31 October 2013

Japan tax newsletter

Ernst & Young Tax Co.

Outline of tax reforms to stimulate investment

Contents

On 1 October 2013, the Japanese government formally confirmed the increase to the rate of consumption tax from 5% to 8% (national and local combined) effective 1 April 2014, in accordance with previously enacted legislation. To mitigate potential negative impact on the economy due to the increase, an economic package was announced at the same time which aims to expand the economy and generate stable growth. The five-trillion yen package includes a variety of tax measures designed to stimulate private sector investment and lower taxes for corporations, as described in the "Tax reform outline to stimulate private sector investment", released on the same day, 1 October 2013. These reforms are part of an economic strategy to promote growth in spite of the consumption tax increase, and are being introduced in advance and separately from the normal annual reforms.

The following is an outline of the main tax reduction measures for corporations.

1. Early repeal of special reconstruction tax

The special reconstruction tax was introduced in April 2012 as a 10% surtax on corporate tax and was intended to last for three years. The government has proposed scrapping this surtax a year early, and will make a final decision in December of this year. If the surtax is abolished, the effective corporate tax rate (Tokyo area, including local taxes) will be reduced from 38.01% to 35.64% from April 2014. The government is also contemplating further measures to reduce the effective corporate tax rate.

2. Tax incentives to promote capital expenditure on productivity-enhancing equipment

Levels of corporate capital expenditure have long been constrained by available cash flow and cost recovery through depreciation. As a result, equipment has aged and deteriorated, stunting growth in productivity. To remedy this situation, tax measures were introduced in the 2013 tax reform to promote capital investment for domestic productivity. The proposed new measures expand upon this, and introduce a system that allows immediate depreciation or tax credits for investments in "productivity-enhancing equipment" as defined in the proposed Industrial Competitiveness Enhancement Act (the Act); specifically, investments in "cutting-edge equipment" with high productivity, or "investments that improve production lines or operations". These incentives apply not only to manufacturing fields, but also to fields such as distribution and logistics.

According to the Act, if a company acquires and places into service in Japan, between the effective date of the Act and 31 March 2016, any machinery, tools, appliances, buildings, facilities pertaining to a building, structures, or software, which is used as "equipment for production"[1] and qualifies as "productivity-enhancing equipment"[2], and which has a unit cost above a set threshold[3], the company can apply either special immediate depreciation up to 100% of the acquisition cost or a tax credit of 5% of the acquisition cost (3% for buildings and structures). The tax credit is capped at 20% of corporate tax for that fiscal year.

For assets acquired between 1 April 2016 and 31 March 2017, either special immediate depreciation of 50% of the acquisition cost (25% for buildings and structures) or a tax credit of 4% of the acquisition cost (2% for buildings and structures) may be applied.

If applicable assets are acquired between the effective date of the Act and 31 March 2014 and in a fiscal year that ends before 1 April 2014, an equivalent amount of special immediate depreciation or tax credit may be applied for the fiscal year that includes 1 April 2014.

1. "Equipment for production" refers to depreciable assets of a corporation which are placed directly into service in the operations of the corporation, and excludes buildings such as the head office facilities and dormitories, office furniture and fixtures, and employee welfare facilities.
2. "Productivity-enhancing equipment" is defined in the Act as either "Cutting-edge equipment" or "Equipment that improves production lines or operations".

   "Cutting-edge equipment" refers to any machinery, tools, appliances, buildings, facilities pertaining to a building, structures, or software that satisfies certain requirements to be deemed "cutting-edge". For assets classified as machinery, there are no particular requirements as to the use or specifics thereof. Cutting-edge equipment must satisfy both of the following requirements (which are partially relaxed in the case of small and medium sized enterprises ("SMEs")):

   a. The equipment must be the latest model (i.e., the most recent model and brought to market within the last 10 years for machinery, 4 years for tools, 6 years for appliances, 14 years for buildings and facilities pertaining to buildings, and 5 years for software. Models acquired in the same or following year in which they were brought to market also qualify).
   b. The equipment must improve average annual productivity by at least 1% compared with the previous model (in terms of production volume per unit of time, accuracy, energy efficiency, etc.).

   "Equipment that improves production lines or operations" refers to any machinery, tools, appliances, buildings, facilities pertaining to a building, structures, or software that satisfies certain requirements related to productivity, and that is documented in an investment plan which has been approved by a METI bureau. The requirement to improve productivity means that ROI under the investment plan must be 15% or more (5% or more for SMEs).
3. For example, one unit of a machine must have an acquisition price of JPY1.6M or more.

Fig. 1: Tax incentives for promoting capital investment in productivity-enhancing equipment

	If acquired between the effective date of the Act and 31 March 2016*	If acquired before 31 March 2017
Machinery, etc.	Immediate depreciation or 5% tax credit	50% special depreciation or 4% tax credit
Buildings and structures	Immediate depreciation or 3% tax credit	25% special depreciation or 2% tax credit

* If acquired in a fiscal year that ends before 1 April 2014, a depreciation or credit equivalent to the special depreciation or credit may be applied for the fiscal year that includes 1 April 2014.

3. Tax incentives to promote venture capital

To promote growth in industry, the Japanese government believes it is essential to create an environment in which individuals and SMEs are empowered to start new businesses. To that end, it is necessary to provide these ventures with the funds necessary to take risks and expand, to build connections between venture companies and their transaction partners, and to support the development of know-how and technology which are vital to commercial success.

To encourage investment and management support to these new businesses at the expansion stage, the Act includes a mechanism for granting approval to qualifying venture funds. Corporate investors of such funds will be eligible for tax relief measures related to investment losses.

The Act's incentives apply to investment made via an investment limited partnership (i.e., a venture fund, defined in the Act) that creates a special investment plan and has it approved under the Act between the effective date of the Act and 31 March 2017.

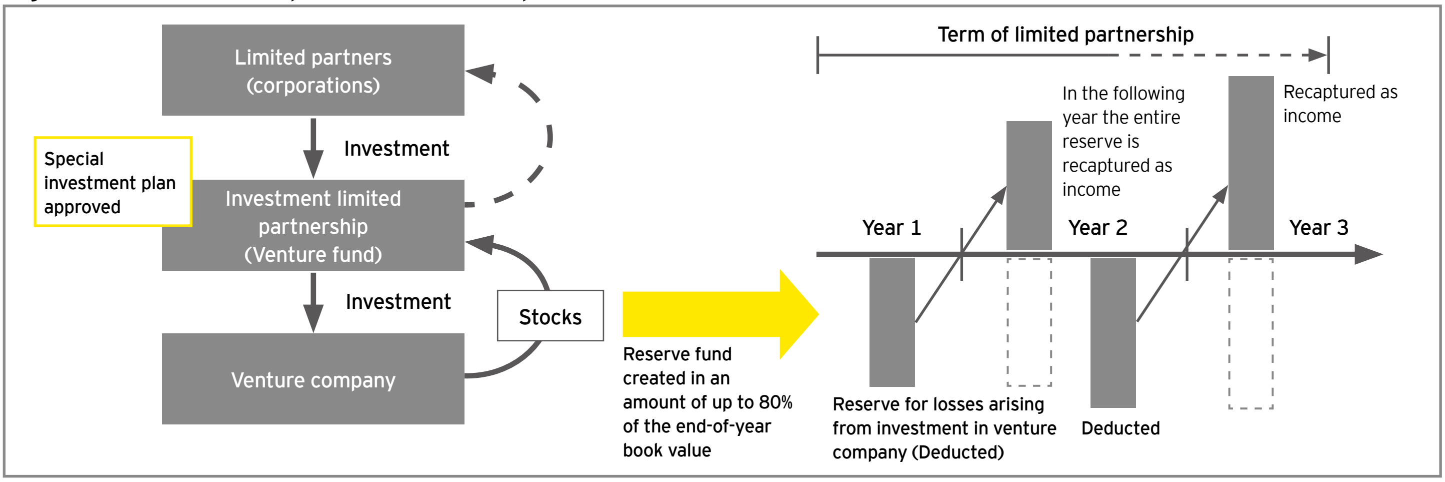
The partnership concludes an agreement with a corporation that files a blue tax return (if the corporation is a qualified institutional investor, limited partners of the partnership must invest JPY200M or more in the partnership).

Upon completion of the above steps, the blue-return corporation invests in the partnership, and after such investment date but before the termination date of the partnership, shares of a business venture (i.e., a venture company, as defined in the Act) are acquired in accordance with the investment plan and become assets of the partnership.

To alleviate potential losses resulting from a decrease in the value of the investment, up to 80% of the book value of the venture shares held at the end of each fiscal year that includes a day in the above period can be placed in a "reserve for losses resulting from an investment in a venture company" which is deductible for that fiscal year of the corporate investor (partner). The reserve loss is recaptured through taxable income in the following fiscal year, but such income would be offset by claiming another reserve loss in the following fiscal year-end.

This mechanism may be applied for fiscal years that end on or after 1 April 2014.

Fig. 2: Tax incentives to promote venture capital



4. Tax incentives to promote corporate reorganization

The Japanese government also believes there is a need to strengthen corporate competitiveness by eliminating redundancies and excesses in the supply infrastructure, and by increasing efficiencies and earnings potential through pooling the resources of companies.

To this end, the Act introduces mechanisms to decrease the tax burden on corporations which conduct certain reorganizations that aim to significantly increase earnings potential, such as business integrations between companies in the same industry. The reorganizations envisaged include, for example, the split off of a business division of one company and merger with the business division of another company, allowing market expansion and enhanced competitiveness by exploiting economies of scale and complementary technology.

The incentives of the Act apply to a corporation that has prepared a specified reorganization plan under the Act which has been approved between the effective date of the Act and 31 March 2017.

The corporation, within a fiscal year that includes a day within a reserve period[1] and within the reserve period itself, acquires "specified stocks, etc."[2] of a specified company as defined in the Act and relating to the specified corporate reorganization as defined in the Act and indicated in the reorganization plan (excluding acquisitions made before the reorganization), and continuously holds such specified stocks, etc. until the last day of the fiscal year in which the stock was acquired.

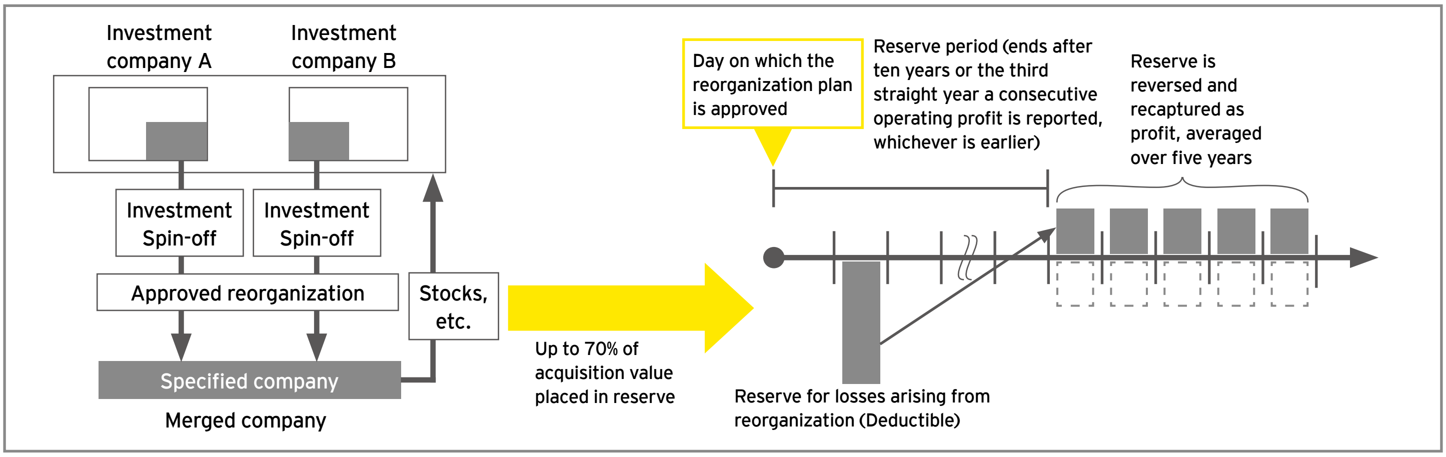
To alleviate potential losses from a decrease in the value of the stock or bad debt, up to 70% of the acquisition cost of the specified stocks, etc. may be placed in a "reserve for losses arising from a specified corporate reorganization" which is deductible in the fiscal year of acquisition. (Additionally, for the first fiscal year of the reorganization, up to 70% of the book value of existing stock held by the company prior to the reorganization and continuously through the last day of the first fiscal year of the reorganization may also be placed in the reserve.)

At the end of the fiscal year in which the final day of the reserve period falls, the reserve balance is reversed, and recaptured through taxable income over a five-year period beginning from the next fiscal year.

This mechanism applies to fiscal years that end on or after 1 April 2014. Further, if stock is acquired between the effective date of the Act and 31 March 2014 and in a fiscal year that ends before 1 April 2014, the reserve amount is deductible for the fiscal year that includes 1 April 2014.

1. The "reserve period" is the ten-year period beginning on the date of approval of the reorganization plan (however, if within that period the company indicated in the reorganization plan reports an operating profit for three consecutive years, such period will end on the final date of the third fiscal year with such operating profit).
2. "Specified stocks, etc." includes cash payments resulting from an establishment or an increase in capital, stocks (including stakes) in the specified company acquired from mergers, splits or contribution in kind, or receivables relating to loans to the specified company.

Fig. 3: Tax incentives to promote corporate reorganization



5. Tax incentives to promote capital expenditure for small and medium sized enterprises (SMEs) extended and enhanced

To further promote the businesses of SMEs which contribute to local economies and employment, the current tax incentives that encourage investment by SMEs (special depreciation or tax credit for acquisition of machinery, etc.) will be extended and enhanced. As explained below, these incentives will be extended for three years through 31 March 2017.

According to the Act, when an SME, etc.[1] acquires certain assets qualifying as productivity-enhancing equipment (as described in the above section "Tax incentives to promote capital expenditure on productivity-enhancing equipment") between the effective date of the Act and 31 March 2017, the SME may apply either special immediate depreciation up to 100% of the acquisition cost (currently 30%) or a tax credit of 7% of the acquisition cost (for certain specified SMEs[2], 10% (currently 7%)).

Amounts that exceed the credit cap may be carried forward for one year. The tax measure is also enhanced so that SMEs with capital of JPY100M or less (but over JPY30M) may also apply the tax credit if they meet certain conditions.

If productivity-enhancing equipment is acquired between the effective date of the Act and 31 March 2014 and in a fiscal year that ends before 1 April 2014, an equivalent amount of special immediate depreciation or credit may be applied for the fiscal year that includes 1 April 2014.

1. An "SME, etc." is a corporation or agricultural cooperative with capital or invested capital of JPY100M or less that files a blue tax return.
2. A "specified SME" is a corporation or agricultural cooperative with capital or invested capital of JPY30M or less that files a blue tax return.

Fig. 4: Tax incentives for promoting investment in SMEs

Corporation capital	Current incentives	Revised incentives*
JPY30M - JPY100M	30% special depreciation (no tax credit)	Immediate depreciation OR 7% tax credit
JPY30M or less	30% special depreciation OR 7% tax credit	Immediate depreciation OR 10% tax credit

* The assets of these incentives (specified equipment, etc.) must be those defined in the incentives for promoting capital investment in productivity-enhancing equipment

6. R&D tax credits extended and enhanced

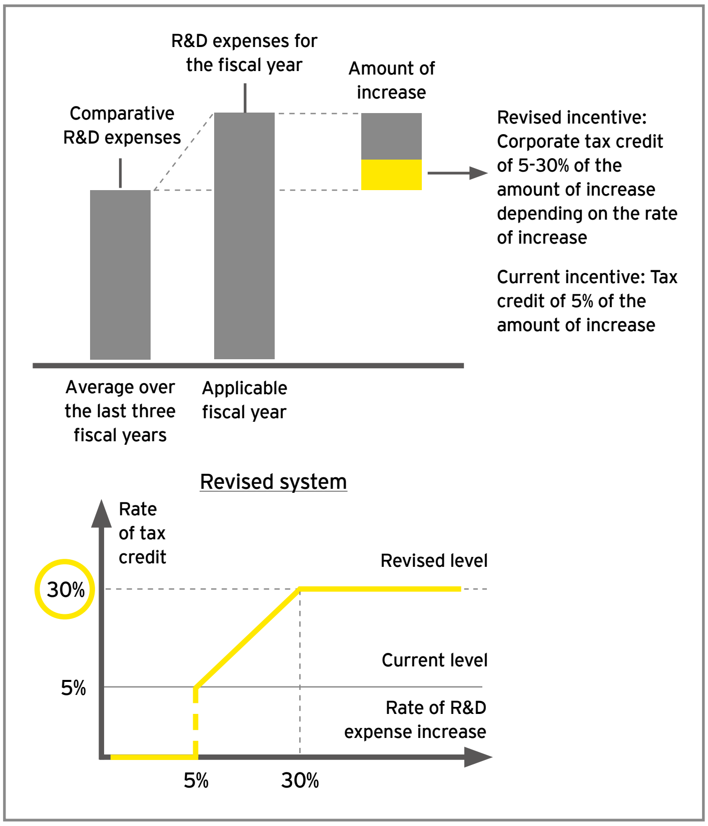
The R&D tax incentive system will be extended and revised to further accelerate investment in R&D which is a major source of economic growth.

Under the current system, a temporary provision of additional tax credits (a tax credit for either an increase in R&D investment ("increased investment credit") or R&D investment greater than 10% of average sales ("high investment level credit")) may be applied. This temporary provision will be extended for three years to apply to fiscal years beginning on or before 31 March 2017.

The increased investment credit will be revised such that, if the increased R&D expenses exceed 5% of a comparative level of R&D expenses, and also the R&D expenses exceed a base level of R&D expenses, then 30% of the amount of the increase[1] may be included in the tax credit (if the rate of increase[2] is less than 30%, such lower rate of increase is used for the calculation).

1. The "amount of the increase" is the amount of R&D expenses remaining after deducting the comparative R&D expense amount.
2. The "rate of increase" is the amount of the increase (defined above) in proportion to the comparative R&D expense amount.

Fig. 5: Tax incentives for promoting investment in R&D (revision of incentives for increased investment)



7. Tax incentives for increasing wages extended and enhanced

The 2013 tax reforms included incentives to promote wage increases by offering tax breaks to employers who increased employee compensation. To accelerate realization of the government's objectives, the government simplifies the tax incentive system and incorporates revisions which benefit companies that raise wages in a planned manner in several stages.

Specifically, the system will be extended for two years to fiscal years that start on or before 31 March 2018 and the following revisions will be incorporated.

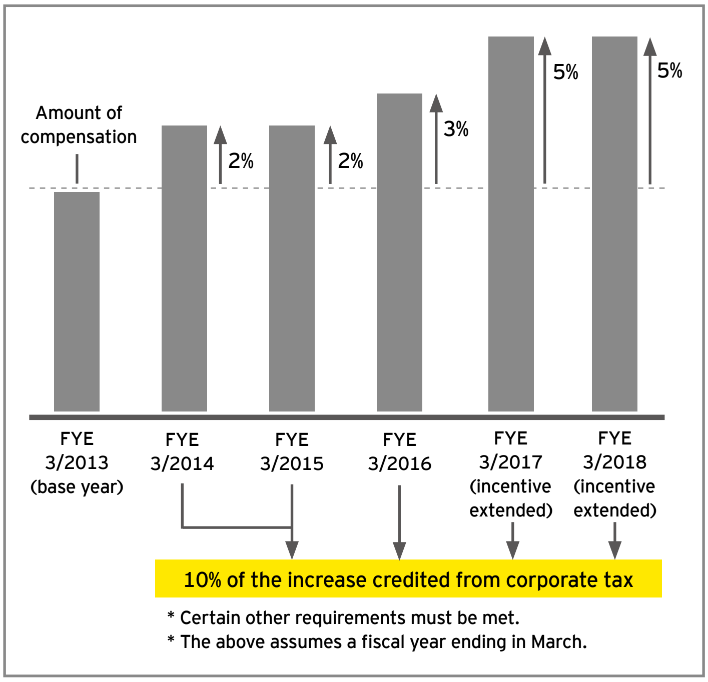
1. The employee wage increase thresholds will be relaxed as follows for the fiscal years indicated below (currently, the incentive applies only if wages are increased by 5% or more compared to a base year).
   a. Fiscal years starting before 1 April 2015: increase of 2% or more
   b. Fiscal years starting from 1 April 2015 to 31 March 2016: increase of 3% or more
   c. Fiscal years starting from 1 April 2016 to 31 March 2018: increase of 5% or more

2. The methodology for calculating average wage will also be revised. Currently, the incentive applies if the amount of average wage is above the amount of comparative average wage (the average wage in the previous fiscal year). Under the reform, the basis of calculation of the average wage and the comparative average wage will be changed from compensation for domestic employees to compensation for domestic "continuous" employees[1]. Further, the average wage will have to exceed the comparative average wage.

The above revisions apply to fiscal years that end on or after 1 April 2014. If a corporation applies the revised incentives in an applicable year that includes this date, and provided all of the revised conditions are met for the elapsed fiscal year (starting on or after 1 April 2013 and ends before 1 April 2014 and to which the previous incentives had not applied), then the corporation may credit against its corporate tax for the applicable year the amount that theoretically would have been credited if the revised tax measures had been applied to the elapsed year, as an additional credit for the applicable year. The annual cap for corporate tax credits is also increased according to the period of the elapsed year. In the case of a corporation with a fiscal year ending in March, the elapsed year will be the fiscal year ending 31 March 2014. If certain conditions are met, the relaxed thresholds for wage increases (an increase of 2% or more compared to the base year) may apply to such fiscal year as well, with the actual credit applying to the fiscal year ending 31 March 2015.

1. "Compensation for domestic continuous employees" refers to compensation which is both; a) paid to domestic employees who have received compensation such as wages in the applicable fiscal year as well as the previous fiscal year, and b) paid to general insured persons according to the Employee Insurance Act. It excludes compensation paid to those employed according to the continuous employment system as defined in the laws relating to the stable employment of senior citizens, etc. Since average compensation decreases as a result of senior citizens retiring and younger staff being hired, the comparison excludes retirees, re-employed retirees and newly hired graduates.

Fig. 6: Tax incentives for promoting wage increases (revision of requirements on the rate of increase of employee compensation)



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