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2016 Asia Pacific Tax Update

Japan

1. Introduction

This paper provides an overview of recent developments in Japan from a tax perspective. Specifically, this paper discusses the most significant Japanese corporate, consumption, individual, and inheritance/gift tax reforms, important developments in Japan's treaty network, and other developments in Japan tax policy and practice.

2. Summary of Significant Developments

A summary of key developments, as discussed in greater length in this paper, is as follows:

- Corporate effective tax rate reduced from 32.11% (33.10% in Tokyo) in 2015, to 31.33% (32.26% in Tokyo) in 2016. (See 3.1.1.)
- The maximum amount of annual income that can be sheltered using NOLs reduced to 65% (from the previous 80%) effective 2015, to be further reduced to 50% of annual income going forward. (See 3.1.2.)
- New Local File, Master File, and CBC reporting requirements come into effect. (See 3.3.1.)
- Significant changes to Japan's consumption tax rules -- including introduction of multiple rates and an invoice system, and an increase in the current flat rate from 8% to 10% -- delayed yet again (See 3.2.1.)
- Going forward, possibly significant changes to Japan's CFC rules, and earnings stripping rules, on the horizon? (See 5.)

3. Tax – Overview of Recent Revisions

3.1 Corporate Tax

3.1.1 Corporate Tax Cut

Japan's effective corporate tax rate was previously cut to 32.11% (33.06% in Tokyo) for fiscal years starting on or after April 1, 2015. The rate has been further reduced to 29.97% (30.86% in Tokyo) for fiscal years starting on or after April 1, 2016.[1]

	April 1, 2015	April 1, 2016	April 1, 2017	April 1, 2018
Standard	32.11%	29.97%	29.97%	29.74%

[1] Even where a corporation has no taxable income, a local enterprise tax based on the amount of capital and the added value (e.g. wages and interest expenses) of a corporation applies. Under the 2015 Tax Legislation, somewhat offsetting the effect of the decrease of tax based on income discussed above, applicable rates of this factor-based local enterprise tax increased.

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Tokyo	33.06%	30.86%	30.86%	30.62%

3.1.2 Net Operating Losses ("NOLs")

Under the 2015 tax reform legislation, the length of time a company is permitted to carry forward NOLs incurred in fiscal years starting on or after April 1, 2017 was increased to **<u>10 years</u>**. The amount of taxable income that can be sheltered by such NOLs, however, was reduced under the 2016 tax reform, as set out below. Please note that small and medium enterprises whose stated capital is JPY 100 million or less (excluding those whose 100% parent company's stated capital is JPY 500 million or more) are not subject to the limitation and are allowed to use NOLs to shelter 100% of their taxable income.

2015 Tax Reform		2016 Tax Reform	
April 1, 2015 - March 31, 2017	65%	April 1, 2015	65%
		April 1, 2016	60%
April 1, 2017	50%	April 1, 2017	55%
		April 1, 2018	50%

3.1.3 Director's Compensation

Deductibility of director's compensation has long been an issue creating difficulties for foreign corporations operating through subsidiaries in Japan, as there are stringent requirements to allow Japanese companies to deduct director's compensation.

New rules have been passed which slightly reduce the procedural burdens associated with enabling a company to obtain a deduction for director's compensation; specifically, with respect to the following:

(i) Fixed compensation, regarding which the company must notify the tax authorities in advance in order to be deductible:

Certain restricted shares granted as compensation for future services performed by directors will be exempted from the requirement of advance notification in order to be deductible.

(ii) Profit based compensation, calculated based on parameters and otherwise satisfying certain conditions, which allow the compensation to be deductible with notice:

The rules are clarified to note that parameters such as ROE (return on equity) are acceptable for a company to calculate such profit-based equity.

Even with the above, many taxpayers have indicated that additional changes, serving to reduce the administrative and practical burdens associated with deductibility of director's compensation further, are warranted.

3.1.4 National Strategic Special Zones

The National Strategic Special Zones Act allows advantages to companies that set up operations in a zone designated by the national government as ones that will boost the international competitiveness of industry and promote the creation of centers of international economic activities. The government thus gives priority to advancing structural reform of the economic system in certain areas. For example, the national government has designated the Tokyo Area zone as the Tokyo Metropolis and Kanagawa Prefecture, and in Chiba Prefecture Chiba City and Narita City. The program has been in effect for a number of years, and the rules of the program have been renewed each year.

A special income deduction, calculated as 20% of income, will be available to eligible companies satisfying the requirements for five-years from the date of establishment. The requirements are that the company is a blue return[2] filing Japanese company which satisfies the following conditions:

- The company is established after the designated date of the relevant national strategic special zone;
- The company has its head office (or a main office) in the national strategic special zone;
- The company engages in certain specified businesses;
- The Minister of the State for the National Strategic Special Zone designates the company as eligible for the benefit with respect to the period of the effective date of the revised National Strategic Special Zones Act until March 31, 2018.

A corporation taking advantage of certain other incentive programs are not eligible for the above described tax incesntive.

Additionally, Certain changes have been incorporated into the rules originally passed in 2014 allowing tax advantages to companies that make certain investments in national strategic special zones. Specifically, eligible companies may now take advantage of special depreciation rules with respect to the total acquisition costs (expensed upfront) of certain machinery and R&D equipment / fixtures.

3.1.5 Other Amendments

(i) Deductibility of Entertainment Expenses

In Japan, there are limits to the amount of "entertainment expenses" (*i.e.*, expenses incurred in wining and dining customers or clients) that a company may deduct. Under the latest tax reform, the currently applicable rules will be extended for an additional two years. Specifically, small and medium-sized companies[3] may deduct 50% of entertainment expenses incurred, up to a total of JPY8M per year. Companies other than "small and medium-sized companies" may deduct 50% of such expenses without the JPY8M cap.

(ii) Deductibility of Restricted Shares

[2] Japanese companies may apply for "blue return" tax filing status (as opposed to the standard "white return" tax filing status). Blue return tax filing status accords the filer certain advantages, such as the ability to carry forward NOLs and a one month extension to file annual returns.

[3] A small or medium-sized company is one with stated capital of JPY 100M or less, except for companies whose shares are (a) 100% owned directly or indirectly by one "large-sized company" (whose stated capital is JPY 500M or more), or (b) 100% owned by two or more large-sized companies within the same 100% ownership group.

There was a change to the timing with which a company may take a deduction for costs associated with the granting of restricted shares to individuals as compensation for future services. Now a company may take a deduction for the costs in the year in which the restricted shares are vested. This will apply to restricted shares granted in accordance with corporate resolutions passed on or after April 1, 2016.

(iii) Lump-Sum Depreciation of Small Assets by Small and Medium-Sized Companies

Where small and medium-sized acquire small depreciable assets with a value of less than JPY 300,000, they may take advantage of lump-sum depreciation in the fiscal year when the companies put the assets into use in the business. Under the latest tax reform, companies with more than 1,000 regular employees will no longer be eligible for the rule. Additionally, the applicability period of the rule was extended for two-years.

3.2 Japanese Consumption Tax ("JCT")

3.2.1 Delay Again of Increase in JCT Flat Rate from 8% to 10%

The JCT rate increased from a flat 5% to a flat 8% from April 1, 2014, and was scheduled to be increased to 10% from April 1, 2017. The increase has now been delayed until October 1, 2019.

3.2.2 Significant Changes (Invoicing Requirements, Multiple Rates) to be Introduced Going Forward

Concurrently with the overall increase in the rate, other significant changes to the JCT system had been considered, including introduction of multiple rates (*i.e.*, reduced rates for food and other consumables), and an invoicing system. Implementation of these changes were delayed along with the delay in the overall increase in the JCT rate.

A cabinet proposal adopted on August 24, 2016 and submitted to the Diet on September 26, 2016 formally set out these proposals. Specifically, a reduced consumption tax rate system applicable to food and other consumables of 8% (after the standard rate has been increased to 10%) will be introduced under the system. The proposal is for multiple rates to go into effect from October 1, 2019. In addition to the reduced consumption tax rate system, an invoice system would go into effect from October 1, 2023.

For some period beginning with the introduction of the reduced consumption tax rate system, until commencement of the invoice system, transitional measures will be available to small and medium sized enterprises due to the expected administrative burden of complying with the new rules. Having said that, the introduction of multiple rates into a system that has until this time had only a single flat rate, coupled with a new invoicing system, will likely lead to a number of complexities for taxpayers going forward.

3.3 International Tax

3.3.1 Transfer Pricing Documentation Requirements

(i) Local File Requirements

Where a Japanese company's total related party transactions exceed JPY 5 billion, or its related party intangible transactions exceed JPY 300 million, the company will be subject to "Local File" contemporaneous documentation requirements. The company would be required to provide this documentation upon request of an auditor (within a maximum of 45 days); if it failed to do so, the tax authorities can use "secret comparables" to make an assessment. Even if a Japanese company does not meet the transaction volume thresholds that would subject it to contemporaneous documentation requirements, the company would still be required to produce TP documentation within 60 days of a request made by auditors in an audit, or face the same results – potential TP assessment through the use of secret comparables.

Local File requirements come into effect with respect to fiscal years of Japanese entities commencing on or after April 1, 2017.

(ii) Master File Requirements

A Japanese company must submit a "Master File" to the Japanese tax authorities if the global MNC's worldwide group revenue was JPY 100B or more in the parent company's previous year.[4] The filing is due within one year of the end of the ultimate parent company's FYE. The rules comes into effect with respect to fiscal years commencing on or after 1 Apr 2016.

(iii) CBC Report (and Japan notification)

If a non-Japanese affiliate of a Japanese company files a CBC Report in another jurisdiction, there is no need for the Japanese company to file the CBC Report in Japan. There is, however, a requirement for the Japanese entity to submit a type of Japanese language notification to the Japanese tax authorities if the worldwide corporate group had consolidated revenue (US parent's consolidated F/S for US GAAP and securities purposes) of JPY 100B or more in the preceding fiscal year, even though the Japanese entity is not the entity in the MNC that is submitting the CBC report. This notification must be submitted by the Japanese entity by the last day of the ultimate parent entity's fiscal year, and does not require the type of detailed financial information that the CBC report itself requires; rather, the notification requires basic information regarding the entity that will be making the CBC filing for the MNC group.

Due to a difference in the deadline to make CBC filings, it may be necessary for a non-Japanese affiliate of a Japanese company to file a CBC report in a jurisdiction outside of Japan before the Japanese CBC rules come into effect. To explain, as noted above, it will be necessary for a Japanese company to file a Japanese language notification to the Japanese tax in the case a CBC report is filed for the MNC in another country (such as the US), assuming the JPY 100B threshold is met. However, the requirement for a Japanese company to file such a notification comes into effect with respect to fiscal years commencing on or after April 1, 2016. Thus, with the understanding that, for example, a US entity making a CBC filing in the US is a calendar year taxpayer, the Japanese affiliate will have to submit a Japanese language notification to the Japanese tax authorities by December 31, 2017, with respect to the US company's CBC filing in the US covering the FYE 2017. If the US affiliate is making a CBC filing in the US with respect to its FYE 2016, however, the Japanese company will not be required to make a Japanese language informational filing with respect to such CBC Report. (Thus, in this example, the informational filing will be due in Japan by December 31, 2017, with respect to the CBC Report presumably to be filed in the US sometime in 2018.)

3.3.2 Change from the Entire Income Approach to the Attributable Income Approach, with respect to Taxation of a Japanese PE

[4] (Note that the JPY100B threshold is calculated by multiplying MNC global revenue as calculated in the parent's currency by the JPY FEX rate.)

Under previous tax legislation, Japan's taxation of a permanent establishment ("PE") of a foreign corporation or a foreign individual was changed from the entire income approach (under which all taxable Japanese source income is taxed regardless of its attribution to a PE in Japan) to the attributable income approach (under which only taxable Japanese source income attributable to a PE in Japan is taxed). In addition, the arm's length principle will apply to intra-company transactions between a company's headquarters (and PEs located other than in Japan) and a PE in Japan.

For foreign corporations, the new rules will apply from fiscal years beginning on or after April 1, 2016. For foreign individuals, the rules will apply from the 2017 calendar year with respect to national tax, and 2018 with respect to local tax.

3.3.3 Changes to Japanese CFC Rules

Certain refinements were implemented to Japan's CFC rules. Specifically, two changes came into effect.

- A Japanese company is currently eligible to take a foreign tax credit with respect to the foreign corporation taxes paid by its CFCs (specifically, CFCs whose income is otherwise subject to immediate inclusion in Japan under the CFC rules); under the latest tax reform, the formula under which a Japanese company may take this FTC has been amended.

- Clarification to the substance test, administration and control test, and the unrelated party test that are exceptions to the general requirements of a Japanese company to take into income currently the income of its CFC, in the specific case of <u>an insurance business operating in the UK Lloyd's market</u>, and which satisfies other conditions.

3.3.4 Changes to Scope of Tax Qualified Contributions-In-Kind

Certain changes were implemented to the scope of transactions eligible for tax qualified (*i.e.*, tax deferred) treatment. One such change involves the transfer by a Japanese or foreign company of Japan assets (specifically, of real estate located in Japan, and other assets attributable to an office in Japan, but excluding shares in a foreign company, whose total shares are owned more than 25% by the transferor company).

Where the transferee is a foreign company, the transfer is in principle non-tax qualified, but can be tax qualified if the transferor Japanese / Foreign company transfers the Japan assets to a PE located in Japan of another foreign company in a contribution-in-kind making all of the assets directly attributable to such PE, and there is an expectation that the Japan assets will not be transferred again after the contribution-in-kind.

3.4 Individual Income Tax

3.4.1 Revision to Exit Tax Rules

Under the 2015 tax reform Japan introduced a so called "exit tax", payable by certain high net worth individuals that expatriate from Japan, effective July 1, 2015. There have been several revisions to the exit tax system, including notably that stock options are excluded from applicable securities.

3.4.2 Revision to Reporting System regarding Stock Options of Foreign Corporation

Where directors or employees of Japanese subsidiary or branch of a foreign corporation receive equity related income, the subsidiary or branch is required file a report. The scope of persons with respect to whom such report applies has been increased to include the following:

- Resident individuals who were directors or employees of Japanese subsidiary or branch of a foreign corporation.
- Non Resident individuals who are directors or employees of Japanese subsidiary or branch of a foreign corporation and receive equity related income sourced in Japan.

3.4.3 Changes to Inheritance Tax Rules

3.5 Other

3.5.1 Increase in Penalties

- Penalties are imposed/increased where an amended tax return is filed after receiving an audit notification.

	Until audit notice	Audit notification to expectation of assessment		After expectation of assessment
		Previously	Now	
Penalties on underreporting	0%	0%	5%, 10%	10%, 15%
Penalties on failure to file tax return	5%	5%	10%, 15%	15%, 20%

- As noted above, the penalty for failure to file tax return is 15% or 20%, and the "heavy" additional tax is 35% or 40%. These penalties are increased by 10% in the case of 'repeat offenders'; *i.e.*, where taxpayers have been assessed such penalties previously within last 5 years. (Thus, in the case of a repeat offender, the maximum penalty rate is 45% or 50%.)

3.5.2 Changes to Delinquency Tax

Based on a Supreme Court decision handed down on December 12, 2014 with regard to the calculation period of delinquency tax, the below revisions were incorporated into the tax law.

Where a downward correction is first made by the tax authorities after a taxpayer has filed a tax return (*i.e.*, the authorities reduce the amount of taxable income on a return), but the tax authorities subsequently make an upward correction to the same return (or the taxpayer files an amended return declaring additional income):

- delinquency tax is not imposed on the tax payable due to the upward correction/filing of the amended tax return, up to the amount declared on the original tax return, from the date of tax payment through the date of upward correction/amended tax return.

- the underreporting penalty is only imposed on that portion of tax payable due to the upward correction/amended tax return exceeding the tax declared on the originally filed tax return.

3.5.3 Tax Payment with Credit Card

Payment of national tax via credit card has been introduced.

3.5.4 Increase in Tax Exemption Allowance for Commuting Expenses

Currently, one may exclude up to JPY 100,000 per month for commutation expenses. With effect for commutation allowances paid by corporations on or after January 1, 2016, the excludable allowance limit has been increased to JPY 150,000 per month.

4. Treaty Developments

4.1 New Tax Information Exchange Agreements

Country	Tax Information Exchange Agreements ("TIEA")
Panama	New TIEA was signed on August 25, 2016.
Switzerland	Joint statement on automatic exchange of financial account information beginning in 2017 was signed on January 28, 2016

4.2 Treaties – Overview of Developments

Country	Treaties
Belgium	Revised treaty was singed on October 12, 2016.
Chile	New tax treaty was signed on January 22, 2016.
Germany	Revised treaty entered into force on October 28, 2016 (with effect on or after January 1, 2017).
India	Protocol to amend the tax treaty will enter into force on October 29, 2016 (with effect on or after January 1, 2017 in Japan, and April 30, 2017 in India).
Qatar	New tax treaty entered into force on December 30, 2015 (with effect on or after January 1, 3016).
Slovenia	New treaty was signed on September 30, 2016.
Taiwan	New treaty entered into force on June 13, 2016 (with effect on or after January 1, 2017). (*) A framework equivalent to a tax convention is established in combination of (1) a private-sector arrangement between the Interchange Association (Japan) and the Association of East Asian Relations (Taiwan) and (2) Japanese domestic legislation to implement the provisions of that private-sector arrangement in Japan. (Quoted from Ministry of Finance HP)

5. Tax Proposals Being Considered for Possible Inclusion in 2017 Legislative Reform

5.1 Strengthening of CFC Rules

In response to the Final paper of BEPS Action 3, the Japanese government has been discussing strengthening Japan's existing CFC rules in the next round of tax reforms (2017). According to materials released by the Government Tax Commission (GTC) in its September 29 and October 14, 2016 meetings, the GTC has concerns that under the existing CFC rules, a number of issues potentially exist. *Possible issues under the current rules include*:

- A CFC's passive income will not be treated as subject to Japan's CFC rules if the CFC satisfies the CFC exemption criteria (*i.e.*, underinclusion), while some income derived from CFC's active businesses may be aggregated with the Japanese parent company's taxable income when the company's effective rate is lower than the trigger rate of 20% (*i.e.*, overinclusion), and

- Existing CFC rules allow taxpayers to circulate funds derived from intangibles etc. into Japan with little or no tax by utilizing the foreign dividend exemption system - a Japanese parent company transfers intangible assets to a foreign subsidiary located in a jurisdiction with a tax rate only slightly higher than 20% (*i.e.*, the current CFC trigger rate), and the subsidiary then remits profits from the intangibles as dividends to the parent company.

In light of the above, the GTC proposed switching from an entity approach to an income approach, under which a CFC's income to be divided into passive and active income categories; the passive income would be subject to the CFC rules, while active income would be excluded, notwithstanding the current trigger tax rate. The GTC also proposed introducing new CFC exemption criteria to replace (or complement) the existing trigger rate.

5.2 Strengthening of Japanese Earning Stripping Rules

Japan has long had "thin cap" rules, which disallow a Japanese corporation from taking interest deductions on related party debt in excess of a 3:1 debt:equity ratio. Japan also has detailed transfer pricing rules that disallow a interest among related parties that is at other than an arm's length rate. Finally, Japan introduced “earning stripping provisions” in 2012, which disallow a Japanese corporation from taking a deduction for interest amounts to a foreign related party in excess of 50% of the Japanese company’s taxable income.

There has been discussion among public officials of reducing the threshold under the earning stripping provisions from the current 50% to 30%, 20% or even 10%

It is unclear which, if any, of the above proposals will ultimately be introduced. The Tokyo Office of Baker & McKenzie will provide updates as new developments take place.

5.3 Introduction of New "Tax Qualified" Spin-Off Rules

There is talk of the Japanese authorities possibly introducing a new type of “tax qualified spin off rule” in the next (2017) tax reform.

Under the current rules, where a spin off results in two unrelated entities (in separate corporate groups), and the spinoff does not satisfy certain “deemed joint venture” rules (which contain continuation of business and other requirements) there is no way for the spin off to be treated as tax qualified.

The rules being considered would address a situation in which a publicly traded company has (for example) one business line that does well, and another business line that is doing poorly. The publicly traded company would possibly like to spin off the underperforming business line from the company, as the underperforming business may be dragging down the company’s stock price. Assume further that there is no buyer immediately available for the underperforming business line. Under the new rules being considered, the company would be able to spin off the business into a new company, resulting in the current shareholders holding shares of both the original company, and of the newly spun-off company. Thus, the two companies (original and spun off) would have the same public shareholders, but would be in two separate corporate groups.

5.4 Possible Changes to Japanese Inheritance and Gift Tax Rules

Currently, under Japan's inheritance and gift tax rules, a foreigner residing in Japan for even a brief period of time will be subject to inheritance and gift tax rules if either the foreigner him or herself becomes deceased, or the foreigner receives an inheritance or gift of either Japan-situs or non-Japan-situs assets. This system has served as a disincentive to non-Japanese high net worth individuals relocating to Japan even temporarily to work in management of Japanese or non-Japanese companies. The government is currently mulling a revision to the current inheritance and gift tax law to address this issue.

5.5 Possible Changes to Director's Salary and Bonus Deductibility Rules

Under current Japanese tax rules, a company may not variable director's compensation, or director's bonuses, unless very stringent and difficult to comply with rules are followed. The government is currently mulling incorporating changes to these rules to allow for more flexibility in the payment of director's compensation, that would be deductible to the payer Japanese company.