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Japan tax newsletter

Ernst & Young Tax Co.

2016 Japan tax reform outline

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The coalition government (of the Liberal Democratic Party and Komeito) released their 2016 tax reform outline (hereinafter, "Outline") on 16 December 2015. This newsletter introduces the main reforms announced in the Outline, including those relating to corporate tax, consumption tax and international taxation.

Since his return to leadership in 2012, Prime Minister Abe has pursued his "three arrows" policy of monetary reflation, progressive fiscal policy and economic growth strategy. During this time, we have seen the establishment of new rules in line with this policy and various reforms have been carried out. To reinforce his original three targets, in 2015 Abe announced three new arrows of a strong economy, support for families, and social security, aiming to stall the ageing of Japanese society and increase the engagement of all citizens. This year's tax reforms again include corporate tax reforms to encourage further economic growth. Notably, the effective corporate tax rate will drop below the 30% mark for the first time. The next step in the combined overhaul of social security and tax will be a rise in the consumption tax rate from 8% to 10% in April 2017 while the 8% rate will be kept for sales of food and drink. On the international tax front, transfer pricing documentation rules will be provided in accordance with Action 13 of the OECD's BEPS (base erosion and profit shifting) project.

Please note that there may be further amendments, deletions or additions to these reforms as the bill passes through the Diet.

For tax reforms relevant to financial services organizations, please refer to our Financial services tax alert.
http://www.ey.com/JP/en/Services/Tax/Japan-Newsletters-2-5-Feb-2016

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Corporate taxation

Overview

The proposed corporate tax reforms achieve the government's aim of bringing the effective corporate tax rate below the 30% mark. By lowering the tax rate while expanding the tax base, structural reforms are designed to encourage growth. The aim of the reforms is to have the corporate tax burden shared more broadly among companies and for the tax payments of companies with strong earnings to be reduced, thereby increasing earnings power, encouraging forward-thinking investment and creating businesses able to make regular, aggressive pay rises. As such, the revisions form part of the government's overall growth strategy.

The reduction of the effective corporate tax rate will take place in two stages. In the first stage, from 1 April 2016 the headline corporate tax rate will be lowered from 23.9% to 23.4% and in local corporate taxation, business scale tax (part of enterprise tax for large corporations) will increase from 3/8 to 5/8 while the standard tax rate for the income levy, including local special corporate tax, will be reduced from 6.0% to 3.6%. This will result in an effective corporate tax rate, including both national and local tax, of 29.97%.

In the second stage, from 1 April 2018 the headline rate will be reduced again to 23.2%, bringing the effective corporate tax rate, combining both national and local tax, to 29.74%. This represents a total reduction of 4.88% in the effective rate from 34.62% in 2014, thus enabling businesses to contribute positively to the economy by increasing capital investment and improving their labor allocation.

In addition, the depreciation rules and loss carryforward rules will be revised to expand the tax base and balance the tax revenue lost due to the corporate tax rate reduction. Meanwhile, revisions to the tax measures for small and medium enterprises (companies with capital of JPY100 million or less) were again postponed for later consideration.

Effective corporate tax rate

	Current		Proposed	
	1 April 2014~	1 April 2015~	1 April 2016~	1 April 2018~
Corporate tax rate	25.5%	23.9%	23.4%	23.2%
Enterprise tax income levy	7.2%	6.0%	3.6%	3.6%
(national + local) Effective corporate tax rate	34.62%	32.11%	29.97%	29.74%

This assumes a large corporation subject to business scale tax (standard rate)

Due to the reduction in the effective corporate tax rate and the changes to the loss carryforward deduction limits, it will be necessary to correct the amount of deferred tax assets and liabilities reported. Depending on the PL status, some companies will face an increase in the tax burden, therefore it is also necessary to make simulations of the change in tax liabilities.

Reduction of the corporate tax rate

The rate will be reduced in stages: for fiscal years beginning on 1 April 2016 or later, the corporate tax rate will be lowered from 23.9% to 23.4%, and for fiscal years beginning on 1 April 2018 or later, the rate will be lowered again to 23.2%.

		Current	Proposed	
		1 April 2015~	1 April 2016~	1 April 2018~
Regular companies		23.9%	23.4%	23.2%
SMEs	Income up to JPY8m/year	19.0% (15.0% *)	19.0% (15.0% *)	19.0%
	Income over JPY8m/year	23.9%	23.4%	23.2%

The reduced rate of 15.0% is applicable for fiscal years starting on or before 31 March 2017.

New enterprise tax rate and expansion of business scale tax

The standard tax rate for enterprise tax and special local corporate tax on regular corporations with capital over JPY100 million will be amended as follows.

		Current	Proposed
		1 April 2015	1 April 2016
Added value levy		0.72%	1.2%
Capital levy		0.3%	0.5%
Income levy	Annual income of JPY4m or less	3.1% (1.6%)	1.9% (0.3%)
	Annual income over JPY4m up to JPY8m	4.6% (2.3%)	2.7% (0.5%)
	Annual income over JPY8m	6.0% (3.1%)	3.6% (0.7%)
Special local corporate tax		93.5%	414.2%

1: The rates in parentheses are the rates after applying the interim measures for special local corporate tax. The maximum rate will be raised to 2 times the standard rate (from 1.2 times the standard rate).

2: Companies that carry out business through offices, etc. in three or more prefectures are not eligible for the reduced rate of income levy.

Tax relief measures that were introduced together with new rules in 2015 will be further expanded in line with

the increase of business scale tax this time. Loss-making companies and companies with low income relative to size that are negatively affected by the expansion of business scale tax and are under a certain size (added value amount) will be eligible for measures to reduce the impact of the increased rates for three years (until 31 March 2019). For companies with added value of JPY3 billion or less, if the tax base (for each of income levy, capital levy and added value levy) in the applicable year multiplied by the tax rate in the applicable year is greater than the tax base multiplied by the 2015 tax rate, a certain proportion (3/4 from 1 April 2016, 1/2 from 1 April 2017 and 1/4 from 1 April 2018) of the increase can be credited from enterprise tax in the applicable year. Companies with added value of over JPY3 billion up to JPY4 billion are also eligible for credits up to a maximum of the above proportions (the proportion decreases gradually as added value approaches JPY4 billion).

Correction of regional tax imbalances

Together with the rise in the consumption tax rate to 10% on 1 April 2017, special local corporate tax will be abolished and replaced with enterprise tax. To correct the imbalances in tax revenue between regions and close disparities in fiscal soundness, the rate of the inhabitants tax (corporate tax levy) will be reduced while the rate of local corporate tax will be raised. The total of the two tax rates remains at 17.3%. This reform addresses tax revenue allocation between regions and in practice, there is very little impact to corporate tax payments.

Revisions to the loss carryforward rules

The timing of the reduction of the loss carryforward limits announced in the 2015 reforms has been broken down as follows, to even out the impact on businesses.

2015 reforms		2016 proposals	
FYs starting	Deduction limit	FYs starting	Deduction limit
April 2015 - March 2017	65%	April 2015 - March 2016	65%
		April 2016 - March 2017	60%
April 2017 -	50%	April 2017 - March 2018	55%
		April 2018	50%

A measure extending the carryforward period to 10 years can be applied to fiscal years beginning on or after 1 April 2018.

Revision of the depreciation rules

Fixtures which form part of a building and other structures which are used long-term in the same way as a building will all be depreciated using the straight line method. This applies to assets acquired on or after 1 April 2016.

Reduction of fixed assets tax for SMEs

On the assumption that the Law regarding Productivity Enhancement of Small and Medium Enterprises is enacted, a measure will be provided for the period from the enforcement date of the law until 31 March 2019 enabling SMEs to reduce the tax base for fixed assets tax on certain machinery and devices acquired to 1/2 of the price paid for the first three years. The machinery, etc. must be productivity enhancing equipment that is stated in an accredited productivity enhancing plan prescribed by the above law.

Adjustments to director compensation rules

The following reforms will be made regarding the deduction of director compensation.

Deductible compensation	Current requirements	Proposed
Regular fixed compensation	Paid regularly in periods of one month or less; same amount paid in each period in a fiscal year	No change
Pre-determined compensation	The amount and timing are pre-determined and have been reported to the Tax Office Director.	Advance notification no longer necessary for restricted-stock compensation.
Profit-linked compensation	Certain profit-linked compensation paid to executive directors.	ROE and other indicators were added to the scope of calculation indicators.

New regional support tax (hometown tax for businesses)

A new "hometown tax" for businesses will be introduced that allows credits for enterprise tax, inhabitants tax and corporate tax when donations are made to certain highly effective businesses which promote regional revitalization. In addition to the current deductibility of donations (approx. 30% reduction), a tax credit of up to 10% of the donation amount (for enterprise tax) and up to 20% (for inhabitants tax and corporate tax) will be possible.

Revisions to the reorganization rules

1. Rules governing share exchanges and share transfers will be revised as follows:

   i. In the continuous management requirement, which is a qualification requirement for share exchanges/ transfers carried out in order to operate a joint business, the tax-qualified share exchange/transfer must not involve the resignation of all of the specified directors with the exchange/transfer.

   ii. The acquisition price of subsidiary shares acquired by a parent company in a qualified share exchange/ transfer if the subsidiary has 50 or more shareholders will be the book value of net assets in the most recent tax return filing plus an adjustment for the amount of capital, etc.

2. Clarifications have been provided regarding the continuous shareholding requirement for tax qualification in the case of incorporation-type mergers, incorporation-type splits and share transfers conducted for the purpose of operating a joint business.

Special measures for investment corporations

1. An adjustment measure has been put in place regarding the calculation of distributable profit as part of the condition that requires that dividends paid by an investment corporation represent more than 90% of distributable profit. As a rule, net asset deduction items exceeding profit carried over from the previous year may be deducted. This measure will be applied to dividends payments made on or after 1 April 2016.

2. One of the conditions for applying the special measure for taxation on investment corporations requires that the proportion of specified assets exceeds 50% of total assets. Tokumei kumiai agreement rights that are specified assets are limited to those which are pledged to manage investment mainly in securities or real estate, etc.

Other

1. Entertainment expenses

   The application of the deduction rule for entertainment expenses will be extended by two years. The application of the special measure for deduction of eating and drinking expenses (50% of expenses) and the special deduction measure for SMEs (fixed deduction of JPY8 million annually) will also be extended by two years.

2. Low-value depreciable assets

   Companies which employ more than 1,000 regular employees will no longer be eligible for the special measure for deduction of the acquisition price of low-value depreciable assets (under JPY300,000 per unit). Application of the measure will be extended for two years.

3. Productivity-enhancing equipment incentive

   The productivity-enhancing equipment tax incentive (introduced in the 2014 tax reforms) will be abolished on 31 March 2017. The measure for additional immediate deprecation will also not be extended (ending on 31 March 2016).

4. Loss carryback refund rule

   The application of the measure in which refunds for loss carrybacks are disallowed for non-SMEs will be extended for two years.

Consumption tax

Introduction of reduced tax rates

To alleviate the burden for low income earners, when the consumption tax rate is raised to 10% on 1 April 2017, the current 8% rate will be retained for certain goods. The lower rate will be applied to purchases of food and drinks (fresh and processed), excluding alcoholic beverages and dining out, as well as to subscriptions of newspapers. Followed by the multiple tax rate circumstance, a new invoicing system will be introduced on 1 April 2021. Until then, a simpler method, categorized-entry invoice will be used instead.

1. Reduced tax rates and items covered

   Taxable sales subject to the lower rate are as follows. The reduced tax rate is 6.24% (8% when combined with local tax).

   i. Sales of food and drinks (excluding restaurant business as defined in the Food Sanitation Act, café business and other provision of meals in places which have certain eating or drinking facilities by an operator that runs a business for the provision of meals, i.e., dining out)

   Note 1: Food and drinks refers to food and drinks as stipulated in the Food Labeling Act (excluding alcoholic beverages stipulated in the Liquor Tax Act).

   Note 2: Goods which are comprised of both food/drink and non-food/drink components will not be categorized as food/drink. However, a product which contains low-value assets under a certain amount but its main component is considered as food/drink will be deemed to be food/drink as a whole and eligible for the reduced tax rate.

   Note 3: Taxable goods imported into Japan that are eligible for the lower rate are also defined as the above-mentioned food and drinks. The 6.24% rate will be applied (8% when combined with local tax).

   ii. Sales of newspapers for which a subscription agreement has been concluded (limited to certain titles of newspapers which feature information on general society such as politics, economics, society and culture which are issued at least twice a week)

2. Categorized-entry invoice method

   For the four years until the new invoice method is introduced, the current invoice method will continue to be used for input tax credits, and to enable accounting categorization, the following categorized-entry invoice measures will be provided.

   a. Additional entry items on the invoice and accounting book

   For taxable purchases of items subject to the reduced tax rate, the accounting book must contain information on which entries are taxable sales subject to the reduced tax rate. Also, the invoice must indicate the total transaction amount for each tax rate and which items are taxable sales subject to the reduced tax rate. Since the party making the taxable sales does not have an obligation to issue and keep invoices stating such information, the recipient of the invoice is permitted to add such information to the invoice according to the facts.

   b. Special measure for the calculation of taxable sales

   A special measure will be provided for businesses where it is difficult to categorize sales for each tax rate. One of the following percentages, i., ii. or iii., can be used for the sales of goods subject to the reduced tax rate when calculating the tax amount. For SMEs with taxable sales of JPY50 million or less, this measure is available for the four years until the introduction of the new invoice method. For other companies, this measure is only available for one year after the start of multiple tax rates.

   i. For wholesale and retail businesses(excluding businesses which use the simplified taxation method);

   $$\frac{\text{Total taxable purchases subject to reduced tax rate}}{\text{Total taxable purchases}}$$

   ii. The ratio for any of 10 continuous business days in the taxable period, providing there are no extraordinary business events during the designated period

   $$\frac{\text{Taxable sales subject to reduced tax rate for 10 continuous days}}{\text{Taxable sales for 10 continuous days}}$$

iii. For businesses where both i. and ii. are not possible, 50%.

c. Special measure for calculation of input tax

Businesses which have difficulties categorizing purchases for each tax rate can adopt either of the following special measure to calculate the amount of input tax credit for one year after the start of multiple tax rates.

i. For wholesale and retail businesses(excluding businesses which use the simplified taxation method);

$$\text{Total amount of taxable purchases} \times \frac{\text{Total taxable sales subject to reduced tax rate}}{\text{Total taxable sales}}$$

ii. Post-facto election and application of the simplified taxation method by the end of the taxable period

Businesses with taxable sales over JPY50 million in the base period which have difficulties in categorization will also be able to file the tax return based on calculations in accordance with the simplified taxation method.

3. Introduction of new invoice method

To replace the current invoice method, retention of qualified invoices or simplified qualified invoices issued by registered businesses will be a requirement for taking input tax credits.

a. Business registration system

Businesses which are not tax-exempted enterprises have to submit an application to the Tax Office Director with jurisdiction to be registered as a business that can issue qualified invoices ("registered businesses"). The name and registration number of registered businesses will be published on the internet.

b. Qualified invoices and simplified qualified invoices

Registered businesses are permitted to issue qualified invoices indicating the following entries. Those conducting certain types of taxable sales to a large number of unspecified people may issue simplified qualified invoices omitting certain entries instead. Registered businesses are required to issue qualified or simplified qualified invoices (excluding certain transactions, such as taxable sales using vending machines) and keep copies of the documents.

Qualified invoice entries:

i. Name and registration number of the registered business

ii. Date of taxable sale

iii. Content of the taxable sale or service (if the taxable sale is subject to the reduced tax rate, this must be indicated)

iv. Total tax-inclusive or tax-exclusive amount of taxable sales for each tax rate, and the tax rates applied

v. Consumption tax amount

vi. Name of the business being issued the invoice

c. Revision of the input tax credit requirements

For taxable purchases which are subject to the reduced tax rate, the accounting book must contain information of reduced-rate transaction. Except for purchases from vending machines and certain other cases, the following documents must be kept as a requirement for taking input tax credits.

i. Qualified invoice

ii. Simplified qualified invoice

iii. Electronic record of the qualified invoice entries*

iv. A purchase detail or purchase calculation document prepared by the business regarding the taxable purchase that indicates the entries required for qualified invoices (only those which have been confirmed by a registered business)

v. Certain documents prepared by a party conducting intermediary or agency business (wholesale markets, agricultural cooperatives and fishery cooperatives, etc.) regarding the sale of agricultural or marine products under contract

** If a registered business receives approval in advance from the business receiving the taxable assets, the qualified invoice entries may be provided as electronic record instead of issuing a qualified invoice.*

d. Method of calculating the tax amount

The consumption tax amount for sales and for purchases is calculated by either of the following methods (if method ii. is used for calculation of tax on sales, method i. cannot be used for calculation of tax on purchases).

i. Total amount-based calculation method;

Calculate the consumption tax portion from total tax-inclusive amount of taxable purchases or sales (by each tax rate category) for the taxable period

ii. Cumulative calculation method;

Calculate the consumption tax amount by cumulating the amount stated on the qualified invoices or simplified qualified invoices that were issued or received (only if copies of qualified invoices are kept)

e. Transitional measure for taxable purchases from tax-exempted enterprises

After the introduction of qualified invoice method, input tax credits will no longer be possible for purchases from tax-exempted enterprises. However, for the first six years, an input tax credit equivalent to 80% or 50% of the consumption tax on the taxable purchases can be taken for domestic taxable purchases from tax-exempted enterprises, provided that certain books and invoices are kept.

Applicable period	Input tax credit ratio
1 April 2021 - 31 March 2024	80%
1 April 2024 - 31 March 2027	50%

4. Applicable period

Reforms in 1. and 2. above will be applied from 1 April 2017, and reforms in 3. above will be applied from 1 April 2021, to domestic taxable sales and purchases conducted by businesses and taxable goods imported into Japan.

The decision on introduction of reduced tax rates for certain goods has been finalized. As this will begin in April 2017, businesses have only a little over a year to prepare for the new rules (categorized accounting, updates to accounting systems). Since categorized accounting will be difficult for some businesses and there may not be enough time to get systems ready, invoices will not be required for the first four years and simplified calculation of sales subject to the reduced tax rate will be acceptable. The government will consider the readiness of businesses for the new invoice system and the impact on transactions, and if necessary, will provide relief measures.

Tax calculation methods and special measure enforcement schedule (proposed)

April 2017 (start) — April 2021 — April 2024 — April 2027

		Current rule	Categorized-entry invoice method (April 2017~)	Qualified invoice method (April 2021~)
Tax calculation method		Total amount-based calculation	No change	Either: ‣ Cumulative calculation ‣ Total amount-based calculation
Invoice requirements		None. Tax-exempted enterprises can also issue invoices	No change	‣ Qualified invoice issue requirement ‣ Cannot be issued by tax-exempted enterprises
Input tax credit requirements		‣ Invoices must be kept ‣ Input tax credit available for purchases from tax-exempted enterprises	No change	‣ Qualified invoices must be kept ‣ No input tax credits for purchases from tax-exempted enterprises
			Input tax credit for using categorized-entry invoice edited by purchaser	Partial input tax credits available for purchases from tax-exempted enterprises 80% 50%
		Input tax credits available with substitute invoices issued for auction sales, etc.	→	→
		Input tax credits available to secondhand goods traders for their purchases from general consumers	→	→
Tax calculation special measures	Calculation of tax on sales		Deemed calculation of reduced-rate sales (4 years)*1	
	Calculation of input tax		Deemed calculation of reduced-rate purchases (1 year)	
		Simplified taxation method	No change / Revision	→
			Post-facto election of simplified taxation (1 year)*2	
Status review		Review	Review	

*1 One-year in the case of non-SMEs.

*2 One-year measure for non-SMEs in which the simplified taxation method and post-facto election are possible.

Source: Ministry of Finance documents

Other

1. Revision of the place-of-supply rule for B2B digital services

From 1 January 2017, determination of the place-of-supply on B2B digital services provided by foreign service provider to the foreign office of a Japanese business or the Japanese permanent establishment of a foreign business will be changed as follows.

- B2B digital services received by the foreign office of a Japanese business solely for foreign sales purpose:

Before reform	Proposal
Domestic transaction (Taxable purchase subject to the reverse charge mechanism)	Foreign transactions (Not subject to consumption tax),

- B2B digital services received by Japanese permanent establishments of foreign businesses solely for domestic sales purpose:

Before reform	Proposal
Foreign transactions (Not subject to consumption tax)	Domestic Transaction (Taxable purchase subject to the reverse charge mechanism)

Since the place of supply for consumption tax on cross-border digital services was defined by the location of the recipient of services (head office or main business premises in the case of a company) in the 2015 tax reform, services received by foreign branches of Japanese companies were subject to consumption tax even though the service provision was carried out abroad. This reform is likely to have particularly significant impact on financial organizations which operate through branches abroad.

2. Revision of the special measure for purchases of high-value assets by SMEs

If a business (which is not a tax-exempted enterprise), in a period when the simplified tax method is not applied, constructs an asset , or makes taxable purchases or importation of certain fixed assets or inventories which costs JPY10 million or more at tax-exclusive value (high-value purchases), the tax exemption for small businesses and the application of simplified tax method will not be available from the taxable period which includes the date of purchase/construction to the taxable period which includes the day before the third anniversary of the first day of the purchase/construction period.

This reform applies to purchases of high-value assets on or after 1 April 2016. However, purchases based on a contract concluded on or before 31 December 2015 are excluded.

	Year 1	Year 2	Year 3	Year 4
Current	Regular method	Simplified method	Simplified method	Regular method
	Complete construction of building (consumption tax refund)	Handover building (report taxable sale)		
Proposal	Year 1	Year 2	Year 3	Year 4
	Regular method	Regular method	Regular method	Regular method

For 2 years after acquisition or construction of a high-value asset, the regular method must be applied.

There had been longstanding issues of tax avoidance with schemes in which a large consumption tax refund was taken by using the regular method in a year when high-value real estate was constructed or acquired and the consumption tax payable on the sales of such assets were exempted or reduced by the simplified method in subsequent years. This reform addresses such issues.

International taxation

Multinational enterprises reporting rules in line with BEPS

Multinational enterprise ("MNE") reporting (transfer pricing documentation) rules will be put into place which increase transparency for tax authorities by considering compliance costs for businesses. Specifically, MNEs must submit (or prepare and maintain) three types of documents for the tax authorities: 1) country-by-country report ("CbC report"), 2) a master file, and 3) a local file.

- **CbC report:** Information on the MNE group's business activities in each country, such as income and allocation of tax payments. To be used to assess whether there are any transfer pricing issues in the MNE group.
- **Master file:** Information on the MNE group's overall activities, including an overview of the organization, financial and business activities. To be used to assess whether there are any significant transfer pricing issues in the MNE group.
- **Local file:** Local file: Detailed information on the calculation of arm's length prices of foreign related transactions with related parties. To be used to check if taxpayers are compliant with arm's length principles and to make transfer pricing assessment.

In Japan, submission of the CbC report and the master file as well as preparation of the local file will be mandatory.

Details of tax reforms relating to Japanese reporting requirements for the above three document types are as follows.

CbC report

1. Outline

   Companies required to report country-by-country information regarding their MNE group must submit a CbC report to the Tax Office Director within one year from the fiscal year-end of the ultimate parent by e-tax filing.

2. Definition of MNE group

   Company group which prepare consolidated financial statements under applicable accounting standards (excluding cases where the consolidated parent company in the consolidated financial statements is a consolidated subsidiary in other consolidated financial statements) and which has businesses which are tax-resident in two or more jurisdictions (including permanent establishment ("PE") and presence equivalent to a PE in other countries).

3. Definition of constituent entity

   a. Entities whose property and profit/loss information is reported in a consolidated financial statement under applicable accounting standards.

   b. Entities which are excluded from the scope of consolidation because of insignificant size of operation.

4. Items to be reported in CbC report

   Income, pre-tax profit, tax paid and other necessary items – as shown in Annex III to Chapter 5 of the drafted revised OECD guideline ("the Revised Transfer Pricing Guideline") based on the recommendations of the BEPS project.

5. Reporting company

   The reporting company will be either a. or b. below.

   a. A Japanese company which is the ultimate parent of a MNE group (a constituent entity which controls other constituent entities) or a surrogate parent entity (a constituent entity in the MNE group designated by the ultimate parent to be the reporting company for CbC information).

   b. A Japanese company which is a constituent entity of an MNE group (excluding ultimate parent and surrogate parent entity) or a PE of a foreign company.

      If there are multiple Japanese constituent entities of an MNE group or PEs of foreign companies, one company may file the CbC report on behalf of all entities.

   Note: b. above will become the reporting company only when it is judged that the Japanese tax authorities cannot obtain a CbC report on the MNE group from the resident jurisdiction (a state with which Japan has concluded a tax treaty) of the ultimate parent (or surrogate parent entity if designated)

6. Reporting obligations

   To determine which company is required to submit a CbC report of the MNE group, a name, location and other necessary information of the CbC reporting company as well as other constituent entities in Japan must be provided to the Tax Office Director through e-tax filing.

7. Exemption from CbC reporting requirement

   MNE group who reported less than JPY100 billion of total consolidated income in the previous fiscal year will be exempted from CbC reporting requirements.

8. Reporting language

   English.

9. Penalties

   Penalties will be given for failure to submit the CbC report by the due date.

10. Timing of enforcement

    The above reform will be enforced to the CbC report of ultimate parent's fiscal year beginning on 1 April 2016 or later.

Ultimate parent will need to obtain information such as actual tax payment per country from all constituent entities; therefore it is necessary to check in advance whether such information is available. It will also be necessary to carry out risk analysis in advance on how the CbC report will be viewed by the tax authorities and make any revisions before the initial reporting deadline. It will be important to watch out for future developments on penalty rules.

Since the standards for exemption of reporting differ from country to country, constituent entities located in countries which have included a provision that is same or similar to ones in 5(2) (and note) above may be asked to submit a CbC report to that country's tax authority.

Master file

1. Outline

   Companies required to report business overview information regarding their MNE group ("master file") must submit a master file to the Tax Office Director within one year from the fiscal year-end of the ultimate parent by e-tax filing.

2. Definition of MNE group

   Company group which prepare consolidated financial statements under applicable accounting standards (excluding cases where the consolidated parent company in the consolidated financial statements is a consolidated subsidiary in other consolidated financial statements) and which has businesses which are tax-resident in two or more jurisdictions (including jurisdictions with a PE or presence equivalent to a PE in other countries).

3. Definition of constituent entity

   a. Entities whose property and profit/loss information is reported in a consolidated financial statement under applicable accounting standards.

   b. Entities which are excluded from the scope of consolidation because of insignificant size of operation.

4. Items to be reported n the master file

   The organizational structure, business overview, financial status and other necessary items – the same as shown in Annex I of the Revised Transfer Pricing Guidelines.

5. Reporting company

   The reporting company for the master file will be a Japanese company which is a constituent entity of a MNE group or a PE of a foreign company. If there are multiple Japanese constituent entities of a MNE group or PEs of foreign companies, one company may file the master file on behalf of all entities.

6. Reporting obligations

   To determine which company is required to submit a master file of the MNE group, a name, location and other necessary information of the reporting company and other constituent entities in Japan must be provided to the Tax Office Director through e-tax filing.

7. Exemption from master file requirement

   MNE group who reported less than JPY100 billion of total consolidated income in the previous fiscal year will be exempted from the master file requirement.

8. Reporting language

   English or Japanese.

9. Penalties

   Penalties will be given for failure to submit the master file by the due date.

10. Timing of enforcement

   The above reform will be enforced to the master file of ultimate parent's fiscal year beginning on 1 April 2016 or later.

Since the definition of a constituent entity differs from country to country (for example, in China, shareholding of 25% or more triggers transfer pricing rules), companies may need to prepare several versions of the master file. Moreover, although the first due date for March-closing companies in Japan is the end of March 2018, the domestic law of other countries may stipulate an earlier due date. In such case, the master file will need to be prepared by that country's due date. It will be important to watch out for future developments on penalty rules.

Local file

1. Outline

   A company which has conducted transactions with foreign related parties must prepare documents (including electrical data) which are considered necessary for calculating arm's length prices ("local file") by the due date of tax returns.

2. Items of local file

   Clarifications will be made regarding the documents listed in the Special Tax Measures Law Enforcement Ordinance 22(10)1 and the items listed in Annex II of the Revised Transfer Pricing Guideline will be added to such "documents".

3. Duration and location for maintaining documents

   The local file must be kept by an office in japan of the company conducting foreign related transactions for seven years from the tax return due date. The original document should to be kept in Japan, however, in case where the original is in oversea, a copy can be kept on behalf.

4. Exemption of foreign related transactions from local file requirement

   Any foreign related transactions with a particular foreign related party with less than JPY5 billion (sum of receipts and payments) in the previous fiscal year (or current fiscal year if there is no previous fiscal year) as well as the intangible assets transactions with less than JPY300 million (sum of receipts and payments) will be exempted from a requirement to prepare and maintain the local file by the due date of tax return ("contemporaneous documentation").

5. Penalties

   The following rules will be established to clarify the conditions of imposing presumptive assessment or carrying out secret comparable approach when the local file is not presented or submitted.

   a. Presumptive assessment on foreign related transactions which is subject to the contemporaneous documentation

      In the following cases, the tax authorities can impose presumptive assessment or carrying out secret comparable approach.

      i. Failure to submit the local file for the foreign related transactions which is subject to the contemporaneous documentation within 45 days of a request from an examiner of the tax authorities.

      ii. Failure to submit documents considered essential for calculating the arm's length price for the foreign related transactions which is subject to the contemporaneous documentation, such as documents which form the basis of the local file and other related documents, within 60 days of a request from an examiner of the tax authorities.

   b. Presumptive assessment on foreign related party transactions which is not subject to the contemporaneous documentation

      The tax authorities can impose presumptive assessment or carrying out secret comparable approach upon failure to submit documents considered essential important for calculating the arm's length price for the foreign related transactions

which is not subject to the contemporaneous documentation, such as documents equivalent to the local file, within 60 days of a request from an examiner of the tax authorities.

6. Other

   Other necessary rules will also be introduced.

7. Clarification to documentation rules for intra-group transactions

   In line with the above, the special measure for taxation of foreign companies' intra-group transactions, the special measure for calculation of Japanese companies' domestic/foreign income, the special measure for taxation of non-residents' intra-group transactions and the special measure for calculation of non-residents' domestic/foreign income will be revised as part of the documentation rules for calculating the arm's length price of intra-group transactions.

8. Timing of enforcement

   The above reform will enforced to corporate tax in a fiscal year beginning on or after 1 April 2017 and income tax in 2018 onwards.

Subject year of the local file is one year behind the one of the CbC report and the master file. However, while the deadline for submission of the CbC report and master file is one year from the end of the fiscal year (end of March 2018 for March-closing companies), the deadline for the local file is the tax return filing deadline for the year (end of June 2018 for non-consolidated March-closing company with an extension), meaning that, in practice, there is not a big difference in timing. Moreover, even for foreign related party transactions which are not subject to the contemporaneous documentation, presumptive assessment or secret comparable approach may be conducted if documents are not submitted within 60 days of a request from the tax authorities. Therefore, irrespective of the requirement of the contemporaneous documentation, in practice it is advisable to prepare and maintain a local file for any foreign related transactions that may have potential transfer pricing risks.

Domestic reforms relating to the new Japan-Taiwan tax agreement

With the signing of the Japan-Taiwan tax agreement in November 2015, on the condition that residents and companies of Japan can receive the same rights in Taiwan (principle of reciprocity), treatment corresponding to the agreement will be incorporated into Japanese law. The same rights are expected to be provided in Taiwan in future.

For further details of the agreement, please see our tax alert on this topic, "Taiwan and Japan sign Income Tax Agreement", of 3 December 2015.

http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--Taiwan-and-Japan-sign-Income-Tax-Agreement

Revision of anti-tax haven rules

The anti-tax haven rules will be revised as follows.

1. Revisions of the exemption criteria

   a. If there is a tax haven subsidiary (which conducts insurance business on the Lloyds market in the UK, the same applies in b) below) that fulfills the requirement that all of their issued shares are directly or indirectly held by a Japanese company and there is another tax haven subsidiary that also fulfills the requirement that all of their issued shares are directly or indirectly held by that Japanese company and fulfills the substance criteria and management control criteria in the country of the tax haven subsidiary's headquarters, the tax haven subsidiary will be said to have fulfilled the substance and management control criteria.

   b. In the non-related party criteria, if a tax haven subsidiary, that fulfills the requirement that all of their issued shares are directly or indirectly held by a Japanese company, conducts transactions with another tax haven subsidiary that also fulfills the requirement that all of their issued shares are directly or indirectly held by that Japanese company, such transactions will not be deemed to be related party transactions.

Subsidiaries of insurance companies that conduct insurance business on the Lloyd's market in the UK generally were not able to satisfy the current exemption criteria due to UK legislation, however, after this revision, the exemption criteria can be satisfied.

2. Revision of foreign tax credits in relation to the anti-tax haven rules

   The amount of foreign corporate tax eligible for a foreign tax credit when the anti-tax haven rules are applied will be calculated as follows. However, dividends received from subsidiaries (companies that fulfill the requirement of 25% or more shareholding) which are not included in the foreign tax base are excluded from tax haven subsidiary income (the denominator) in the following calculation of income inclusion percentage.

$$\text{Foreign corporate tax on the TH sub's income in the tax year} \times \frac{\text{Taxable amount for Japanese company}}{\text{TH sub's income in the tax year}} \text{ (income inclusion percentage)}$$

   These reforms apply to the tax haven subsidiary from the fiscal year beginning on or after 1 April 2016.

Measures in line with the shift to the income attribution principle

The following measures will be established in order to implement a smooth transition to the income attribution principle for international taxation (effective 1 April 2016) which was introduced in the 2014 tax reforms.

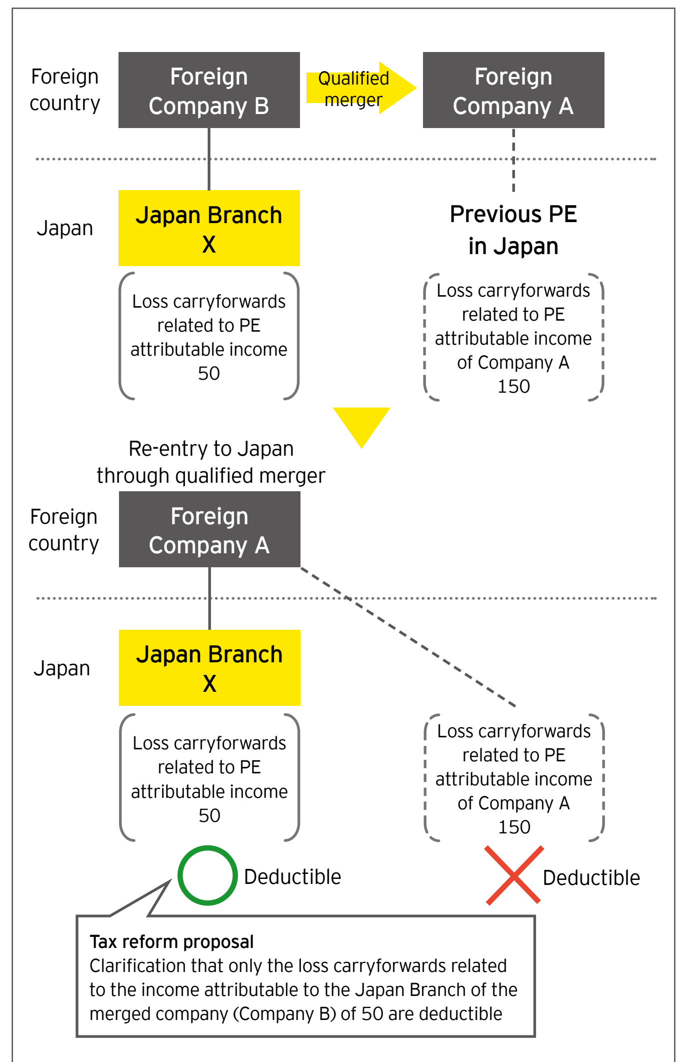
1. Change in the foreign income amount for foreign tax credits

   Clarification has been made that in the calculation of the foreign income amount for the foreign tax credit of a Japanese company, if income attributable to foreign business premises is less than zero, it will be the amount less than zero, and if foreign income (the total of income attributable to foreign business premises plus other foreign source income) is less than zero, it will be zero.

2. Change to the loss carryforward rules for foreign companies

   It has been clarified that when a foreign company (which previously had a permanent establishment) comes to hold a new permanent establishment through a qualified merger, deduction of loss carryforwards from the permanent establishment that it previously held will not be permitted (see Figure A).

Figure A



Source: LDP Tax Commission documents

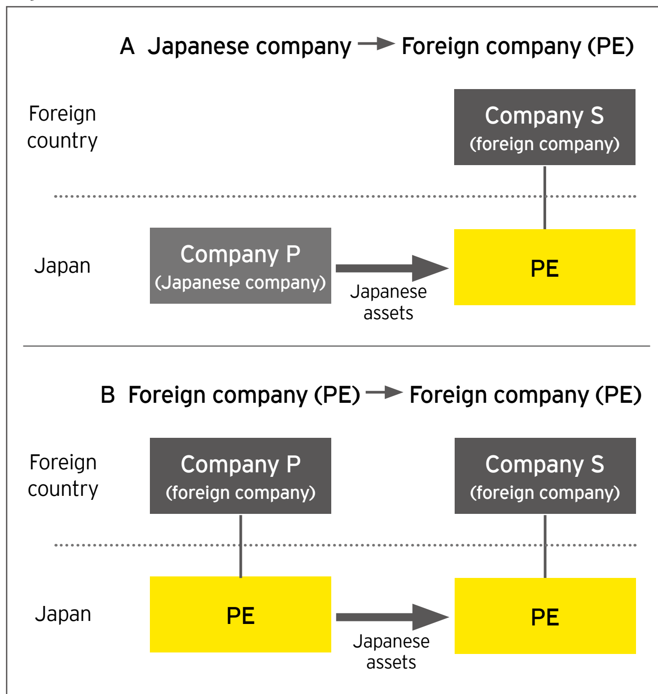
When a foreign company re-enters the Japanese market through a qualified merger, loss carryforwards that it previously held in a Japan branch (PE) cannot be used.

Revisions to the tax-qualified contribution in kind rules

Revisions will be made to the scope of tax-qualified contributions in kind related to contributions in kind made by a foreign company, and contributions in kind made to foreign companies.

1. Contributions in kind made to foreign companies in which all Japanese assets transferred are directly attributed to a permanent establishment will be included in the scope of qualified contributions in kind. However, if real estate in Japan or other assets based on an intra-group transaction from other permanent establishment in Japan to a foreign headquarters at book value are included in the contribution in kind, it is only qualified when the assets in Japan are not expected to be sold in an intra-group transaction after the contribution in kind (see Figure B).

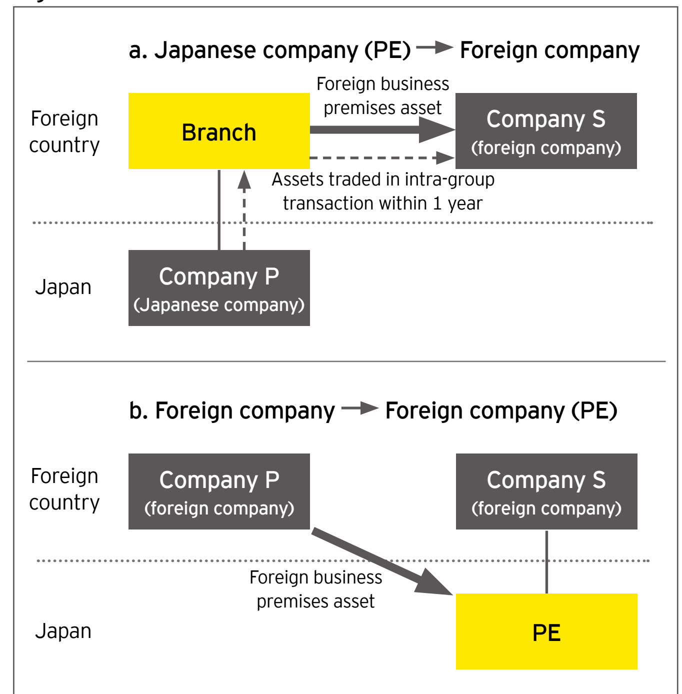
Figure B



Source: LDP Tax Commission documents

2. The following types of contribution in kind will not be allowed as qualified contributions in kind (see Figure C).
   a. A contribution in kind made by a Japanese company to a foreign company in which assets (excluding cash, savings, inventory assets and securities), that became assets of a foreign business premises through an intra-group transaction from the head office of the Japanese company up to one year before the contribution in kind, are directly attributed to a business premises other than a permanent establishment of the foreign company
   b. A contribution in kind made by a foreign company in which the assets of the foreign business premises being transferred are directly attributed to a permanent establishment of another foreign company

Figure C



Source: LDP Tax Commission documents

In line with the shift to the income attribution principle for international taxation introduced in the 2014 tax reforms, the scope of qualified contribution in kind where a foreign company makes or receives the contribution in kind will change.

Individual income taxation

New deduction incentive for capital gains related to unoccupied houses

A JPY30 million special deduction for capital gains on residence-use property will be available in cases where a house (with land) which became unoccupied due to inheritance reasons or land after such an unoccupied house has been demolished is sold, subject to certain conditions.

New incentive for three-generation house renovations

A new tax credit will be introduced for cases where renovations for housing three-generations together are carried out either through the use of a loan or the family's own funds.

Income tax and inhabitants tax credit for housing purchases by non-residents

A special income tax credit will be available in cases where a non-resident, during their period of non-residency, builds, acquires, extends or renovates a house, fulfills the same requirements as residents, and has taken out a mortgage.

New medical expense deduction incentive to encourage self-medication

A new medical expenses deduction incentive will be introduced whereby a person purchasing more than JPY12,000 of certain prescription-to-OTC switch drugs* in a year for themselves, their spouse or other family member with which living expenses are shared, can deduct the excess amount (up to JPY88,000) from total income. If the existing deduction for medical expenses is applied, this special measure cannot be applied.

* *Certain prescription-to-OTC switch drugs refers to behind-the-counter or over-the-counter medicines which were formerly prescription drugs (excluding where similar prescription drugs are not eligible for medical insurance coverage).*

Revisions to exit tax rules

An exit tax was introduced in the 2015 tax reforms in order to prevent avoidance of capital gains tax in Japan by moving abroad while holding securities with built-in gains and later selling them. The 2016 reforms bring additional changes. Stock options will be excluded from the scope of securities subject to exit tax as income from exercising stock options can be taxed in Japan even after moving abroad. The tax payment deferral deadline when assessing exit tax will be five years and four months (currently five years) from the date of moving abroad, the gift or the start of inheritance proceedings.

Statement on exercising stock options granted by a foreign parent company

Stock options granted to executives or employees of the Japanese subsidiary or Japanese branch by a foreign parent company do not satisfy the requirements for tax qualification and are therefore subject to income tax when exercising the rights. To prevent failure to report this, the Japanese subsidiary or branch is required to submit a statement regarding such economic benefits by 31 March of the year following exercise of rights. The reforms this time expand the scope of persons required to file a statement to the following:

1. A resident who was an executive or employee of a Japanese company that is a subsidiary of a foreign company
2. A non-resident who is an executive or employee of a Japanese company that is a subsidiary of a foreign company (including those who were an executive or employee of the Japanese company) and who has been granted economic benefits that are Japan source income

Tax administration

New credit card payment rule

To broaden possible methods for paying national tax, new rules will be introduced allowing payment by credit card for national taxes that can be paid using a payment statement.

Revisions to the scanned document rules

Certain national tax documents may be kept in electronic form. Under the existing law, the device used to capture documents must be a scanner, however under these reforms, digital cameras and smart phones will be permitted. The checks and balances requirement and the regular checks requirement, two of the administrative process requirements for scanned documents, will also be revised.

Revisions to the penalties

1. Amended tax returns filed after an advance notice for tax audit

   In order to deal with cases of avoiding penalties for under-reporting or non-reporting of tax due to filing an amended tax return or filing after the due date, directly after receiving a tax audit notice, the penalties for the period from receiving an audit notice to anticipation of a correction will be set as follows, at a lower rate than after anticipation of a correction. There are no changes to the penalties for non-payment of withholding tax.

<table>
<tr><th></th><th>Initial filing to receiving an audit notice</th><th>Audit notice to anticipation of correction</th><th>After anticipation of correction</th></tr>
<tr><td>Before reform</td><td colspan="2">Under-reporting 0%
Non-reporting 5%</td><td rowspan="2">Under-reporting 10% (15%)
Non-reporting 15% (20%)</td></tr>
<tr><td>After reform</td><td>Under-reporting 0%
Non-reporting 5%</td><td>Under-reporting 5% (10%)
Non-reporting 10% (15%)</td></tr>
</table>

The rates in parentheses above are the penalties after including the additional penalty taxes.

2. Repeated failures to file, falsifications or concealments over a short period

   In order to prevent fraudulent practices, persons that have been subject to penalties for non-reporting or fraud due to anticipating of a correction in the last five years and which file an amended tax return once again based on failure to file, falsification or concealment, a further 10% will be added to both non-reporting penalties and fraud penalties.

Change to the calculation of interest in accordance with the court's decision

In the Supreme Court decision on 12 December 2014, it was judged that when a taxpayer reports and pays tax by the statutory due date and a Tax Office Director corrects the amount downwards upon a claim for correction but later makes a correction upwards, interest should not be incurred during the period from the statutory due date to the tax payment due date for re-correction upwards. Based on this decision, the calculation period for interest will be revised in certain cases.

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