," e.g., provision of e-books, online advertising services)<br>- Includes the licensing of copyrighted materials that does not involve the transfer or lease of the copyright |
| Place of supply of digital services | Where the office of the service provider related to the supply is located | Where the primary office or domicile of the service recipient is located |

Cross-border digital supplies will be categorized into B2C supplies and B2B supplies, and treated differently for JCT purposes.

| | B2B supplies | B2C supplies |
|---|---|---|
| Suggested definition | Supply of digital services that are clearly intended for businesses, given their nature and service terms | Supply of any digital services other than B2B supplies |
| Examples | Advertising services, legal services, cloud services for businesses | E-book distribution, video/music streaming, cloud services for individuals |
| Potential implications to foreign suppliers | - Reverse-charge mechanism* will apply<br>- Foreign suppliers must notify recipients that a reverse charge applies. | - Charge and collect JCT<br>- Appoint a JCT representative in Japan<br>- Pay JCT and file JCT returns<br>- Apply for registration with the NTA Commissioner |

*Japanese recipients, instead of suppliers, will be liable to account for output JCT on the supply

A foreign supplier registration system will be implemented for B2C supplies:

- A foreign supplier satisfying the following conditions may apply for registration with the National Tax Agency ("NTA") Commissioner.
  - (i) Has an office in Japan, or has appointed a tax representative in Japan.
  - (ii) Has no outstanding JCT liabilities, and at least one year has elapsed since the prior revocation of registration.
- Input JCT incurred on B2C supplies from non-registered suppliers will not be creditable.
- Applications for registration will be accepted from 1 July 2015.
- Information on registered companies (e.g., name, address, registration number, etc.) will be published on the internet.

The rules for determining JCT status[3] shall be amended:

- If the beginning of a company's base period is before 1 October 2015, the JCT taxable sales for the base period will be calculated as if the new rules had been implemented on the beginning date of that base period.
- If the above calculation is difficult, companies may use the JCT taxable sales for the period between 1 April 2015 and 30 June 2015 that would be accounted for if the new rules were in place during that period, multiplied by a factor of four, to determine their JCT status.

Other notable proposals related to JCT, include:

- Japanese recipients of B2B supplies with a taxable sales ratio (basically, the ratio of taxable sales to taxable sales + non-taxable sales) of 95% or more may disregard the supplies on their JCT return.
- JCT exempt enterprises receiving B2B supplies from foreign suppliers will not be liable to file and pay JCT on the supplies.
- From 1 April 2016, services related to entertainment and sports provided in Japan by foreign suppliers will also be subject to a reverse-charge.

## 2) Postponement of JCT increase to 10%

- The increase of the JCT rate to 10% was postponed from 1 October 2015 to 1 April 2017.
- The economic conditions clause giving the government discretion to further postpone or cancel consumption tax rate increases based on prevailing economic conditions has been removed.
- The threshold date to determine the applicability of the transitional measures regarding certain contract shall be 1 October 2016.

### Deloitte's view

The changes to the cross border digital services rules may have significant implications for foreign suppliers, and place additional burden on their resources. To prepare for the changes, foreign suppliers should start considering:

Whether they can properly categorize each customer as B2B or B2C and identify the location of each customer

Correct Invoicing and JCT reporting requirements and processes

Possible impact on accounting systems and their business operation

Implications of registering with the NTA

Along with some additional guidance on the implementation of the new digital services rules, we expect the government to focus some of its attention toward discussing a multiple JCT rate system over the next year.

3 Whether or not a company is a JCT taxpayer and required to file a JCT return is basically determined by whether it had JCT taxable sales of more than JPY 10 million in its base period (a fiscal year two fiscal years prior to the current fiscal year)

## Individual Tax

### 1) Establishment of "Exit Tax" on individuals leaving Japan

The Proposal introduces an "Exit Tax" aiming to prevent individuals from leaving Japan and moving to a low or no tax jurisdiction before selling appreciated securities. Financial assets, such as securities and investments, held as of the time of exit from Japan (meaning to cease to have an address, etc., in Japan) shall be deemed transferred at the time of the exit and unrealized capital gains on these securities and investments shall be taxed in Japan.

| | |
|---|---|
| Covered individuals | Japanese residents satisfying the following two conditions:<br>(1) Holds "covered assets" of JPY100 million or more.<br>(2) Has an address or domicile in Japan for more than five years within the past ten years preceding the date of the exit (does not include time when resident has certain residency status). |
| Covered assets | (1) Securities and investment under a *tokumei kumiai* agreement as provided for in the Income Tax Law<br>(2) Unsettled derivative transactions, margin transactions, etc. |

The following are some additional measures, among others, that will also be introduced as part of the exit tax regime:

- If a covered individual returns to Japan within the five years from the exit and still holds the covered assets, the tax imposed under this measure may be refunded if a request for correction is filed within four months after the return.
- Covered individual can defer the tax by providing collateral equal to the total tax that would be imposed under this measure and satisfies other conditions.

This measure shall be applicable to an exit taking place on or after 1 July 2015.

### 2) Increased requirements to claim a non-resident dependent exemptions

Additional documentation requirements will be imposed on resident claiming non-resident dependent exemptions, and will be effective from 1 January 2016. Specifically, documents proving family relationship and showing cash transfers supporting the dependent must be submitted as part of the tax return or shown to the tax office.

**Deloitte's view**

As foreign nationals are not precluded from the definition of a covered individual, each foreign national should determine whether he/she is (or will be) a covered individual prior to exiting Japan. U.S. citizens, who are covered individuals, are not likely to be impacted by this proposal from a tax cost perspective. This is because U.S. citizens are taxable in the U.S. on gains from the sale of covered assets regardless of where they are resident, but may be required to comply with various administrative procedures. For other foreign nationals, the tax costs will depend on which jurisdiction the foreign national relocates to. For example, foreign nationals who relocate to a jurisdiction that does not impose tax on the transfer of covered assets are likely to be required to recognize any unrealized gain/loss.

There are several relief measures that could apply to prevent potential double taxation, but it is not yet clear what documentation will be needed from taxpayers to apply such measures. It is clear, however, that the administrative burden of tracking gains and filing claims will likely be high.

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Not all articles or facts and circumstances are covered in this alert. If you have any questions regarding your specific situation, please contact one of the tax professionals at our Deloitte office in Tokyo as follows:

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