

Japan Tax Update

Tax Legislation Update for 2011 & 2012 Tax Reform (Part 1)

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On November 30, 2011, the “Amendment to the 2011 Tax Reform Bill” (“2011 Reform Amendment Tax Law”) and “Special Measures to Secure the Financial Resources to Implement the Restoration from the Tohoku Earthquake” (“Special Restoration Tax Law”) were approved in the Diet and were promulgated on December 2, 2011.

Following the above legislation, the Draft Bill of the 2012 Tax Reform (“2012 Tax Reform”) will be submitted to the Diet for discussion during January 2012.

This Japan Tax Update reports the current status of the tax legislation and changes contained in the above tax laws which apply to mainly corporate taxpayers.

1. Tax Legislation Update

On November 30, 2011, the 2011 Reform Amendment Tax Law and the Special Restoration Tax Law were approved in the Diet and were promulgated on December 2, 2011.

Originally, the 2011 Reform Amendment Tax Law provisions were contained in proposed legislation which contained a fundamental reform of the corporate tax, income tax and inheritance/gift tax systems, and also contained other significant changes including the adoption of a “Taxpayers’ Declaration of Rights”. Only the amendments to the corporate tax law and certain general tax law provisions were finally approved by the Diet while the rest of the proposed amendments, including the adoption the “Taxpayers’ Declaration of Rights”, were handed over to the next Diet session.

As compared with the original proposed legislation, the Special Restoration Tax Law was amended with regard to the Income Tax surtax (surtax rate and applicable period were changed) while the Corporation Tax surtax proposal was passed unchanged. As far as corporate taxpayers are concerned, both the 2011 Reform Amendment Tax Law and the Special Restoration Tax Law generally apply to tax years beginning on or after April 1, 2012. In summary, the 2011 Reform Amendment Tax Law reduces the National corporation tax rate from 30% to 25.5%. After taking into account effects to other taxes, the effective corporate tax rate will be reduced by approximately 5% from 40.69% to 35.64% for a large corporations operating in Tokyo (the rates can be slightly less in other areas).

However, the “Restoration Surtax” included in the Special Restoration Tax Law will increase the effective rate to approximately 38.01% for the tax years to which the Restoration Surtax applies (in principle, a three year period from the first tax year which begins during the period between April 1, 2012 and March 31, 2015). A summary of the effective applicable tax rates taking into account the general rate reductions and the Restoration Surtax is as follows:

Tax year	Effective corporate tax rate
Begins on or before 3/31/2012	40.69%
Begins between 4/1/2012 and 3/31/2013	38.01%
Begins between 4/1/2013 and 3/31/2014	
Begins between 4/1/2014 and 3/31/2015	
Begins on or after 4/1/2015	35.64%

2. 2011 Reform Amendment Tax Law Changes (Reduction of Corporate Tax Rates and Increase in Taxable Base)

(1) Reduction of Corporate Tax Rates

Effective for tax years beginning on or after April 1, 2012, the national corporate tax rates are reduced as shown in the table below. As the inhabitants tax corporate tax is calculated as a percentage of a corporation’s national tax liability, the reduction in tax rate will also result in a lower inhabitants tax. After taking into account the deductibility of enterprise tax, the 2011 Reform Amendment Tax Law reduces the effective corporate tax rate (Note 1) from 40.69% to 35.64% (for corporations with capital exceeding JPY 100 million in the Tokyo Metropolitan Area). A summary of the marginal and effective tax rates not taking into account the surtax is as follows:

	Current			After Reform		
	Statutory tax rate	Effective tax rate		Statutory tax rate	Effective tax rate	
		Income not exceeding JPY 8 million			Income not exceeding JPY 8 million	
Ordinary Corporations	30%	—	40.69%	25.5%	—	35.64%
Ordinary small and mid-sized ordinary corporations (“SMEs”) (Note 2)	30%	18% (Note 3)		25.5%	19% (15%) (Note 4)	

(Note 1)
$$\frac{\text{Corporate Tax Rate} \times (1 + \text{Inhabitants Tax Rate}) + \text{Enterprise Tax Rate}}{1 + \text{Enterprise Tax Rate}}$$

(Note 2) Small to medium sized enterprises (“SMEs”) are ordinary corporations with capital not exceeding JPY 100 million and not wholly owned by a corporation with capital of JPY 500 million or more.

(Note 3) Tax rate applicable to tax years ending prior to April 1, 2012.

(Note 4) Under the 2011 Reform Amendment Tax Law, the tax rates in parenthesis are applicable to tax years beginning on or after April 1, 2012 but prior to April 1, 2015.

(2) Limitations on the net operating loss deduction

Effective for tax years beginning on or after April 1, 2012, the use of carried forward net operating losses (“NOLs”) is limited to 80% of current year taxable income. Similar measures are introduced for the consolidated taxation system.

The NOL limitation does not apply to (i) SMEs, (ii) certain “Investment Vehicle” corporations to which the dividend deduction tax regime is applied (Note 1), and (iii) corporations using NOLs to offset debt forgiveness income under the Corporate Rehabilitation Law (Note 2).

(Note1) TMKs, J-REITs, certain Special Purpose Trusts and Specified Investment Trusts.

(Note 2) For corporations (i) which had debt forgiveness under Corporate Rehabilitation Law and (ii) the decision to commence legal procedures is ordered by the court prior to April 1, 2012, the current 100% NOL deduction will be allowed for 7 years from the approved date of the Corporate Rehabilitation Plans.

To minimize the impact on the tax loss expiration which can occur as a result of the above 80% deduction limitation, the period within which NOLs can be carried forward is extended from seven years to nine years for certain NOLs. Accordingly (i) taxpayers must maintain their books and records for tax years in which NOLs were recognized and (ii) the maximum time within which taxing authorities can reduce the amount of NOLs on audit is extended to nine years (currently seven years). The extension of the NOL carryforward period and items (i) and (ii) apply to NOLs incurred in tax years ending on or after April 1, 2008. A summary table is as follows:

	Current	After Reform
SMEs and Investment Vehicle corporations Deductible NOLs against taxable income Carryforward years/ tax audit open years	100% 7yrs	100% 9 yrs
Corporations other than above Deductible NOLs against taxable income Carryforward years/ tax audit open years	100% 7yrs	80% 9 yrs

(3) Allowable depreciation method amendments

The 2011 Reform Amendment Tax Law defers tax deductions by reducing the declining balance method (“DBM”) multiple from the current 250% (applied to the depreciation rate under the straight-line method) to 200% for depreciable assets acquired on or after April 1, 2012.

Fixed assets by acquisition date	Depreciation method (DBM)
Acquired before 4/1/2007	Old DBM
Acquired before 4/1/2012	250% DBM
Acquired on or after 4/1/2012	200% DBM

(4) Abolishment of bad debt allowance

Effective for tax years beginning on or after April 1, 2012, the 2011 Reform Amendment Tax Law abolishes tax deductions for bad debt allowances for corporations other than SMEs, banks, insurance companies and other similar financial corporations. The abolishment is phased in over four years:

Applicable tax years	% of the deductible amount (100%=current deductible amount)
Begins between 4/1/2012 and 3/31/2013	75%
Begins between 4/1/2013 and 3/31/2014	50%
Begins between 4/1/2014 and 3/31/2015	25%
Begins on or after 4/1/2015	0%

Corporations that is able to claim deduction of bad debt allowance	Scope of bad debt allowances
SMEs	Same as the current regime (Note1)
Financial institutions (banks, insurance, and etc.)	
Finance lease receivable and other certain monetary receivable owned by other than SMEs or financial institutions	Limited to the finance lease receivable and other certain monetary receivable

(Note 1) Special bad debt allowance (112% of the statutory rate) for SMEs is provided to the years beginning on or before March 31, 2015.

(5) Donation deduction limitations

Effective for tax years beginning on or after April 1, 2012, the 2011 Reform Amendment Tax Law halves the deductibility of donation expense to 25% (50% currently) of the sum of (i) the capital basis (i.e., 0.25% of capital plus capital surplus) and (ii) the income basis (i.e., 2.5% of taxable income). For corporations with no capital, deductions will be limited to 1.25% (2.5% currently) of taxable income. However, deductions for donations to designated public purpose companies are increased. A summary of the changes is as follows:

	Deductible amount – current	Deductible amount - after reform
General donation	$((0.25\% \text{ of capital plus capital surplus}) + (2.5\% \text{ of income})) \times 1/2$	$((0.25\% \text{ of capital plus capital surplus}) + (2.5\% \text{ of income})) \times 1/4$
Donations made to designated public purpose companies	$((0.25\% \text{ of capital plus capital surplus}) + (5.0\% \text{ of income})) \times 1/2$	$((0.375\% \text{ of capital plus capital surplus}) + (6.25\% \text{ of income})) \times 1/2$

(6) Amendment to the foreign tax credit (“FTC”) regime

The FTC tax regime was amended to generally lower the allowable tax credit amount.

- 1) Foreign tax levied over a 35% rate will no longer be qualified as a foreign tax in the FTC regime.
- 2) Non-taxable foreign source income (tax exempt in the source country) will be 100% (2/3 currently, will be reduced to 5/6 for the transitional 2 years beginning between April 1, 2012 through March 31, 2014) excluded from foreign source income for purposes of the calculation of the FTC limitation.
- 3) The special calculation method for foreign source income under the 90% rule is abolished.

“1)” applies to foreign taxes paid in tax years beginning on or after April 1, 2012 while both “2)” and “3)” apply to tax years beginning on or after April 1, 2012.

(7) Expiration of certain tax incentives

The following tax incentive measures will expire without extension (the expiring tax incentives generally apply to qualified assets acquired on or before March 31, 2012).

- 1) The special depreciation or tax credit regime provided for specified assets acquired for energy rationalization.
- 2) The special depreciation or tax credit regime provided for specified assets acquired to reinforce and promote business innovation.
- 3) A special depreciation regime provided for specified assets acquired by SMEs.

3. Taxpayer Relief Amendments

A number of procedural taxpayer relief provisions were passed including (1) an extension of the statutory limitation to request a downward tax adjustment to a previously filed tax return, (2) elimination of requirements that certain claims be made in an original tax return, and (3) clarification of certain audit procedures.

(1) Extended statutory limitation for correction

The statutory limitation to request a downward correction of prior year tax liabilities is extended from one year from when the original tax return was filed to five years. In addition, a similar statutory limitation to request an increase in a prior year loss amount was extended from one year to nine years. Finally, the general statutory limitation to assess prior year tax liabilities was extended as summarized in the following table:

	Statutory limitations	
	Current	After Reform
Corporate tax law		
-Regular corporate tax assessment	5 yrs	5 yrs
- Transfer pricing assessment	6 yrs	6 yrs
-Loss reduction	7 yrs	9 yrs
-Request for correction	1 yrs	Same as above depending on the issue
Consumption tax		
-Tax assessment	3 yrs	5 yrs
-Request for downward correction	1 yrs	5 yrs

The extended statutory limitations are effective for tax returns due on or after December 2, 2011. However, guidance by the National Tax Agency has indicated that, if requested by filing a “Request Form for Correction”, taxpayers may obtain essentially the benefit of the new rules for tax returns due before December 2, 2011.

(2) Requirement for election statements in original final tax returns

Previously certain items could not be subject to a request for correction in an amended tax return. However, under the 2011 Reform Amendment Tax Law taxpayers may request an amendment for a number of items in other than the original tax return including the exclusions of dividend income, domestic tax credits (e.g., research credits), foreign tax credits, deduction of loss upon bad debt forgiveness, and carryover of losses in a corporate reorganizations.

The amendment is effective for tax returns due on or after December 2, 2011.

(3) Amendment to tax audit procedures

An amendment clarifies that, prior to conducting tax audits, in principle tax agents are required to notify taxpayers, and that, upon completion of tax audits, tax agents are required to provide to taxpayers a brief written summary of their findings, etc.

The amendment is effective for tax audits commencing on or after January 1, 2013 (except for the tax audits commenced prior to January 1, 2013).

4. Introduction of Special Tax Measures to Fund Restoration

On October 7, 2011, the Cabinet approved the third Supplementary Budget for this tax year and the Basic Policy for Funding the Restoration from the Tohoku Earthquake (“Basic Policy”). According to the Basic Policy, the Japanese Government estimated that the restoration cost for the Tohoku Earthquake would be eleven trillion yen. In addition, the Government adopted as part of the Basic Policy the intention to fund nine trillion of the restoration costs by adopting temporary tax measures.

The Special Restoration Tax Law contains temporary tax measures to fulfil the Basic Policy which apply to income tax, corporation tax, and individual inhabitant tax.

With respect to corporation tax and income tax, a temporary surtax (“Restoration Surtax”) was introduced with the following basic provisions (see the following table).

	Corporation Surtax	Income Surtax
Tax base	Corporation tax before (1) surtax on special family corporation, (2) income tax credit, (3) foreign tax credit (“FTC”), (4) tax deduction upon downward correction, etc. (“Base Corporation Tax”).	Income tax before FTC (“Base Income Tax”) by different category of taxpayers. <ul style="list-style-type: none"> • Permanent resident: Base Income Tax on world-wide income. • Non-Permanent resident: Base Income Tax on domestic source income and remitted or domestically-paid foreign source income. • Non-resident: Base Income Tax on domestic source income. • Domestic corporation: Base Income Tax (i.e., withholding tax) on income including interest, dividend, etc. • Foreign corporation: Base Income Tax (i.e., withholding tax) on domestic source income including interest, dividend, etc.
Surtax rate	10%	2.1%
Person who bears/withholds the tax	Corporate taxpayers	Income tax and withholding tax taxpayers
Periods effected	Three year period from the first tax year which begins during the period between April 1, 2012 and March 31, 2015.	<ul style="list-style-type: none"> • Income tax levied on resident or non-resident for income earned from 2013 through 2037. • Withholding tax levied on income earned by domestic corporation or foreign corporation for the period from January 1, 2013 through December 31, 2037.
Tax return filing/ tax payment	<ul style="list-style-type: none"> • Taxpayer will be obliged to file a Surtax tax return as well as the final National tax returns unless there is no tax liabilities • Taxpayer will pay the Corporate Surtax together with the corporate tax liability. • Withholding Surtax will be credited to Corporate Surtax or will be refunded by filing a Surtax tax return. 	<ul style="list-style-type: none"> • Taxpayer will be obliged to file the Surtax tax return as well as the final tax return if obliged to file the final tax returns. • Taxpayer who is not obliged to file the final tax returns will be only subject to the Withholding Surtax (and Interim Surtax if interim tax is to be paid). • Taxpayer will pay the Income Surtax together with regular income tax liabilities. • Withholding Surtax will be credited against Income Surtax or will be refunded by filing a Surtax tax return.

Restoration Surtax will not be levied on Local tax. Consequently, only the national withholding tax on income such as dividend, interest etc., will be subject to the Withholding Surtax.

A non-resident or a foreign corporation who is not obliged to file final tax returns will be only subject to the Withholding Surtax. If the non-resident or foreign corporation is a resident of a tax treaty country with Japan, dividend, interest and royalties will not be subject to the Withholding Surtax to the extent that the applicable rate agreed in the tax treaty is lower than the aggregate domestic rate (including regular and Withholding Surtax).

For more information, please consult your tax representative or contact any of the following members listed below:

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