March 2013

Japan tax newsletter

Ernst & Young Shinnihon Tax

2013 Japan tax reform outline

Content

Introduction

On 24 January 2013, the Liberal Democratic Party and its coalition partner New Komeito Party unveiled the 2013 tax reform outline. The outline was approved by the Abe cabinet on 29 January 2013. The tax reform bill was drafted based on the outline and submitted to the Diet as a tax reform proposal on 1 March 2013. It should be noted that adjustments, rescissions, and additions may result from the forthcoming discussions on the tax reform bill in the Diet. The outline includes corporate tax, inheritance and gift tax, securities transactions and international tax, and a wide range of incentives for new investment and hiring.

I. Corporate taxation

1. 30% depreciation or 3% tax credit for new machinery and equipment

To encourage new investment in manufacturing facilities, the outline provides for 30% depreciation or a 3% tax credit for the acquisition cost of manufacturing machinery and equipment if the following two conditions are satisfied (see also Chart 1).

(1) The current year total investment in manufacturing goods and equipment exceeds the current year total depreciation expense.

(2) The current year capital expenditure for manufacturing goods and equipment has increased by 10% in comparison to the prior year.

This incentive is capped at 20% of the national corporate tax liability and is available for corporations that file a blue tax return for taxable years beginning on or after 1 April 2013 through 31 March 2015, excluding the year of formation.

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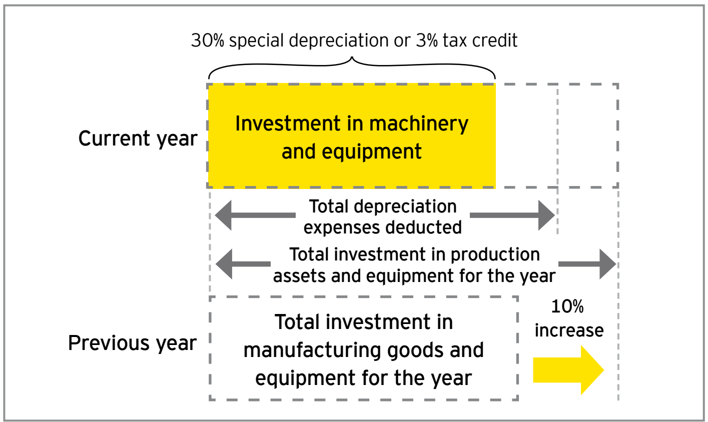
Chart 1



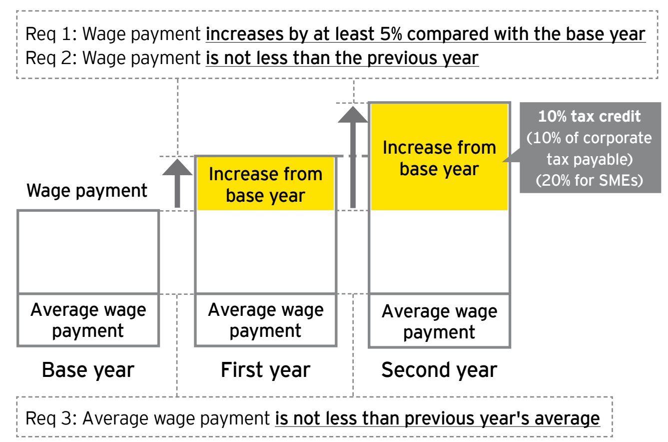
2. 30% depreciation or 7% tax credit for capital investments improving trade and service operations of SMEs

For small and medium sized enterprises ("SMEs")[1] making capital investments to improve their trade and service operations, 30% depreciation or a 7% tax credit is provided on qualified investments. Qualified investments include renovations of retail and service outlets, i.e. capital expenditures for furniture and fixtures and facilities and buildings. The investments should be made pursuant to guidance and advice provided by the chamber of commerce, etc. The incentive is available for corporations that file a blue tax return for taxable years beginning on or after 1 April 2013 through 31 March 2015. The 7% tax credit is capped at 20% of the SMEs' national tax liabilities and only SMEs with a share capital of JYP 30 million and less are eligible for the tax credit.

3. Tax credit for wage increases

Under the outline, a taxpayer can claim 10% of the amount of wage increase as a tax credit if the increase is at least 5% from the base amount (as referred to in chart 2) and certain conditions are satisfied. The maximum amount of credit is limited to 10% of the corporate tax liability (20% in the case of SMEs[2]). This credit is available for corporations that file a blue tax return for taxable years beginning on or after 1 April 2013 through 31 March 2016.

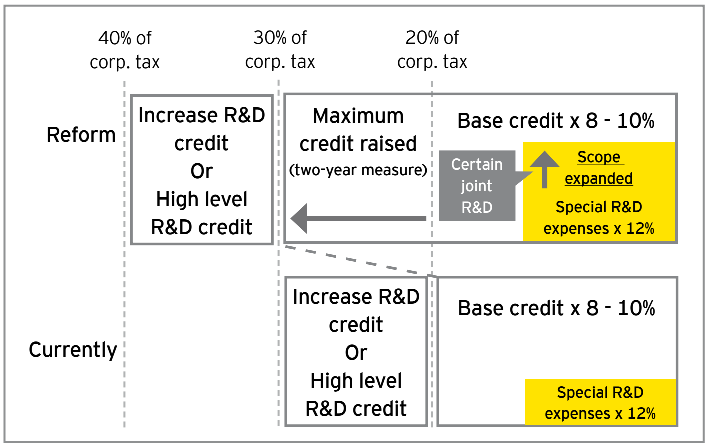
Chart 2



Source: *2013 Tax Reform*, January 2013, Ministry of Economy, Trade and Industry

4. Increase in research and development ("R&D") credit

Under the outline, the maximum R&D credit will be increased from 20% to 30% of a corporation's tax liability. Furthermore, eligible expenses will be expanded to include joint research conducted between corporations based on certain contractual arrangements, such as cost sharing agreements.



1 SMEs for the incentives purposes are defined as corporations, whose paid-in capital is JPY 100 million or less (not owned 50% or more by a corporation whose paid-in capital is more than JPY 100 million, or two-thirds or more by corporations whose paid-in capital is more than JPY 100 million, etc.)

2 The definition of SMEs for the credit purposes are same as 2 above.

5. Expansion of recruiting tax incentives

Currently, a tax credit of JPY 200,000 per newly hired employee is available for a company that increases its number of regular employees by 10% or more and by at least 5 employees over the prior year. Regular employees are employees subject to social security and for whom confirmation by the labor standard office is obtained. As an additional hiring incentive, the outline increases the tax credit for each newly hired employee to JPY 400,000 and provides that the definition of regular employees will be more precisely defined.

6. Tax treatment of entertainment expenses made by small and medium sized enterprises

Under Japanese corporate tax rules, corporate expenses incurred to cater guests and employees are subject to various tax rules and are classified in various categories depending on the purpose, attendees and alcohol consumption. Such categories include fully tax-deductible meeting expenses, social welfare and fringe benefits. If expenses for meals exceed JPY 5,000 per person, such expenses are treated as "entertainment expenses." Large corporations cannot deduct entertainment expenses, while SMEs[3] can currently deduct 90% of their entertainment expenses up to JPY 6 million per year. For SMEs[3], under the outline, the deduction is increased to 100% of their entertainment expenses with a cap of JPY 8 million per year. For entertainment taxation purposes, an SME is defined as a corporation whose paid-in capital is JPY 100 million or less, regardless of whether the corporation is a wholly owned subsidiary of a large corporation.

3 SMEs for entertainment taxation purposes are defined as corporations whose paid-in capital is JPY 100 million or less and who are not a wholly owned subsidiary of large corporation(s) (either Japanese or non-Japanese) whose paid-in capital is JPY 500 million or more at the fiscal year end.

II. Inheritance tax and gift tax

1. Review of the basic exemptions and tax rate structure of inheritance tax

The outline changes the inheritance tax exemption, the tax rate and the tax rate structure. The current JPY 50 million basic inheritance tax exemption will be reduced to JPY 30 million. A graduated tax rate structure comprised of eight levels is being introduced with the top tax rate increasing to 55%. This reform is applicable to properties inherited on or after 1 January 2015.

Current		Draft revision	
Statutory inheritance amount of the statutory inheritor	Tax rate	Statutory share of the heir	Tax rate
Amounts up to JPY 10m	10%	Same as left	
Amounts up to JPY 30m	15%	Same as left	
Amounts up to JPY 50m	20%	Same as left	
Amounts up to JPY 100m	30%	Same as left	
Amounts up to JPY 300m	40%	Amounts up to JPY 200m	40%
		Amounts up to JPY 300m	45%
Amounts over JPY 300m	50%	Amounts up to JPY 600m	50%
		Amounts over JPY 600m	55%

2. Rules on residential properties, minors, etc.

For specified residential property, etc., a special reduction of 20% of the official land appraisal price applies to property with a surface area of up to 240 m^2. This size limitation is being increased to 330 m^2.

The deduction for heirs who are minors will be increased from JPY 60,000 per year of age (up to 20 years) to JPY 100,000. For heirs with a disability the deduction will be increased from JPY 60,000 per year of age (up to 85 years) to JPY 100,000 (JPY 200,000 in the case of special disabilities).

(1) Deduction for under-age inheritors

Current	Draft revision
Number of years of age until age 20 x JPY 60,000	Number of years of age until age 20 x JPY 100,000

(2) Deduction for inheritors with disabilities

Current	Draft revision
Number of years of age until age 85 x JPY 60,000 (JPY 120,000 in case of special disability)	Number of years of age until age 85 x JPY 100,000 (JPY 200,000 in case of special disability)

The above reforms will primarily be applicable to properties acquired through inheritance or testamentary bequest on or after 1 January 2015.

3. Review of the tax rate structure for inter-vivos gifts

For gifts received inter-vivos from parents, grandparents, and other lineal ascendants, the tax rate will be reduced for gifts in the bracket of amounts over JPY 3 million to amounts up to JPY 30 million. In alignment with the increase in the top inheritance tax rate, the top gift tax rate will also be increased to 55% and two additional tax brackets will be introduced.

(1) Case of gift from lineal ascendance to donees aged 20 or higher

Current		Draft revision	
Assessed value	Tax rate	Assessed value	Tax rate
Amounts up to JPY 2m	10%	Same as left	
Amounts up to JPY 3m	15%	Same as left	
Amounts up to JPY 4m	20%	Amounts up to JPY 4m	15%
Amounts up to JPY 6m	30%	Amounts up to JPY 6m	20%
Amounts up to JPY 10m	40%	Amounts up to JPY 10m	30%
Amounts over JPY 10m	50%	Amounts up to JPY 15m	40%
		Amounts up to JPY 30m	45%
		Amounts up to JPY 45m	50%
		Amounts over JPY 45m	55%

(2) Gift tax rate structure on gifted properties other than in (1) above

Current		Draft revision	
Assessed value	Tax rate	Assessed value	Tax rate
Amounts up to JPY 2m	10%	Same as left	
Amounts up to JPY 3m	15%	Same as left	
Amounts up to JPY 4m	20%	Same as left	
Amounts up to JPY 6m	30%	Same as left	
Amounts up to JPY 10m	40%	Same as left	
Amounts over JPY 10m	50%	Amounts up to JPY 15m	45%
		Amounts up to JPY 30m	50%
		Amounts over JPY 30m	55%

Note: The above reforms will become applicable to gift tax on properties acquired as a gift on or after 1 January 2015.

4. Other gift tax changes

The conditions for the application of the unified inheritance and gift tax system under the gift taxation will be expanded. The eligibility of donees will include grandchildren aged 20 years and older (currently only children of donors are included) and the required age of the donor will become 60 years and older (currently 65 years and older). This reform is applicable to gift tax on properties acquired as a gift on or after 1 January 2015.

An exemption from gift tax for up to JPY 15 million of education funds per donee under 30 years old, has been added. The funds must be placed in a trust, etc., with a financial institution by a lineal ascendant during the period of 1 April 2013 to 31 December 2015. Up to JPY 5 million of the JPY 15 million funds can be paid to a person, other than to school, etc. It should be noted that unused balances remaining in trust on the date the donee becomes 30 years old will be deemed taxable.

5. Business succession

In order to facilitate the utilization of the inheritance tax and gift tax rules for business successions resulting from transferring unlisted stocks, etc., the previously strict requirements for eligibility, which hampered smooth business successions, will be significantly eased. The measure for the employment assurance requirement will change to 80% or higher of average retention over a five year period, rather than annual retention of 80% for every year for five years. Further, eligibility will be expanded to include successors who are not family members. The new rules will apply to properties acquired through inheritance, testamentary bequest or gift on or after 1 January 2015.

III. Income tax

1. Increase of the top income tax rate

Beginning January 2015, the top national income tax rate for taxable income exceeding JPY 40 million will be 45%. "Income disparity" and the need to "redistribute income" are cited as the reasons for the increase by the Liberal Democratic Party. As a result, the combined marginal income tax rate, including local tax and reconstruction surtax, will become approximately 55.9%. In comparison to the 2012 marginal income tax rate of approximately 47.5%, this is an increase of 8.4% (combining the effect of the cap on the employment income deduction, the 1 January 2013 introduction of the reconstruction surtax and increase of the top income tax rate).

2. Assets and liabilities statement

Taxpayers with total annual income in excess of JPY 20 million, are required to include a statement of assets and liabilities with their tax return filing. Currently, the statement is required to disclose public and corporate bonds and stocks, etc., at face value. Under the outline, the disclosure methodology for such assets would change to market value. This change is intended to achieve consistency with the regulations for the foreign properties survey statement created in the 2012 revision which take effect 1 January 2014.

IV. Taxation of finance and securities

1. Fundamental reform of taxation method to achieve integration of taxation on financial income

(1) Taxation method for bonds

In general, capital gains or losses arising from the transfer of bonds are currently not subject to tax. On or after 1 January 2016, capital gains or losses arising from the transfer of specified bonds will be subject to the 20% tax. However, the interest and capital gains or losses from specified bonds can be offset by dividends and capital gains or losses from listed shares in calculating the amount of financial income. Specified bonds include JGBs, local government bonds, foreign government bonds, listed or publicly offered corporate bonds, corporate bonds issued by companies filing securities reports and others. Capital gains or losses arising from the transfer of bonds other than specified bonds will be subject to the 20% tax, though they cannot be offset by interest from bonds and dividends and capital gains or losses from listed shares.

(2) Taxation method for discount bonds

In general, profits from redemption of discount bonds are currently subject to 18% withholding tax at the time of issuance, while capital gains or losses arising from transfer of discount bonds are disregarded for tax purposes. Due to such withholding tax at the time of issuance, discount bonds are seldom issued in practice, except short-term discount bonds like TB or CP, which are not subject to such withholding tax. On or after 1 January 2016, 18% of the withholding tax at the time of issuance will be eliminated and instead, profits from the redemption of discount bonds as well as capital gains or losses arising from the transfer of discount bonds will be subject to the 20% tax.

Beginning 1 January 2016, the disparate taxation method for bonds and shares will become integrated. At the same time, the scope of netting financial income will be expanded to include interest and capital gains or losses from specified bonds and dividends and capital gains or losses from listed shares. This development marks a big step forward in the integration of the taxation of financial income. It also means that all at once the various practical issues will be resolved that have been inherent to the current taxation method for bonds, including the issue of withholding taxation of discount bonds at the time of issuance. For the future taxation of finance and securities this reform can be called epoch-making and will prove hugely significant. It should be noted that, based on this latest reform which includes bonds, deliberations will continue for the further integration of financial income from derivatives, with a view to contribute to the creation of a comprehensive financial product exchange and with full attention to the prevention of deliberate tax evasion.

2. Expansion of the Japanese version ISA

Japanese version ISA are tax-exempt Individual Savings Accounts. Small investments in listed shares or publicly offered beneficial interest of share investment trusts in Japanese version ISA are exempt from dividends and capital gains taxation. The period during which tax-exempt accounts can be established will be extended to 10 years beginning 1 January 2014 (currently for three years from 1 January 2014).

For individual investors planning on future asset formation through steady investment in small amounts of listed shares or publicly offered beneficial interest of share investment trusts, this proposition offers an attractive tax relief measure. The expectation is that the Japanese version ISA will become widespread and contribute to the asset formation of households.

3. Permanent tax-exemption for interest on book-entry transfer corporate bonds

Interest income from corporate bonds is tax-exempt to foreign investors if the "book-entry transfer" system is applied. This exemption currently expires 31 March 2013. This expiration shall be repealed, and the exemption will become permanent. However, for book-entry Islamic bonds, the tax-exemption will only be extended three years to 31 March 2016. Further, beginning 1 January 2016, foreign investors having no permanent establishment in Japan will not be subject to Japanese tax on profits from redemption of book-entry transfer discount bonds, so long as certain procedural requirements are satisfied.

V. International taxation

1. Taxation of non-Japanese heirs and donees residing outside Japan

Properties located outside of Japan, which are transferred to heirs and donees residing outside of Japan and who are not Japanese nationals, will become subject to Japanese Inheritance and Gift Tax. This revision becomes applicable with respect to inheritance tax or gift tax on foreign properties acquired by inheritance or testamentary bequest or gift on or after 1 April 2013.

This measure intends to address inheritance tax and gift tax planning where children or grandchildren acquire foreign citizenship. Under the current law, such non-Japanese and non Japan resident heirs and donees are not subject to the inheritance and gift bequest for properties located overseas.

2. Transfer pricing

For transfer pricing, the so-called Berry ratio, which is the ratio of gross profits to operating expenses, will be added to the profit level indicators used in the calculation of arm's length prices. The Berry ratio is a profit level indicator accepted by the OECD transfer pricing guidelines. It is also permitted for use as a transfer pricing practice of foreign companies' affiliates in Japan importing goods, etc., from other affiliates.

3. Review of anti-tax haven rules (CFC rules)

In the case when a controlled foreign corporation is located in a country which does not levy corporate tax, while operating a branch in a country where corporate tax is imposed, the corporation's aggregated taxable income will no longer be considered as tax-exempt foreign-source income for foreign tax credit regime purposes. As a consequence of not treating such income as tax-exempt foreign-source income, the corporation may be able to obtain a foreign tax credit.

4. Earnings stripping rules

The earnings stripping rules' provisions to avoid a double application of earnings stripping and thin capitalization rules will be revised. The earnings stripping rules will provide a "current-year income" adjustment rule to take into account timing effects related to the tax base of the added-value enterprise tax. The earnings stripping rules will become applicable beginning with business years that start on or after 1 April 2013.

5. Foreign properties reporting

Individual taxpayers will have to report Japanese securities, issued by a Japanese corporation, if held in accounts in overseas financial institutions. Foreign securities, issued by a foreign corporation, which are held in accounts with domestic financial institutions, will be excluded from foreign properties reporting. This reform will become applicable to foreign properties reporting statements to be submitted on or after 1 January 2014.

The foreign properties reporting regime was created by the 2012 tax reform to enforce the declaration of income from - and the inheritance of - foreign properties.

6. Application for tax treaty benefits on dividends from Japanese listed stocks

Non-residents, who seek application of tax treaty benefits, such as reduced withholding rates, for listed stock dividends paid through a payment agent, will be able to submit a "special" treaty application form providing information about the non-resident applicant. This reform will become applicable to listed stock dividend payments made on or after 1 January 2014.

The reduced tax rate (10%) on dividends and capital gain income from listed stocks will be abolished at the end of 2013 and beginning in 2014 the original tax rate (20%) will become applicable. Beginning in 2014, the withholding tax rate under domestic tax law on dividends from listed stocks paid to non-residents will generally exceed the reduced tax rate under the tax treaty. Non-residents investing in listed stocks in Japan must be sure to submit the treaty application form. As a result of the above reform, the submission procedure for treaty application is simplified where non-residents receive dividend payments from listed stocks through payment agents.

7. Future implementation of the Authorized OECD Approach into Japanese Tax Law

Further to a 2010 revision of the OECD Model Tax Treaty, permanent establishments would nearly be treated as fully separate entities for tax purposes under the so-called "Authorized OECD Approach." The Authorized OECD Approach will allow the recognition of taxable income and expenses arising from internal transactions between headquarters and branches. The section "Future Considerations" to the Outline of 2013 Tax Reform carefully describes how the future implementation of the OECD Approach into Japanese Tax Law is presently viewed: "With regards to the principles of taxation of non-residents and foreign corporations, based on the revision of the OECD Model Tax Treaty and with consideration to various industries, existing regulations relying on the so-called "entire income principle" will be recast into regulations which will be based on the attributable income principle in alignment with the Authorized OECD Approach."

VI. Consumption tax rate increase

1. Introduction of a reduced tax rate (multiple rates)

The reform outline considers introducing a reduced tax rate by the time when the consumption tax rate will be raised to 10%.

2. Residential property and automobile taxation

The following measures will be implemented to spur demand in residential properties and automobiles, which are feared to decline as a consequence of the consumption tax rate increase.

- Repeal of the automobile acquisition tax when the consumption tax rate is raised to 10% and the review of tax relief for automobile weight tax, with specific conclusions expected to be reached in 2014 tax reform.
- Expansion of tax relief, etc., for mortgage loans related to the acquisition of residential property, etc. In the case of general residential property mortgage loan tax credit, the following table applies:

Year of residency	Maximum loan balance	Credit rate	Maximum tax credit per year	Maximum tax credit in total
January 2014 - March 2014	JPY 20m	1.0%	JPY 200,000	JPY 2m
April 2014 - December 2017	JPY 40m	1.0%	JPY 400,000	JPY 4m

VII. Review of delinquency tax, etc.

In line with low interest rates, late tax filing dues and interest payments will be reduced starting 1 January 2014 as follows:

	Main rate	Current rate	Draft revision
Interest for late payment	14.6%	-	Standard rate*+7.3%
Interest (for the first 2 months from the due date only)	7.3%	4.3% Note (Official discount rate + 4%)	Standard rate*+1%
Interest for filing extension period (e.g., corp tax)	7.3%	4.3% Note (Official discount rate + 4%)	Standard rate*
Interest on refunds	7.3%	4.3% Note (Official discount rate + 4%)	Standard rate*

Note: The applicable rate for the year 2012.

**The "standard rate" is 1% + the rate announced by the Minister of Finance every year on 15 December as the average interest rate on short-term bank loans between October of two previous years and September of the previous year.*

Comments or general inquiries regarding this tax newsletter may be directed to our Corporate Communications team at tax.marketing@jp.ey.com.

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