2 February 2015

Japan tax newsletter

Ernst & Young Tax Co.

2015 Tax reform outline

Contents

On 30 December 2014, the 2015 Tax reform outline (hereinafter, "Outline") was released. In this newsletter, we will introduce the main changes and revisions to corporate taxation, international taxation and consumption taxation, etc. that were made public in the Outline.

Please be aware that some items may be changed, removed or added through deliberation in the coming Diet session.

Building a better working world

Background of the 2015 tax reform

- Corporate tax will be reformed with an emphasis on growth with the aim of overcoming deflation and achieving economic revitalization.
- Measures will be taken to combat the low birth rate/aging population/population decline, correct the overconcentration of people in Tokyo and revitalize rural regions.
- Measures will be taken to correspond with the change in timing of the consumption tax increase.
- Efforts will be made to appropriately tax transactions made over international borders and the movement of people, in light of the contents of the BEPS project that the OECD is promoting.

Corporate taxation

Framework of corporate tax reform

The purpose of the new corporate tax reform is to change the structure of corporate taxation to a growth-oriented structure by "lowering the tax rate with the enlargement of the taxation base." Under the new structure of corporate taxation, companies will be encouraged to actively undertake capital investments for profitability improvement and take on challenges for new technology development by reducing the tax burden for companies that have a strong "earning power" or are willing to generate corporate income as the tax burden is shared by broader sources, so as to stimulate growth.

The reform aims to lower the effective corporate tax rate to below 30% over several years starting on FY2015, while alternative permanent tax revenue will be secured through, among others, the enlargement of the taxation base under the improved system.

The first step is to lower the corporate tax rate from the current 25.5% to 23.9% in the 2015 tax reform simultaneously with the revision of the net operating loss (NOL) carry-forward system, the revision of the dividends received deduction (DRD) system, the expansion of size-based taxation (corporate enterprise tax), and the revision of special taxation measures. The standard tax rate for corporate enterprise tax per income levy for large corporations (including local corporate special tax) will be lowered from the current 7.2% to 6.0% in FY2015 and 4.8% in FY2016 in conjunction with the expansion of size-based taxation. Through these measures, the effective corporate tax rate through the country and municipalities will be lowered from the current 34.62% to 32.11% (down 2.51%) in FY2015 and 31.33% (down 3.29%) in FY2016.

Effective corporate tax rates

Current	FY2015	FY2016
34.62%	32.11%	31.33%

Note: Calculated based on a model large corporation subject to size-based taxation (standard tax rate)

The second step will be to lower the tax rates further in the FY2016 tax reforms by securing tax revenue through, among others, the enlargement of the taxation base. Tax reforms in subsequent years will continue to make similar efforts to lower the effective corporate tax rate to below 30%. As part of these efforts, issues such as the scope of corporations subject to size-based taxation, the unification of depreciation method to the straight-line method, and whether to repeal the deductibility of corporate enterprise tax will be considered.

Small and medium-sized enterprises (i.e., corporations with stated capital of 100 million yen or less), which make up 99% of all corporations, are treated differently from large corporations under many taxations systems in addition to the application of lower tax rates and various other tax measures. The appropriateness of the uniform treatment of corporations with stated capital of 100 million yen or less as Small and medium-sized enterprises will be examined with careful evaluation of the actual conditions of these corporations. Meanwhile, given that 70% of Small and medium-sized enterprises are not generating taxable income and the tax burden concentrates on those generating taxable income, which are only a small portion of the total, the examination of the overall taxation on Small and medium-sized enterprises will be continued from a broad perspective in consideration of the purpose and background of various taxation systems.

Taxation on public interest corporations, cooperatives, etc., will also be subject to ongoing examination with careful evaluation of their actual conditions and in light of the intent of the new corporate tax reforms.

Corporations will be required to adjust the carrying amounts of deferred tax assets and liabilities for any change in the effective corporate tax rate if the reform bill has been promulgated and the applicable future tax rates and the details of the new taxation have been finalized by their financial year end date. Therefore, March year-end companies need in practice to evaluate the effect of the new tax reforms on accounting for income taxes in advance.

Corporate tax rates lowered

A final decision has been made to lower the national corporate tax rates. As a result, the national corporate tax rate will be lowered from 25.5% to 23.9% for fiscal years beginning on or after 1 April 2015. The special tax benefits to Small and medium-sized enterprises will be extended for 2 years and the tax rate applicable to their annual income up to 8 million yen will continue to be lowered from 19% to 15% for fiscal years beginning on or before 31 March 2017.

		Current	Proposed
Ordinary corporations		25.5%	23.9%
Small and medium-sized enterprises (Note 1)	Annual income up to 8 million yen	15%(Note 2)	
	Portion of annual income in excess of 8 million yen	25.5%	23.9%

Notes:

1 "Small and medium-sized enterprises" in the table above mean ordinary corporations with stated capital or capital contributions of 100 million yen or less or without any capital or capital contributions as of the end of each fiscal year (excluding wholly-owned subsidiaries of a large corporation with capital of 500 million yen or more and corporations whose outstanding shares are wholly-owned by multiple large corporations within a 100% group)

2 The lower tax rate applicable to Small and medium-sized enterprises that would otherwise be 19% had been lowered to 15% as part of "special tax benefits." The application period of these special tax benefits will be extended for 2 years.

Revision of the net operating loss (NOL) carry-forward system

The net operating loss (NOL) carry-forward system will be revised as follows:

1. The limit on NOL deduction under the carry-forward system for loss on blue-return filing, loss on disaster and consolidated loss will be lowered in phases as follows:
    - i. For fiscal years beginning between on or after 1 April 2015 and on or before 31 March 2017 to which loss is carried forward, the limit will be lowered to the amount equivalent to 65% of taxable income before the application of loss carried forward (from the current 80%).
    - ii. For fiscal years beginning on or after 1 April 2017 to which loss is carried forward, the limit will be lowered to the amount equivalent to 50% of taxable income before the application of loss carried forward.

	Current	Fiscal years beginning between on or after 1 April 2015 and on or before 31 March 2017	Fiscal years beginning on or after 1 April 2017
Limit on NOL deduction	80% of taxable income	65% of taxable income	50% of taxable income

2. In conjunction with the revision described in *1* above, the following measures will be taken for fiscal years beginning on or after 1 April 2015.
    - i. The current limit on NOL deduction (equivalent to 100% of taxable income) will continue to be applied to Small and medium-sized enterprises.
    - ii. For corporations that have commenced reorganization or rehabilitation procedures, the applicable limit will be the amount equivalent to 100% of taxable income for fiscal years which contain days within the period starting from the day on which a decision is granted to commence such procedures to the day on which 7 years have passed since the day on which a decision is granted to approve the reorganization or rehabilitation plan. (However, this does not apply to fiscal years ending on or after the day on which shares of such a corporation are listed again on a financial instruments exchange.)
    - iii. For newly established corporations, the applicable limit will be the amount equivalent to 100% of taxable income for fiscal years which contain days within the period starting from the establishment date of a corporation to the day on which 7 years have passed since the establishment date. (However, this does not apply to fiscal years ending on or after the day on which shares of such a corporation are listed on a financial instruments exchange.)

      Note: Excludes wholly-owned subsidiaries of a large corporation with capital of 500 million yen or more and corporations whose outstanding shares are wholly-owned by multiple large corporations within a 100% group.
    - iv. The current limit on NOL deduction (equivalent to 100% of taxable income) will continue to be applied to specific purpose companies (TMKs), investment corporations (J-REITs), etc., to which the dividend deduction system applies.

<table>
<tr><th rowspan="2"></th><th colspan="2">Limit on NOL deduction</th></tr>
<tr><th>Current</th><th>Proposed</th></tr>
<tr><td>Small and medium-sized enterprises</td><td colspan="2">100% of taxable income</td></tr>
<tr><td>Corporations that have commenced reorganization or rehabilitation procedures: for fiscal years which contain days within the period starting from the day on which a decision is granted to commence such procedures to the day on which 7 years have passed since the day of such a decision</td><td>100% of taxable income</td><td>100% of taxable income
(However, this does not apply to fiscal years ending on or after the day on which shares of such a corporation are listed again on a financial instruments exchange.)</td></tr>
<tr><td>Newly established corporations</td><td>-</td><td>100% of taxable income
(However, this does not apply to fiscal years ending on or after the day on which shares of such a corporation are listed on a financial instruments exchange.)</td></tr>
<tr><td>Specific purpose companies (TMKs), investment corporations (J-REITs), etc., to which the dividend deduction system applies</td><td colspan="2">100% of taxable income</td></tr>
</table>

3. The carry-forward period of loss on blue-return filing, loss on disaster and consolidated loss will be extended from 9 years to 10 years. In conjunction with this extension, the preservation period of books and documents pertaining to the application of the NOL carry-forward rules, the loss reassessment deadline, and the deadline for the submission of request for loss reassessment will also be extended from 9 years to 10 years. This revision will apply to losses arising in fiscal years beginning on or after 1 April 2017.

The lowering of the limit on NOL deduction is expected to have a significant impact on accounting for income taxes at the year-end. Corporations that have recognized deferred tax assets for its tax loss carryforwards may need to reverse part of them. If there are both corporations generating taxable income and those generating taxable losses within a corporate group in which each corporation files a stand-alone tax return, the incentive to file tax returns under the consolidated tax return system will be higher.

Revision of the dividends received deduction (DRD) system

The dividends received deduction (DRD) system will be revised as follows:

1. The amount that can be excluded from gross revenue for each stock ownership ratio category will be amended as follows:

<table>
<tr><th colspan="2">Current</th><th colspan="2">Proposed</th></tr>
<tr><th>Category (ownership ratio)</th><th>Amount excluded from gross revenue</th><th>Category (ownership ratio)</th><th>Amount excluded from gross revenue</th></tr>
<tr><td>Shares of wholly-owned subsidiaries (100%)</td><td>Full amount of dividends received</td><td>Shares of wholly-owned subsidiaries (100%)</td><td>Full amount of dividends received</td></tr>
<tr><td rowspan="2">Shares of affiliates (Less than 100%, but not less than 25%)</td><td rowspan="2">Full amount of dividends received (with debt interest exemptions)</td><td>Shares of affiliates (More than 1/3, less than 100%)</td><td>Full amount of dividends received (with debt interest exemptions)</td></tr>
<tr><td rowspan="2">Other shares (More than 5%, up to 1/3)</td><td rowspan="2">50% of dividends received (no debt interest exemptions)</td></tr>
<tr><td rowspan="2">Other than the above (Less than 25%)</td><td rowspan="2">50% of dividends received (with debt interest exemptions)</td></tr>
<tr><td>Shares held for non-controlling purposes (5% or less)</td><td>20% of dividends received (no debt interest exemptions)</td></tr>
</table>

2. Dividends of securities investment trusts other than bond investment trusts will be fully included in the gross revenue. However, 20% of dividends of specified equity investment trusts (such as ETFs) will be excluded from gross revenue as their beneficial interest is treated in the same way as shares falling under the category of shares held for non-controlling purposes in *1* above.

3. In conjunction with the revision above, a special provision will be created under which 40% of dividends received by an insurance company filing blue tax returns from shares held for non-controlling purposes may be excluded from gross revenue. The special provision on dividends received deduction (DRD) system for non-life insurance companies (special provision on debt interest exemptions pertaining to special interest) will be repealed.

Note: The base year for the purpose of applying the simplified method of the calculation of debt interest exemptions for shares of affiliates will be a fiscal year beginning between on or after 1 April 2015 and on or before 31 March 2017.

In most cases, the ownership ratio of listed shares held for investment purposes would be 5% or less. For dividends received from such shares, the amount that can be excluded from gross revenue will be lowered significantly (from 50% to 20%).

Revision of tax credit for research and development (R&D) expenses

Tax credit for R&D expenses will be revised as follows:

1. The limit on the total tax credit available (for both general R&D expenses and special R&D expenses) will continue to be 30% of the corporate tax liability of each fiscal year.
2. Tax credit for special R&D expenses will be revised as follows:
   i. The tax credit rate will be raised as follows:
      a. Joint research with special R&D institutions or universities and research commissioned to such institutions: 30%; and
      b. Special R&D other than the above: 20%

   ii. The limit on the tax credit available for special R&D expenses will be 5% of the corporate tax liability of each fiscal year separate from the limit on the total tax credit available for R&D expenses and the limit on the R&D tax credit available for Small and medium-sized enterprises to strengthen their technological base.

   iii. The scope of special R&D expenses will be revised as follows:
      a. With regard to special R&D institutions, corporations other than national research and development corporations will be excluded from the scope of R&D Incorporated Administrative Agencies.
      b. The scope of outsourcing contractors for the contract research to which specified Small and medium-sized enterprises are commissioned will include public interest corporations, local government agencies, and local independent administrative agencies.
      c. Royalties for the use of intellectual property rights paid to specified Small and medium-sized enterprises will be included.
3. The limit on the total tax credit available for R&D expenses and the limit on the R&D tax credit available for Small and medium-sized enterprises to strengthen their technological base will be lowered to 25% of the corporate tax liability of each fiscal year from the current 30%.

   Note: The amount of R&D expenses subject to the regime above will not include the amount of special R&D expenses for which separate tax credits for special R&D expenses are available.
4. The carryover of unused creditable amount including that for Small and medium-sized enterprises will be repealed.

		Current	Proposed
Limit on total tax credit		30% of the corporate tax liability	
General R&D expenses	Tax credit rate	8~10% (12% for Small and medium-sized enterprises)	
	Limit on tax credit	30% of the corporate tax liability	25% of the corporate tax liability
Special R&D expenses	Tax credit rate	12%	i. Joint research with special R&D institutions or universities: 30% ii. Other than the above: 20%
	Limit on tax credit	Within the limit on tax credit available for general R&D expenses	5% of the corporate tax liability of each fiscal year separate from the limit on tax credit available for general R&D expenses
Unused creditable amount		Carryover for 1 year	Carryover will be repealed

Expansion of size-based taxation

1. Revision of corporate enterprise tax rate

   The standard tax rates of corporate enterprise tax and local corporate special tax for ordinary corporations with stated capital or capital contributions (hereinafter referred to as "capital") of more than 100 million yen will be revised as follows:

		Current	Proposed	
			FY2015	FY2016 -
Per value added levy		0.48%	0.72%	0.96%
Per capital levy		0.2%	0.3%	0.4%
Per income levy	Annual income of 4 million yen or less	3.8%(2.2%)	3.1%(1.6%)	2.5%(0.9%)
	Annual income of more than 4 million yen, but not more than 8 million yen	5.5%(3.2%)	4.6%(2.3%)	3.7%(1.4%)
	Annual income of more than 8 million yen	7.2%(4.3%)	6.0%(3.1%)	4.8%(1.9%)
Local corporate special tax		67.4%	93.5%	152.6%

Notes:
1. The percentages in the parentheses in the per income levy column indicate the tax rates after the application of the Act on Temporary Measures concerning Local Corporate Special Tax.
2. No tax rate reduction with respect to per income levy will be available for corporations that operate by establishing offices or business offices in 3 or more prefectures.

2. Revision of the taxable basis of corporate enterprise tax per capital levy and the tax rate category of corporate inhabitant tax per capita levy

   The amount of capital for tax purposes (the stated capital plus capital surplus for tax purposes) of a corporation may become extremely small due to, for example, the acquisition of its own shares. In order to address such a situation, the taxable basis of per capital levy will be changed from the amount of capital for tax purposes under the current rule to the larger of the "amount of capital for tax purposes" and the "total amount of stated capital and legal capital reserve." The tax rate category of corporate inhabitant tax per capita levy will also be changed to the larger of the "amount of capital for tax purposes" and the "total amount of stated capital and legal capital reserve."

3. Introduction of taxation for the promotion of salary growth with regard to per value added levy

   For fiscal years beginning between on or after 1 April 2015 and on or before 31 March 2018, an increase in salary under the tax credits for the salary growth system can be deducted from the taxable basis of per value added levy if the following requirements are satisfied:

   i. The percentage increase in salary to the standard salary amount <u>is equal to or greater than a prescribed percentage</u>.

   ii. The amount of salary for the current fiscal year is equal to or greater than that for the previous fiscal year.

   iii. The average amount salary for the current fiscal year exceeds that for the previous fiscal year.

   Note: For the specific values of prescribed percentages in *a* above, see "Revision of the salary growth system" in *8* below.

4. Measures to reduce tax burden increases resulting from the revision of the corporate enterprise tax rates

   For ordinary corporations with stated capital of more than 100 million yen, but with a value added amount of less than 4 billion yen, measures will be implemented to reduce tax burden increases resulting from the revision of the corporate enterprise tax rates for a period of 2 years.

Value added amount	Amount deducted from corporate enterprise tax due	
	Fiscal years beginning between on or after 1 April 2015 and on or before 31 March 2016	Fiscal years beginning between on or after 1 April 2016 and on or before 31 March 2017
3 billion yen or less	(Amount of enterprise tax for the fiscal year - Amount calculated by multiplying the taxable basis of each category for the fiscal year by the applicable enterprise tax rate as of <u>31 March 2015</u>) × <u>1/2</u>	(Amount of enterprise tax for the fiscal year - Amount calculated by multiplying the taxable basis of each category for the fiscal year by the applicable enterprise tax rate as of <u>31 March 2016</u>) × <u>1/2</u>
More than 3 billion yen, but less than 4 billion yen	(Amount of enterprise tax for the fiscal year - Amount calculated by multiplying the taxable basis of each category for the fiscal year by the applicable enterprise tax rate as of <u>31 March 2015</u>) × <u>a percentage between 1/2 and 0 depending on the amount of value added amount</u>	(Amount of enterprise tax for the fiscal year - Amount calculated by multiplying the taxable basis of each category for the fiscal year by the applicable enterprise tax rate as of <u>31 March 2016</u>) × <u>a percentage between 1/2 and 0 depending on the amount of value added amount</u>

Creation of a taxation system for helping corporations to strengthen their local presence

In conjunction with the amendment to the Local Revitalization Act, measures will be taken to introduce special depreciation or a special tax credit for corporate tax applicable to the acquisition of a building located in a local area and to expand the job development tax system. Under this system, separate measures will be taken to help local corporations to strengthen their headquarter functions (expansion type) and help corporations to relocate their headquarter functions from a metropolitan area to a local area (relocation type).

1. Special depreciation or special tax credit for the acquisition of a building located in a local area

   The "expansion type" measures will apply to cases where a corporation filing blue tax returns receives approval for the local operation reinforcement implementation plan (provisional name) under the Local Revitalization Act during the period from the enforcement date of the amendment to the Local Revitalization Act to 31 March 2018, and acquires and makes available for use in its business operations a building and its improvements and structures specified in the local operation reinforcement implementation plan within 2 years from the date of the approval provided that the acquired property satisfies a certain size requirement. The "relocation type" measures will apply to cases where the local operation reinforcement implementation plan proposes the relocation of a specified facility (provisional name) under the Act from one of the specified areas (provisional name) under the Act to an area other than large cities (provisional name) under the Act (relocation from a metropolitan area to a local area). The ratio of special deprecation and the ratio of special tax credit for both cases are shown in the following table. A corporation may only elect the application of either the special depreciation or the special tax credit. The amount of special tax credit is subject to a limit of 20% of corporate tax liability of each fiscal year.

Note: "Provided that the acquired property satisfies a certain size requirement" mentioned above refers to cases where the total acquisition cost of a building and its improvements and structures is at least 20 million yen (or 10 million yen for Small and medium-sized enterprises).

	Ratio of special depreciation	Ratio of special tax credit	
		Acquisitions by a corporation that has received the approval for the plan by 31 March 2017	Acquisitions other than those specified in the left column
Expansion type	15%	4%	2%
Relocation type	25%	7%	4%

2. Expansion of the job development tax system

The application of the job development tax system in cases where the number of employees has increased will be revised as follows:

i. In the case where a corporation filing blue tax returns receives approval for the local operation reinforcement implementation plan during the period from the enforcement date of the amendment to the Local Revitalization Act to 31 March 2018 and has relocated to, newly established or expanded a business office that is a specified facility (such as a local office) in accordance with the local operation reinforcement implementation plan during the fiscal years containing the period from the date of the approval to the day on which 2 years have passed since the date of the approval (eligible fiscal years), the amount of tax credit available will be calculated by multiplying the number of increased employees at the specified facility (up to the number of increased employees in the entire corporation) by either of the following amounts as applicable:

   a. Cases where the current requirements are satisfied: 500,000 yen; or

   b. Cases where the current requirements other than the requirement that the ratio of the increase in the total number of employees be 10% or more are satisfied: 200,000 yen.

ii. In the case where "relocation type" measures are applicable under *i* above, the amount of tax credit available in each eligible fiscal year after the fiscal year in which such measures are applied will be calculated by multiplying the total number of increased employees at the business office that is a specified facility during eligible fiscal years prior to said fiscal year by 300,000 yen.

Notes:

1. In the case where the measures mentioned in *i* above are applicable, if the case falls under *a* above, the number of increased employees underlying the application of said measures will be deducted from the number of increased employees underlying the application of the current job development tax system.
2. The measures mentioned in *ii* above will not be applicable to cases where employees are terminated at the convenience of the employer or the employer engages in an amusement business.
3. The measures mentioned in *ii* above will not be applicable to a fiscal year in which the number of employees at the business office that is a specified facility or in the entire corporation has decreased, and subsequent fiscal years.
4. The amount of tax credit under *i* and *ii* above will be subject to a limit that is calculated by subtracting the amount of tax credit available under the current job development tax system and the amount of credit available under *1* above from 30% of the corporate tax liability of each fiscal year.

	Tax credit (per increased employee)	
	The percentage increase in the total number of employees of the entire corporation: less than 10%	The percentage increase in the total number of employees of the entire corporation: 10% or more
Expansion type	200,000 yen	500,000 yen
Relocation type	200,000 yen + (300,000 yen (up to 3 consecutive years))	500,000 yen + (300,000 yen (up to 3 consecutive years))

Others

- Revision of the salary growth system

With regard to the requirements for the application of the salary growth system listed below, the required percentage increase in salary in *a* below will be revised.

Requirements

a. The percentage increase in salary to the standard salary amount is equal to or greater than a prescribed percentage.

b. The amount of salary for the current fiscal year is equal to or greater than that for the previous fiscal year.

c. The average amount salary for the current fiscal year exceeds that for the previous fiscal year.

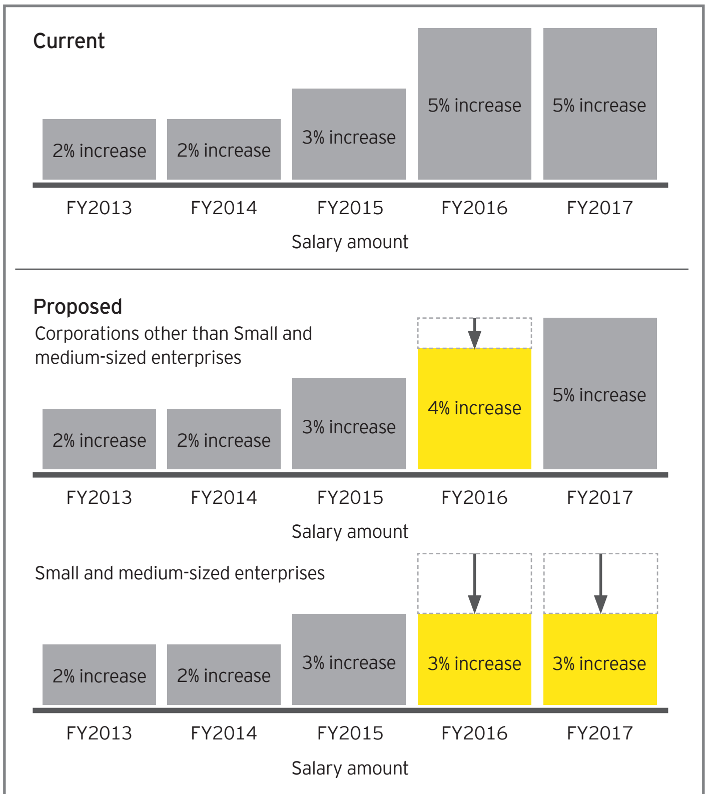
Proposal of the required percentage increase in salary

1. Small and medium-sized enterprises

   The required percentage increase in salary will be changed from 5% to 3% for the applicable fiscal years beginning on or after 1 April 2016.

2. Corporations other than Small and medium-sized enterprises

   The required percentage increase in salary will be changed from 5% to 4% for the applicable fiscal years beginning between on or after 1 April 2016 and on or before 31 March 2017.



Source: The Tax Reform Outline of FY2015, Ministry of Finance, with partial edits

- **Revision of the method for effectiveness testing of option transactions**

With regard to hedge effectiveness testing for option transactions accounted for under the deferral or fair value hedge accounting, a corporation may change the effectiveness testing method to a method based on the comparison between the valuation difference on assets that are hedged items and changes in fair value of the underlying instrument of the option transactions by submitting a written notice to the district director of the tax office.

- **Revision of the special provisions for taxation on specific purpose companies (TMKs)**

With regard to the special provisions for taxation on TMKs, TMKs established on or before 1 April 2010 that have not submitted the notice of the commencement of business by 31 March 2015 will be subject to the requirement that the ratio of specified capital contributions offered within Japan should exceed 50% starting in fiscal years beginning on or after 1 April 2015.

- **Elimination of double taxation due to the tax-accounting mismatch in investment corporations (J-REITs)**

Given the amendment to the Investment Trust Act, an amount equivalent to the amount of increase in the provision for temporary difference adjustment (provisional name), which is part of the distribution of excess profit, will be included in the amount of dividends that are included in the amount of allowance for temporary difference (provisional name). In addition, the amount of increase in the reserve for temporary difference adjustment (provisional name) will be deducted from the amount of distributable profit under the over 90% controlling dividend requirement.

- **Extension of the special provisions on replacement under item 9 (deferred capital gain taxation applicable to the replacement of long-lived assets)**

The application period of the special provision on the replacement of specified assets as applicable to the replacement of domestic and long-lived land, buildings, etc. with domestic land, buildings, machinery and equipment, etc. (Article 65-7(1)(ix) of the Special Taxation Measures Law) will be extended for a period of 2 years and 3 months (until 31 March 2017) subject to the following revisions:

1. Machinery and equipment and container freight cars will be excluded from the scope of eligible replacement assets.
2. With regard to the replacement of assets from those in an area other than large cities (provisional name) under the amended Local Revitalization Act with assets from those in a large city, the ratio of deferred taxation will be lowered from 80% to 75% (in the case of the replacement of assets to specific area (provisional name) under the amended Local Revitalization Act, the ratio of deferred taxation will be lowered from 80% to 70%).

International taxation

Revision of the foreign dividends exclusion (FDE) system

- Dividends that a domestic corporation receives from its foreign subsidiary (i.e., a foreign corporation satisfying certain requirements including a stock ownership ratio of 25% or more) will be excluded from the FDE system if they are wholly or partially included as deductible expenses according to the laws of the country where the headquarters of the foreign subsidiary reside.
- If a portion of the dividends that a domestic corporation receives from its foreign subsidiary are included as deductible expenses as mentioned above, the domestic corporation may elect to exclude only such portion from the FDE system. In this case, the domestic corporation is required to attach prescribed statements to the tax return and preserve certain documents.
- Foreign tax credits will be available for the amount of withholding taxes imposed on dividends that are excluded from the FDE system.

This revision will apply to dividends that a domestic corporation will receive from its foreign subsidiary in fiscal years beginning on or after 1 April 2016. However, the old rule will continue to apply to such dividends received from a foreign subsidiary during fiscal years beginning between on or after 1 April 2016 and on or before 31 March 2018 (limited to those pertaining to stocks of said foreign subsidiary held by the domestic corporation as of 1 April 2016).

> The foreign dividends exclusion (FDE) system, which was introduced as part of the 2009 tax reforms, permitted the exclusion of foreign dividends from taxable income without any limitation on the eligible amount, including those that are included as deductible expenses on the part of the paying entity (deductible dividends). BEPS (Base Erosion and Profit Shifting) Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements published in September 2014 addresses the issue of double non-taxation resulting from the existence of dividends that are included as deductible expenses in the country where the paying entity resides and excluded from taxable income in the country where the receiving entity resides. In response to this recommendation, deducible foreign dividends (such as preferred dividends on redeemable preference shares in Australia and interest on capital dividends in Brazil) will be excluded from the FDE system.

Revision of the controlled foreign company rules

1. Revision of the trigger tax rate

   The effective tax rate used as a measure for determining whether a foreign subsidiary is a specified foreign subsidiary under the controlled foreign company rules (also called the trigger tax rate) will be changed from "20% or less" to "less than 20%."

2. Revision of the exemption rules

   - The scope of controlled companies as applicable to the business purpose test will include a domestic corporation satisfying certain requirements including 50% or more of its outstanding shares owned by a specified foreign subsidiary. Under the current requirements, a foreign corporation that would otherwise be treated as a specified foreign subsidiary will be exempted from the application of the CFC rules as a regional headquarters company if it manages and controls at least two controlled companies. Under the new requirements, such a foreign corporation would be treated as a regional headquarters company if it manages and controls multiple controlled companies including at least two controlled companies that are foreign corporations.
   - Under the revised rules, for a foreign corporation to be qualified as an operating holding company in the application of the business purpose test, the ratio of the total book value of the shares held by the regional headquarters company in its controlled companies that are foreign corporations to the total book value of the shares held by the regional headquarters company in all of its controlled companies, or the ratio of the total consideration received by the regional headquarters company for its management and control activities conducted for its controlled companies that are foreign corporations to the total consideration received by the regional headquarters company for its management and control activities conducted for all of its controlled companies will be required to exceed 50%, in addition to the existing requirements.
   - In the application of the unrelated party test, transactions between a regional headquarters company whose main business is wholesale trade and its controlled company that is a domestic corporation will be regarded as related-party transactions.

3. Revision of return filing requirements

   In the case where no document stating that the exemption rules have been applied had been attached to the tax return or no materials clarifying the application of the exemption rules had been preserved, the exemption rules may still be applied if the district director of the tax office finds any unavoidable grounds for such omission of attachment or preservation provided that said document and materials have been submitted.

   The revisions described in *1* through *3* above will apply to the fiscal years of a specified foreign subsidiary beginning on or after 1 April 2015.

4. Treatment of cases where a specified foreign subsidiary receives dividends from its subsidiary

    - Dividends that a specified foreign subsidiary receives from its subsidiary (i.e., a corporation satisfying certain requirements including a stock ownership ratio of 25% or more) will not be deducted in the calculation of the amount included in the taxable income of the specified foreign subsidiary if they are deductible dividends (i.e., the dividends are wholly or partially included as deductible expenses according to the laws of the country where the headquarters of the subsidiary reside).
    - Any portion of deductible dividends that a specified foreign subsidiary receives from another specified foreign subsidiary will be deducted in the calculation of the amount included in the taxable income of the former to the extent it arises from the amount included in the taxable income of the latter.

    This revision will apply to the amount included in the taxable income of a specified foreign subsidiary for its fiscal years beginning on or after 1 April 2016.

5. Treatment of cases where a domestic corporation receives dividends from its specified foreign subsidiary

    Deductible dividends that a domestic corporation receives from a specified foreign subsidiary will not be included in the calculation of taxable income of the domestic corporation until the cumulative amount of such deductible dividends reaches the total amount included in the taxable income of the specified foreign subsidiary during its fiscal year that includes the day on which the domestic corporation receives dividends and fiscal years beginning within 10 years before the day on which said fiscal year begins.

    This revision will apply to dividends that a domestic corporation will receive from its specified foreign subsidiary in fiscal years beginning on or after 1 April 2016. However, the old rule will continue to apply to such dividends received from a specified foreign subsidiary during fiscal years beginning between on or after 1 April 2016 and on or before 31 March 2018 (limited to those pertaining to stocks of said specified foreign subsidiary held by the domestic corporation as of 1 April 2016).

As a result of the revision of the trigger tax rate, a foreign subsidiary residing in a country whose corporate tax rate is 20% such as the U.K. (in or after April 2015) and Thailand will not be treated as a specified foreign subsidiary. (However, such a foreign subsidiary may continue to be treated as a specified foreign subsidiary after the effective date of the revision if it has a certain amount of non-taxable income.)

Measures concerning the change to the attributable income approach

For the smooth implementation of the change in international taxation principle to an attributable income approach introduced as part of the 2014 tax reforms, the following measures will be taken:

1. It will be clarified that interest that a foreign corporation receives on trade receivables due within 6 months does not fall under "domestic asset investment/holding income," a category of Japan-sourced income under the Corporate Tax Act.
2. If there is any intra-company transaction between a permanent establishment (PE) of a foreign corporation and its headquarters that falls under an asset transfer or acquisition by the PE that would give rise to Japan-sourced income such as a capital gain or rental income on domestic real estate that is taxable regardless of whether it is attributable to the PE, the intra-company transaction will be deemed to have been carried out at the amount equivalent to the book value immediately preceding the transaction in the calculation of income of the foreign corporation pertaining to the PE-attributable income.
3. The deductible amount under the interest expense deduction system pertaining to capital of a foreign bank will be limited to the amount stated in the tax return.
4. A calculation method to calculate foreign income for foreign tax credit purposes for a domestic corporation will be prescribed separately for PE-attributable income and other foreign-sourced income. In addition, necessary measures will be taken to clarify the calculation of income of the domestic corporation pertaining to PE-attributable income.

This revision will apply to corporate tax for fiscal years beginning on or after 1 April 2016 and income tax for 2017 and thereafter.

Other revisions

1. Reporting requirements for the automatic exchange of financial account information on non-residents

    A person who intends to carry out a certain transaction such as the conclusion of a contract with a bank or certain other financial institution for the acceptance of deposits or savings through its domestic sales office (specified transaction) on or after 1 January 2017 will be required to submit a written notice containing, among other necessary matters, the following information to the head of the sales office of the reporting financial institution each time the person carries out such a specified transaction: the person's name, address, date of birth, country of residence, taxpayer identification number in the country of residence if it is a foreign state, and if the country of residence is different from the country or the region of its address, the details of such circumstances.

In response to the agreement reached at the G20 summit to automatic exchange of account information on non-residents among the tax authorities of the G20 countries to prevent international tax evasion, new rules will be introduced that require Japanese financial institutions to report account information on non-residents.

2. Revision of the special provisions on eligibility assessment pertaining to cross-border reorganization

    - In the case where the actual tax burden rate of a foreign corporation cannot be calculated because of a short time period elapsed since its establishment, the tax burden rate of such a foreign corporation shall be deemed to be the foreign corporate tax rate of the country where its headquarters reside that is applicable to the foreign corporation if it had reported income.
    - In conjunction with the abovementioned change of the trigger tax rate under the CFC rules from "20% or less" to "less than 20%," the tax burden rate used as a measure for determining whether a foreign corporation is a specified foreign corporation with less tax burden will also be changed from "20% or less" to "less than 20%."

    This revision will apply to mergers and other reorganizations undertaken on or after 1 April 2015.

Consumption taxation

Consumption tax increase

The increase of consumption tax to 10% had been scheduled for October 2015 based on the Joint Reform of Social Security and Tax Systems Law. However, as Prime Minister Abe announced last November regarding the delay of the increase, the following reforms are expected.

- Consumption tax rate (national and local) will be increased to 10% on 1 April 2017.
- Designated date for transitional measures of contracted construction, etc. will be 1 October 2016.
- An "economic resiliency" clause in the Supplementary Provisions Article 18 Item 3 will be deleted.

The expiry date of the Act Concerning Special Measures for Pass-on of Consumption Tax will be extended to 30 September 2018, according to the change of date of the consumption tax increase to 10%.

Multiple consumption tax rates will be introduced at the time consumption tax rate is raised to 10% based on the understanding of the public including relevant businesses. Deliberations for concrete measures regarding applicable items, accounting classifications and secure funding will be conducted as soon as possible.

Consumption tax for cross-border service provision

1. Revision of the place-of-supply criteria for the provision of digital services

    The place-of-supply criteria for the provision of digital services (provision of services via telecommunication lines, such as the distribution of e-books, music and advertisements) will be changed from the location of the office, etc. providing the service, to the address, etc. of the person receiving the service.

2. Scope of affected transactions

    Digital services do not include the provision of services accompanying the transfer of assets (other than digital services) or simply allowing the use of telecommunication lines; however, transactions pertaining to the "licensing of copyrighted work" are included. Further deliberations regarding the scope of applicable transactions are expected to take place.

3. Implementation of reverse charge mechanism for B-to-B transactions

    For the provision of B-to-B digital services, a reverse charge mechanism will be implemented, which places the obligation to paying consumption tax for the transactions on the business receiving the services.

    i. Provision of B-to-B digital service

        The provision of digital services, where it is clear from the nature of the services provided or relevant contractual provisions that the receiver of such services is a business, will be classified as the "provision of B-to-B digital services".

ii. Overseas businesses (provider)

Overseas businesses providing B-to-B digital services will provide digital services to domestic businesses without charging consumption tax. Overseas businesses providing B-to-B digital services to domestic businesses will be required to indicate to the domestic businesses in advance that the domestic business will be responsible for paying consumption tax.

iii. Domestic businesses (customer)

As stated above, the obligation to paying consumption tax for B-to-B digital services will be placed on the business receiving the service. Although domestic businesses will receive B-to-B digital services without being charged consumption tax, the domestic businesses will become responsible for paying consumption tax related to the reverse charge. The domestic businesses will be able to claim an input tax credit for the amount of consumption tax paid.

If a tax-exempt business receives B-to-B digital services, the business will not be obligated to pay consumption tax. In addition, if the taxable sales ratio for the taxable period that a domestic business receives B-to-B digital services is 95% or greater, for the time being, the service provision performed during this taxable period is deemed null and excluded from the entity's consumption tax returns.

4. Method of taxation for B-to-C transactions and measures to secure appropriate taxation

For the provision of B-to-C digital services by overseas businesses to the Japanese market, overseas service providers will be obligated to pay consumption tax. If the B-to-C digital service is provided to domestic businesses, in principle, the domestic businesses will not be allowed to claim input tax credit for the time being. However, under certain conditions in the overseas business registration system described in section *5* below, the domestic businesses will be allowed to claim input tax credits.

i. Provision of B-to-C digital services

All digital services provided by overseas businesses other than B-to-B digital services will be classified as the "provision of B-to-C digital services".

ii. Overseas businesses (provider)

As stated above, overseas businesses providing B-to-C digital services to the Japanese market will be obligated to pay consumption tax. When B-to-C digital services are provided to domestic businesses, the overseas business registration system described in section 5 below may be applied.

iii. Domestic businesses (customer)

If services received by domestic businesses are classified as B-to-C telecommunication services, in principle, the domestic businesses receiving services classified as B-to-C digital services will not be allowed to claim input tax credits for the time being. However, the domestic businesses will be allowed to claim input tax credits if certain requirements, such as the storing of invoices listing the registration number of the overseas business, are met under the overseas business registration system described in section *5* below .

5. Establishment of the overseas business registration system

i. Registered overseas businesses

Certain overseas service providers (other than businesses which are subject to the tax exemption for small businesses) satisfying the following criteria may become registered overseas businesses by submitting an application to the Commissioner of the National Tax Agency via the district director of the tax office with jurisdiction over the place of tax payment and becoming registered.

- The overseas service provider has a business office, facility or establishment of a similar nature in Japan related to the provision of digital services for the Japanese market, or a tax agent for consumption tax purposes
- For businesses that do not have an office in Japan, etc. but are required to have a tax representative, that a tax representative has been appointed.
- There is no delinquency in payment and at least one year has passed since the cancellation of a previous overseas business registration.

ii. Application and cancellation

The application outlined above in *i* may be made on or after 1 July 2015.

Information including the name of the registered overseas business, the address or location of its headquarters or principal office, and the registration number will be immediately disclosed online after registration is complete.

If a notification requesting a cancellation of the registration is submitted to the Commissioner of the National Tax Agency via the district director of the tax office with jurisdiction over the place of tax payment, the registration will lose its validity as of the day following the final day of the taxation period in which the notification was submitted (if the notification is submitted after a certain date, of the following taxation period).

The tax exemption for small businesses will not apply for taxation periods following the taxation period in which it was registered unless a notification to request the cancellation of the registration is submitted.

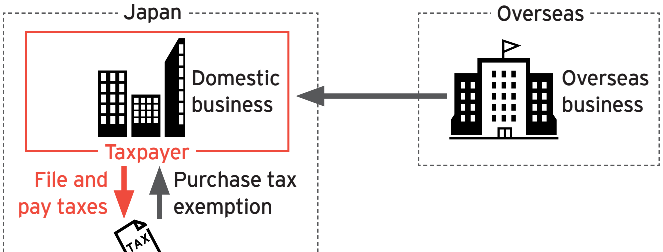
6. Tax exemption for small businesses

The Japanese consumption tax law provides an exception which exempts enterprises from consumption tax obligations under certain circumstances, such as where taxable sales during the base period do not exceed JPY10M.

The tax reform provides the following exceptions in determining the tax obligations of overseas service providers.

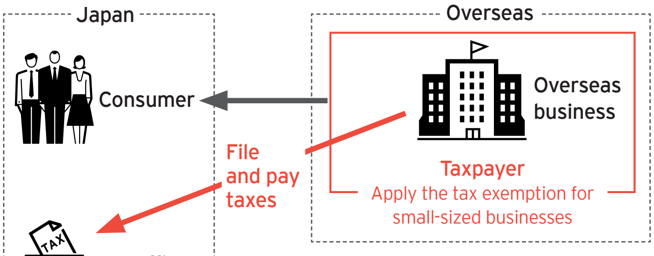
- For the tax exemption for small businesses, if the first day of the base period for the taxable period is before 1 October 2015, the tax reforms are deemed to have been effective from the first day of the base period.
- However, if there are circumstances which make it challenging to calculate the taxable sales with the tax reforms deemed to be effective from the first day of the base period, it is acceptable to use the amount of taxable sales calculated by deeming the tax reforms to be effective from 1 April 2015 to 30 June of the same year and multiplying it by 4.

Method of taxation for B-to-B transactions (reverse charge mechanism)



Domestic business files and pays taxes for B-to-B services.

Method of taxation for B-to-C transactions (Overseas business tax filing method)



Overseas business files and pays taxes to Japanese tax office for B-to-C services.

7. Applicable period

With the exception of reforms regarding applications for registration as a registered overseas business as described in *5.ii.* above, these reforms will apply to the transfer of assets, etc. in Japan, taxable purchases, and the withdrawal of taxable goods from a bonded area occurring on or after 1 October 2015.

Under current consumption tax law, domestic businesses engaging in the distribution of e-books, music or advertisements to the Japanese market should be subject to consumption tax, while overseas businesses providing the same services should not be taxed. This has resulted in an un-level playing field between domestic and overseas businesses providing the same services. The Government Tax Commission had been discussing the potential levy of Japan Consumption Tax on cross-border services to level the playing field for some time, and this has been incorporated in the current tax reform package.

With regard to this reform, businesses involved in cross-border e-commerce, etc. (both providers and customers) should take actions such as the review of applicable transactions, the review of the classification of the services provided/received, the consideration of changes in contractual provisions, and the consideration of technological requirements for new processes. In addition, we recommend that overseas businesses (providers) check their tax filing obligations and consider registration, and that domestic businesses (customers) check tax obligations from reverse charge mechanism and, for the purpose of considering potential measures to mitigate the additional tax costs incurred depending on the situation, check the registration status of the overseas service provider and make planning decisions in the case of a low taxable sales ratio.

Consumption tax on provision of services such as entertainment and sports by overseas business providers

For the provision of services such as entertainment and sports performed by overseas business providers after 1 April 2016, the reverse charge mechanism will be introduced. The obligation of consumption tax payment related to the transactions will be transferred to the business receiving the services from the business providing the services.

Individual taxation

New exit tax (special provision on capital gains when moving residence out of Japan)

In order to prevent tax evasion by crossing international borders, a special provision on capital gains tax for unrealized capital gains of stocks, etc. at the time of departure from Japan will be established.

1. Outline of the proposed exit tax

   Where a resident in Japan meets the criteria given in *i* below, holds applicable assets outlined in *ii* and leaves Japan to become a non-resident, the assets shall be deemed to have been transferred/sold at the time of such exit and any such gain is subject to the new proposed exit tax.

i. Taxable persons	Residents meeting **both** of the following criteria a. A person whose total value of taxable financial assets outlined in *ii* below is JPY 100 million or more **AND** b. who has had a Jusho in Japan for more than 5 years over the 10 years prior to exit (for the purpose of determination of the 5 year period above, duration of stay in Japan under certain visa categories are not counted – typically Intra Company Transferee, Investor/Business Manager, Specialist in Humanities/International Relations and all visa categories contained in Table 1 of Immigration Control and Refugee Recognition Act are not counted)
ii. Taxable assets	a. Shares, government and private bonds and all securities under the Income Tax Law, contributions under a silent partnership (*tokumei kumiai*) agreement, and b. Unsettled derivative transactions, credit transactions or when-issued transactions
iii. Effective date	Applicable to exits from Japan on or after 1 July 2015
iv. Treatment of the exit taxation on returning to Japan	Where the taxpayer who has incurred exit tax on leaving Japan returns to Japan within 5 years (upto 10 years upon application) and remains the holder of the previously taxed assets, the previous taxation can be reversed upon an amended tax return filing within 4 months after the return date.

2. Grace period for payment of the exit tax

   The taxpayer shall be granted a five-year (upto ten-year upon request) grace period for payment of the exit tax from the time of departure from Japan by pledging an asset as collateral to cover the amount of exit tax and by appointing a tax representative in Japan.

3. Adjustment for double taxation

   Where the taxpayer, whilst abroad, transfers or sells the taxable asset for which a grace period has been granted earlier and that country does not permit an adjustment for double taxation that arises due to the exit tax levied in Japan, foreign tax credit of foreign income tax shall be available in Japan.

   Furthermore, in the event that the taxable assets which were subject to foreign exit tax are transferred in Japan, an adjustment by stepping up the cost basis shall be permitted in Japan.

4. Transfer by gifting or inheritance

   If the eligible assets of the person subject to this system (see section *1*) are transferred via gift, inheritance or bequest to a non-resident, this system will be applied to the unrealized capital losses or gains on the eligible assets at that moment.

This system is being introduced to tax unrealized capital gains at the time of departure from Japan in order to prevent tax evasion by moving to a country that does not tax capital gains and disposing of stocks, etc. there. There had been concerns about how this would affect foreign residents of Japan, but it has been clarified that most foreigners residing in Japan will be excluded from this system. The foreigners that will be subject to this system are thought to be limited to those with permanent residence status or staying on a spouse visa.

Expansion of NISA (Nippon Individual Savings Account)

1. Establishment of Junior NISA

   A measure called Junior NISA will be established exempting tax on dividend income and capital gains from small amounts of listed stocks in the account of minors. Dividends and capital gains from small amount of stocks, etc. in accounts opened by those under age 20 will not be taxed. The yearly investment maximum is JPY 800,000 and the maximum non-taxable period is 5 years. Therefore, the maximum non-taxable investment will be JPY 4M (JPY 800,000 x 5 years). Such accounts can be newly opened during the 8-year period from 2016 to 2023.

2. Increase of maximum investment amount.

   The maximum investment amount of current NISAs (currently JPY 1M) will be increased to JPY 1.2M from 2016.

These measures aim to increase investment by young people and raise the amount of non-taxable investment at the household level.

Establishment of measures to exempt lump-sum gifts of marriage/child-rearing funds from gift tax

When a lineal ancestor (such as parent or grandparent, hereinafter "donor") contributes a lump-sum fund for the purpose of the payment of funds for marriage or child-rearing to an individual (between 20 and 49 years of age, hereinafter "donee") and entrusts that fund to a financial institution, an amount up to JPY 10M (maximum of JPY 3M for marriage expenses) per donee will not be taxed, as long as it was contributed during the period 1 April 2015 to 31 March 2019.

When the donee turns 50 years old (the end of the marriage/child-rearing fund management contract) and there is an outstanding balance of the non-taxable contributed amount after subtracting the amount spent on marriage/child-rearing, then the donee will be taxed as if the balance was gifted at that moment.

If the donor dies before the end of the marriage/child-rearing fund management contract, the balance of the non-taxable contributed amount after subtracting the amount spent on marriage/child-rearing will be deemed as having been inherited by the donee from the donor as an inheritance or bequest, and will be added to the taxed estate for the purposes of inheritance tax.

> Seeing as future financial instability is one of the major reasons that younger people are reluctant to marry or have children, these measures have been established to support one's marriage, childbirth and child-rearing through the transfer of their parents' or grandparents' assets at an early stage.

Expansion and extension of tax regime for promoting the acquisition of a residence

1. Measures for exemption from gift tax for the acquisition of a residence by fund donation

   The applicable period will be extended until 30 June 2019. It is expected that there will be an increase in last-minute demand for acquisition of property through the end of September 2016 when transitional measures for the rise of consumption tax to 10% will end (*1), and that from October 2016 there will be a large reactionary drop. As a counter measure, the exempt amount will be lowered (demand-side control) from January 2016 to September 2016, and the exempt amount will be increased (demand stimulation) from October onwards to prevent the reactionary drop. In particular, from October 2016 to September 2017, the maximum non-taxable amount will be JPY 30M (only if the incurred consumption tax is 10%).

   (*1) If a contract is signed by September 2016, the old rate of 8% will apply even if the actual transfer of property occurs after April 2017.

2. Tax reduction on mortgages

   The end date of the effective period will be extended for 1 year and 6 months, from 31 December 2017 to 30 June 2019.

Other

1. Expansion of *furusato* (hometown) tax payment

   The limit for special deductions will be expanded to between 10% and 20% of individual inhabitants' tax. This revision will be applicable to individual inhabitants' tax for 2016 and after. A system will be introduced in which salary income earners who normally do not need to file a return and elect hometown tax payment will be able to receive the deduction in one step.

2. Overseas dependents

   Taxpayers who are eligible for dependent exemptions related to family residing outside of Japan will be required to attach documents that verify that the dependent is a family member to their return or to present such documents. This change will apply to income tax for 2016 and after.

3. Extension of tax exemption for the lump-sum gift of education funds

   The effective period will be extended until 31 March 2019.

Tax administration

Revising the statement of assets and liabilities

In light of the establishment of exit tax, the submission criteria and items to be entered for statements of assets and liabilities will be revised, and the new version will be called "record" of assets and liabilities. This revision will apply to records of assets and liabilities that should be submitted on or after 1 January 2016.

Revising the system of scanning electronic copies of tax documents

The monetary condition for having contracts or receipts saved electronically (currently under JPY 30,000) will be abolished. Several other conditions related to electronic copies will be relaxed. These revisions will be applied to applications for approval related to the electronic saving of documents that are dated 30 September 2015 and after.

Penalty tax for late/no filing

Regarding the system in which penalty tax is not imposed on taxpayers who intended to submit before the due date but did not, the time one has to submit the return after the due date will be extended to within one month after the statutory due date (currently within two weeks). This revision will be applied to national tax filings, the due date of which comes on or after 1 April 2015.

Procedures for tax audits

The scope of a previous audit that is a condition for a re-audit will be limited to "field investigations." In the event that the previous audit was "an audit other than a field investigation," even if there is no "newly obtained information," a re-audit may still be conducted. These revisions will apply to re-audits where the previous audit that is a condition for the re-audit is conducted on or after 1 April 2015.

Social Security and Tax Number and savings account information

The Act on General Rules for National Taxes will be revised together with the Act on the Use of Numbers to Identify a Specific Individual in the Administrative Procedure. Banks, etc. will be required to manage savings accounts in a way that information is searchable by Social Security and Tax Number (for individuals and corporations) in order to efficiently handle various inquiries.

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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