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JAPAN

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Japanese Diet Passes 2011 Tax Reform Legislation without the Corporate Tax Rate Reduction

On June 22, 2011, the Japanese Diet passed portions of the 2011 Tax Reform legislation, which was previously suspended subsequent to the earthquake in March. Generally effective June 30, 2011 (with certain exceptions), the newly enacted legislation does not include the proposed corporate tax rate reduction or the related tax-base-broadening provisions, such as the limitation on NOL utilization (see the Asia Pacific Tax Newsalert dated January 5, 2011).

Although officially the provisions surrounding the corporate tax rate reductions are still awaiting consideration by Congress, the prospects for their enactment remain uncertain. This is especially true given Prime Minister Naoto Kan's resignation; he was a main proponent of the corporate tax rate reduction. His successor, Prime Minister Yoshihiko Noda, is proposing a tax increase to support the country's reconstruction effort and is, simultaneously, planning to reduce the corporate tax rate. This would result in approximately a 2% net reduction for three years starting in April, 2012 (see "Prospects for the Corporate Tax Rate" below). The key enacted provisions (2011 Tax Reform) relevant to US MNCs and Japanese-headquartered companies in the United States are summarized below.

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2011 Tax Reform Provisions

Corporate Tax

Contributions-in-kind Made by Foreign Corporations

A foreign corporation's contribution of property located outside Japan to a Japanese corporation's capital is no longer treated as a qualified contribution. The property is treated as being transferred at fair market value for Japanese tax purposes. As such, capital gain or loss will be recognized from such a contribution. Such capital gains are not necessarily subject to Japanese tax, especially for a foreign transferor that has no permanent establishment in Japan. However, even in this case, certain capital gains may still be subject to Japanese tax under the 25/5 rule, Japanese version of Foreign Investment in Real Property Tax Act ("FIRPTA"), or other provisions. A transferee, on the other hand, will record the contributed property at fair market value, and therefore, the tax basis will be stepped up or down.

On the other hand, with respect to a contribution of property located in Japan (i.e., property attributable to a branch or permanent establishment in Japan), the 2011 Tax Reform abolished the business continuity and continuity of interest requirements. As a result, a foreign corporation may more easily qualify a contribution of domestic assets for tax-free treatment. Therefore, the conversion of a Japanese branch to a Japanese domestic corporation or a Japanese limited liability company will be easier to implement from a Japanese tax perspective under the new law. The new provisions apply to contributions made on or after June 30, 2011.

New Foreign Investment Incentives

In order to increase domestic investments in Japan, the 2011 Tax Reform introduced various incentive programs. Foreign corporations may take advantage of these programs by establishing a qualified domestic corporation.

1. Designated International Strategic Area

   Qualified corporations engaged in specified businesses in the Designated International Strategic Area ("DISA") may claim <u>one</u> of the following tax incentives. (i) A special depreciation of 50 percent (25 percent for buildings) or (ii) a tax credit of 15 percent (8 percent for buildings) on certain capital expenditures (JPY 20 million or more for machinery and equipment and 100 million yen or more for building and construction) for assets acquired and placed in service in the DISA between June 30, 2011 and March 31, 2014. The tax credit is limited to 20 percent of the taxpayer's tax liability before the credit with a one year carry-forward. Alternatively, the qualified corporation may exclude 20 percent of income attributable to the specified business activities performed in the DISA. A corporation must be approved as a qualified corporation between June 30, 2011 and March 31, 2014. The exclusion is available for five years after approval. In addition, the qualifying corporations must be incorporated in the DISA and incur certain capital expenditures.

2. Asian Headquarters Tax Incentives

Qualified corporations established by a foreign corporation that are primarily engaged in operational management or research & development activities may exclude 20 percent of income attributable to the specified business activities. A corporation must be approved as a qualified corporation between June 30, 2011 and March 31, 2014. The exclusion is available for five years after the approval. A qualified corporation claiming the 20% income exclusion under the Asian Headquarters Tax Incentives will not be eligible for the DISA incentives discussed above.

International Tax

Modified Definition of Foreign Tax

The definition of foreign taxes is slightly modified for the anti-tax haven rules (i.e., Japanese CFC rules) and the foreign tax credit regime. Under the new law, any foreign taxes in excess of the lowest statutory rate are disregarded if the applicable tax rates are determined based on an agreement between a taxpayer and a foreign country's tax authority. The new provision was enacted primarily to prevent a taxpayer from purposefully setting the tax rate high enough to avoid the anti-tax haven rules. This provision is effective for any foreign taxes remitted on or after June 30, 2011.

Clarification of Anti-Tax Haven Rules

The 2011 Tax Reform clarifies many provisions in the anti-tax haven rules.

1. Active Business Exception for Qualified Headquarter Companies

   With respect to a qualified regional headquarter company that solely manages other foreign corporations, the 2010 Tax Reform allowed the holding of shares to satisfy the business purpose test under the active business exception. The 2011 Tax Reform clarifies that the holding of shares can also satisfy other active business exception tests (i.e., the substance test, the administration and control test, and the local country or unrelated party test).

2. Qualifying Exempt Dividends for the Triggering Rate Calculation

   The new law eliminates the ownership requirement for determining qualifying exempt dividends for triggering rate calculation purposes. A taxpayer can now exclude exempt dividends received by a CFC from the denominator of the triggering rate calculation. This reduces the likelihood that a Japanese company will be subject to the anti-tax haven rule.

3. Non-applicability of Domestic Deferral Rules

   A taxpayer may follow Japanese domestic tax law in determining the CFC taxable income subject to the anti-tax haven rule. The new law clarifies that the deferral of a gain on a distribution-in kind under the domestic group taxation rules is disregarded for CFC taxable income calculation purposes. Thus, the gain from a property distribution is included in current year taxable income.

4. Tainted Income (Passive Type Income) Inclusion

The 2011 Tax Reform also provides detailed rules on tainted income. For example, for tainted income derived from a dividend from a less than 10-percent owned corporation, the stock ownership is determined at the time the right to receive the dividend is fixed. Similarly, for gain from the sale of a less than 10-percent owned corporation's stock, the stock ownership will be determined immediately before the sale. The 2011 Tax Reform also clarifies how to calculate net tainted income and determine whether the exceptions (the 5-percent pre-tax income limitation and the JPY 10 million total tainted income threshold) are met.

Transfer Pricing - Application of the "Most Appropriate Method"

The 2011 Tax Reform incorporates revisions made to the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* in 2010. The priority is no longer given to the three traditional transactional methods prescribed in Japanese tax law. Instead, the "most appropriate method" shall be applied. It is applicable for years beginning on or after October 1, 2011.

Consumption Tax

Limitations on Consumption Tax Exemptions and Credits

The 2011 Tax Reform restricts consumption tax exemptions. A corporation with at least JPY 10 million sales in the first six months of the current year will be subject to the consumption tax in the following year. The new law generally reduces the two-year exemption period under the old law to one year for qualifying taxpayers. However, the new law also provides a new exception that allows a taxpayer to use payroll, instead of sales, to determine whether a taxpayers is still eligible for the exemption. The amendment is effective for tax periods beginning on or after January 1, 2013.

In addition, the previous rule that allowed full input credit for taxpayers with the taxable sales ratio of at least 95 percent (the so-called 95-percent rule) is now only applicable to a company with an annual sales amount of JPY 500 million or less. The amendment is effective for tax periods beginning on or after April 1, 2012.

Prospects for the Corporate Tax Rate

On September 27, the Tax Committee agreed how to raise revenue for the reconstruction effort for the March earthquake. In addition to individual and inhabitant tax increases, the agreement would increase the national corporate tax by 2.55% for three years, starting in April 2012. The rate increase is based on the assumption that the current national corporate tax rate of 30% would be reduced to 25.5% as originally proposed by the 2011 Tax Reform. Therefore, the net national corporate tax rate would be 28.05% starting the next fiscal year if the agreement is approved by Congress. The agreement is currently being debated by Congress; the current session is expected to adjourn by the end of October.

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