The ruling coalition parties released their 2017 Tax Reform Outline (the Outline) on 8 December 2016. In this alert, we provide an overview of the major reforms and revision items in the Outline. Please note that this content is subject to change dependent on the course of the bill through the Diet.

**Corporate taxation**

1) Revision of R&D tax incentives

The rules will be revised so that tax credits increase in line with increases in R&D costs (total cost-type incentive). For large corporations, a tax credit for 6%-14% of R&D costs will be provided according to the percentage of increase/decrease (two-year temporary measure up to 14%; current rate is 8%-10%). For small and medium corporations, there will be a two-year temporary measure providing a tax credit for 12%-17% of R&D costs (currently 12%). The scope of the incentive will also be expanded to include service development costs in the “quaternary industry”.

2) Revisions related to director compensation

Revisions will be made to enable flexible use of performance-linked remuneration so that management can be incentivized over the medium to long term.
3) Revisions to the reorganization taxation rules

The rules will be revised to enable the smooth implementation of spin-offs in which a specific business is established as an independent company. There will also be revisions to the asset market valuation rules for share exchanges and tax consolidation, as well as a number of other items.

4) Revision of the corporate tax filing due date

Subject to certain requirements, an extension of the filing due date will be allowed for up to four months.

5) Elimination of the preferential measures for SMEs (stated capital of JPY100m or less) in the Special Taxation Measures Law (STML)

The preferential measures provided to small and medium enterprises under the STML (R&D incentive, wage increase incentive, reduced tax rates, etc.) will be eliminated for fiscal years in which average taxable income (over the past three fiscal years) exceeds JPY1.5b. This reform will be applicable to fiscal years starting on or after 1 April 2019.

6) Others

Various incentives to encourage capital investment by small and medium businesses will be introduced or expanded. Support through wage increase incentives for SMEs will also be strengthened.

International taxation

Fundamental reforms will be made to the CFC income inclusion rules (anti-tax haven rules).

1) Method of determining foreign companies subject to income inclusion

- The trigger rate (criteria for identifying low-tax jurisdictions) to be abolished.
- The method of calculating the shareholding ratio to determine foreign related companies will be revised.
- Companies with no equity relationship, but which are substantially controlled, will be covered by the CFC rules.

2) Income inclusion rule on an entity-wide basis

- The existing “exemption criteria” will be transformed into the “economic activity-based criteria” – the criteria that are applied in the first step of the CFC rules. Foreign related companies which do not fulfill one of the economic activity-based criteria (business criteria, substance criteria, control criteria, and location or unrelated party criteria) will be subject to income inclusion on an entity-wide basis.

- Foreign related parties whose principal business is the leasing of aircraft will be deemed to fulfill the business criteria, subject to certain requirements.

- Foreign related companies whose principal business is manufacturing and who are actively and independently involved in manufacturing through important manufacturing work in the country of the head office will be deemed to fulfill the location criteria.

- The shareholding threshold requirement regarding exemption of dividends received (25% or more) will be set at 10% or more for foreign companies whose principal business is the extraction of crude oil, petroleum gas, inflammable gas or coal (fossil fuels), and which own a fossil fuel extraction site in a country that has a tax treaty with Japan.

- If the effective tax rate of the foreign related company is 20% or more, it will be exempted from income inclusion on an entity-wide basis.

3) Partial income inclusion rule for passive income

- If all of the economic activity criteria are fulfilled, only certain types of passive income will be subject to inclusion.

- The main types of income subject to such partial inclusion are as follows:
  - Interest (excluding interest on deposits, loan interest from certain group financing)
  - Dividends (excluding dividends from companies which fulfill the 25% shareholding requirement)
  - Capital gains/losses on securities (excluding capital gains/losses on shares of companies which fulfill the 25% shareholding requirement)
  - Derivative trading gains/losses (excluding those for hedging purposes)
  - Foreign exchange gains/losses (excluding those occurring in a usual procedure for its business)
• Royalties on intangibles (excluding royalties on certain in-house developed IP)
• Capital gains/losses on intangibles (excluding capital gains/losses on certain in-house developed IP)
• Irregular profit which has no basis in the foreign subsidiary (profit which is not supported by assets, depreciation expenses and personnel expenses, etc.)
  • If the effective tax rate of the foreign related company is 20% or more, it will be exempt from partial income inclusion rule.
  • The materiality threshold will be raised to JPY20 million (currently JPY10 million).

4) Income inclusion on an entity-wide basis for specific types of foreign related companies
  • Paper companies that fulfill certain conditions will be subject to income inclusion on an entity-wide basis.
  • De facto “cash box” companies that fulfill certain conditions will be subject to income inclusion on an entity-wide basis.
  • Foreign related companies located in blacklist countries (designated by the Minister of Finance) will be subject to income inclusion on an entity-wide basis.
  • If the above foreign related companies’ effective tax rate is 30% or more, income inclusion on an entity-wide basis will be exempted.

5) Applicable period
  • The above reforms will be applied to fiscal years of foreign related companies beginning 1 April 2018 onwards.

Individual income tax

1) Revisions to individual income tax (spouse deduction)

A spouse deduction can be taken where the annual salary income of the individual's spouse is under JPY1.5 million. If the taxable salary income of the individual themselves exceeds JPY10 million (JPY12.2 million annual salary income), no spouse deduction can be taken. This reform will be applied to individual income for 2018 and thereafter.

2) Revisions to inheritance tax

In the case of inheritance between foreign persons living in Japan temporarily, foreign property will not be subject to inheritance taxation. Also, in order to prevent tax evasion, if the heir or the deceased are Japanese and have had an address in Japan in the last 10 years, domestic and foreign property will be subject to inheritance taxation.

3) Others
  • A new-type NISA will be introduced to encourage long term investment by individuals (annual investment limit of JPY400,000; tax exempt for 20 years).
  • The business succession rules will be revised.

Tax administration and others

1) Revision of filing requirements

In the foreign tax credit, R&D tax credit regime and other similar regimes, subject to certain requirements, when the tax is adjusted upwards by the Tax Office Director, the tax credits will increase accordingly.

2) Revision of liquor tax

The tax rates for beer, low-malt beer and new-type beer will be consolidated on 1 October 2026.

3) Vehicle taxation

Eco-car tax breaks will be revised and extended for two years.

4) Others
  • Revisions of audit procedures on national tax violations.
  • Consumption tax exempt on trading of virtual currencies (e.g., bitcoin).
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Japan Tax SCORE 20161212

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