

Japan Tax Update

2011 Tax Reform

Issue 66, July 2011



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On January 25, 2011 a draft bill for the 2011 Tax Reform (“Draft Bill”) was submitted to the Diet. After the Tohoku Earthquake the discussion on the Draft Bill was suspended. A part of the Draft Bill was approved on June 22, 2011 and become effective on June 30, 2011 (the “June Bill”). It is expected that discussion will continue on the remaining part of the Draft Bill which was not part of the June Bill including the proposed reduction in the corporate tax rate. This Japan Tax Update discusses the June Bill.
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1. Corporate Tax

(1) Group Taxation

Group Taxation Regime introduced by the 2010 Tax Reform was amended.

1. When a corporation which is a member of a 100% group is in the process of liquidation, is expected to be dissolved (by other than merger), or is expected to be dissolved in a tax qualified merger with another member of the 100% group or otherwise, any loss from impairment or devaluation on the shares of the liquidating corporation shall not be recognized effective June 30, 2011. Similar treatment is applicable for the asset valuation loss at the time of tax consolidation is introduced or triggered as a result of a tax disqualified share for share swap.
 2. For purposes of determining the deductibility of expired losses of a liquidating corporation, the amount of negative capital plus capital surplus of such liquidating corporation shall be taken into account. In 2010 Tax Reform, the liquidation income taxation was abolished; however, this measure is introduced in response to cases where the insolvency is caused by negative capital instead of negative retained earnings. This reform is applied for tax years beginning on or after April 1, 2011 (excluding years ending before June 30, 2011).
 3. Acquiring treasury stock via tax-qualified drop-down, split-up, contribution-in-kind or dividend-in-kind (“Tax Qualified Reorganizations”) will no longer trigger the loss limitation rules.
 4. The special measures listed below that are otherwise applicable to corporations with capital not exceeding JPY 100 million (i.e., small and mid-sized ordinary corporations (“SMCs”)) does not apply if all of their outstanding shares are owned by one or more corporations with capital JPY 500 million or more (“Large Corporation”) in the same 100% group. Prior to the June Bill, the special measures were not applied to a SMC that was wholly owned by a single Large Corporation, but applied to a SMC that was wholly owned by more than a single Large Corporation. Under the June Bill, regardless of the number of the parent Large Corporations, the special measure are not applied to SMCs for tax years beginning on or after April 1, 2011 (excluding years ending before June 30, 2011).
 - a. Lower corporate tax rate
 - b. Exemption from taxation of excess retained earnings of family corporations
 - c. Statutory rate method to estimate bad debt allowance
 - d. Deductions for entertainment expenses
 - e. Tax refund by tax loss carried back
- (2) Tax-qualified contributions-in-kind made by foreign corporations
- a. Contribution-in-kind that is carried out on or after June 30, 2011 by foreign corporations of property located outside Japan is no longer treated as tax-qualified contributions-in-kind.
 - b. When a foreign corporation, with a branch PE in Japan, contributes assets of its Japan branch to a Japanese corporation in exchange for shares in the Japanese corporation on or after June 30, 2011, the two requirements that the Japan branch must be kept open and that the shares of the Japanese corporation must be held by the Japan branch is no longer required in order for the transferor to avoid taxable capital gain from transferring assets.
 - c. The capital gain tax that used to be imposed if a foreign corporation fails to satisfy either of the two requirements after the contribution-in-kind is abolished. The capital gain taxation will not apply if a foreign corporation on or after June 30, 2011 fails to satisfy either of the two requirements made prior to June 30, 2011
- (3) Application of the New Accounting Standards
- 1) Retroactive amendments (“Restatement of Financial Reporting”)
Consistent with IFRS, a new Japanese accounting standard has been issued to deal with retroactive amendments and will apply to amendments made after the start of the fiscal year beginning on or after April 1, 2011. Under this accounting standard, changes in accounting estimates will not be amended retroactively but will be adjusted during the period of change or in the future. When the useful life of an asset is shortened, the one-time depreciation expense will no longer be recognized but the deficiency will be amortized over the remaining useful life.

The tax rules was amended corresponding to the accounting rules described above.

- a. The special depreciation of obsolete assets is abolished.
- b. If the shorter useful life is approved by the Regional Taxation Bureau, the taxpayer is able to depreciate the assets by applying the estimated useful life.

The above amendments apply to assets with which the application is approved pursuant to the amended law on or after June 30, 2011 in the fiscal year starting on or after April 1, 2011.

- 2) Inventory
The method applied to write down inventory to market (Kirihanashi-Teika-Hou) was abolished. A transitional measure was introduced to deem the value of the fiscal year prior to the first fiscal year starting on or after April 1, 2011 and ending on or after June 30, 2011 as the acquisition cost.

2. In-bound Investment Incentives for International Foreign Corporations

(1) Designated International Strategic Area

Qualifying corporations doing business in certain designated metropolitan areas (the “Designated International Strategic Area”) will be granted the following tax incentives in order to attract corporations to Japan.

- 1) If qualifying corporations are engaged in specified businesses in the Designated International Strategic Area, certain capital expenditures (20 million yen or more for machinery and equipment and 100 million yen or more for building and construction) incurred for the specified businesses will be eligible for either (i) a deduction equal to 50% of the capital expenditures (building is limited to 25%) or (ii) a tax credit equal to 15% of the capital expenditures (building is limited to 8%) with the maximum credit amount in any given tax year being equal to 20% of the tax liability before the credit with one year carry-forward.
- 2) If qualifying corporations are engaged primarily in specified businesses in the Designated International Strategic Area, they will be entitled to an income exclusion of up to 20% of income for five years provided they are incorporated in the Designated International Strategic Area and incur certain capital expenditures. If qualifying corporations claim the 20% income exclusion, they will not be entitled to the tax credit regime described in 1) above.

Qualifying corporations will be eligible for the tax credit regime described in 1) with respect to capital expenditures incurred from the effective date of the law concerning this regime through March 31, 2014. Corporations will be eligible for the 20% income exclusion regime for 5 years once they are specified as qualifying corporations during a period from the effective date of the law concerning this regime through March 31, 2014.

(2) Tax Incentives for Asian Headquarters

In order to attract Asian headquarters and R&D centers of multinational corporations to Japan, a qualifying corporation filing blue form tax returns that will be primarily engaged in the operational management or R&D activities established by an international foreign corporation will be entitled to claim 20% income exclusion over 5 years from the date it is specified (during the period from the effective date of the law concerning this regime through March 31, 2014) as a qualifying corporation pursuant to the relevant law. A qualifying corporation claiming 20% income exclusion will not be eligible for R&D tax credit or tax incentive granted in (1) above.

(3) Employment Promotion Taxation

The following tax measure is implemented for the enhancement and creation of employment and subsequent economic development.

If qualifying corporations increase the number of employees subject to employment insurance by 10% or more and by 5 people (2 in case of SMC) or more from the end of the prior tax year, the qualifying corporations will be eligible for the tax credit equal to the increased number of the employees multiplied by JPY200,000 with the

limitation of 10% (20% in case of SMC) of the tax liability before the credit subject to certain conditions for the tax years which commences from April 1, 2011 (excluding years ending before June 30, 2011) to March 31, 2014.

(4) Environmental Investment Taxation (Green tax deduction)

In order to promote the development of environmental and energy saving technologies, where qualifying corporations acquire equipment which is expected to significantly contribute to the reduction of CO₂ emission or enhance of energy recycle from June 30, 2011 to March 31, 2014 and place it in service within one year of the acquisition, the qualifying corporations will be eligible for the accelerated amortization of 30%. SMCs may instead elect a tax credit equal to 7% of the capital expenditures with the maximum credit amount in any given tax year equal to 20% of the tax liability before the credit with one year carry-forward.

(5) The applicable years for the following incentive tax measures is extended through March 31, 2012

- 1) Preferential corporate tax rate for SMCs
- 2) R&D tax credit
- 3) The energy rationalization special depreciation and tax credit regime
- 4) Special depreciation and tax credit regime for certain machinery and equipment acquired by SMCs

3. International Tax

(1) Foreign Tax Credit

In connection with the foreign tax credit regime, the June Bill introduced the following amendments.

- 1) Where the applicable tax rates vary depending on an agreement with local taxing authorities, any taxes in excess of the amount computed using the lowest applicable rate will be excluded for purposes of the foreign tax credit computation or the anti-tax haven rules. The amendment is effective for any foreign taxes remitted on or after June 30, 2011.
- 2) For purposes of computing the foreign tax credit limitation, income of a corporation which may be taxed in a foreign country in accordance with the tax treaty between Japan and that foreign country shall generally be deemed to be treated as foreign source income for fiscal years starting on or after April 1, 2011.

(2) Anti-Tax Haven (“CFC”) Rules

- 1) Under the CFC rules, a foreign corporation that would otherwise be treated as a CFC is exempted from the application of the CFC rules if it satisfies the conditions (“active business exception”) listed below. When the main business of the CFC is holding securities as a regional headquarters corporation, the amendment clarifies that the conditions other than the business purpose test will be judged based on the headquarters activities in order to qualify for the active business exception.
 - Business purpose test
 - Substance test
 - Administration and control test
 - Local country test or unrelated party test
- 2) For purposes of computing the effective tax rate for CFC purposes, the amendment abolished the shareholding requirements in order to exclude foreign dividends from the untaxed foreign income. Thus, tax-exempt foreign dividends will be fully excluded from untaxed income and thus will not need to be added back to the denominator of the CFC’s effective tax rate computation.
- 3) The amendment clarifies that a gain on a distribution-in-kind from a CFC cannot be deferred when computing the CFC’s taxable retained earnings under Japanese domestic tax principles. Thus, any gain that would otherwise be deferred will be recognized by the domestic corporate shareholder under the CFC rules.
- 4) Others
 - a. When a foreign corporation’s income is nil, the effective tax rate for purposes of the CFC rules will be the nominal tax rate.

- b. With respect to tainted income of the CFC derived from a dividend from less than 10% shareholdings, whether the CFC owns less than 10% shareholdings will be determined at the time the right to receive the dividend becomes fixed. With respect to tainted income of the CFC derived from the sale of less than 10% shareholdings, whether the CFC owns less than 10% shareholdings will be determined immediately before the sale.
 - c. For purposes of computing net tainted income, the following shall be taken into consideration:
 - (i) Foreign withholding tax imposed on interest or dividends will be deductible.
 - (ii) For purposes of computing expenses attributable to bond redemption using the simplified method, the total assets will be the net book value of the total assets at the end of the year preceding the year of redemption.
 - (iii) The cost basis for purposes of determining gain from the sale of shares or bonds will be computed using the moving average method.
 - (iv) Amortization of intangibles from which royalties are derived will be computed under Japanese domestic tax law or foreign tax law applicable to the CFC provided that such amortization method is continuously utilized.
 - d. The amendment clarifies the current exceptions to tainted income.
 - (i) As a de minimis rule, the tainted income rule should not apply if the total tainted income of the CFC is less than 5% of the CFC's pre-tax income. The amendment clarifies that the CFC's pre-tax income will exclude any foreign withholding tax.
 - (ii) As a de minimis rule, the tainted income rule should not apply if the total tainted income of the CFC is less than JPY 10 million. Tainted income from bond redemption will be the net gain rather than the gross proceeds.
- 5) The amendments above are also applicable to the corporate inversion rules.

The amendment is effective for Japanese corporations' tax years ending on or after April 1, 2011 where CFC's income for its tax year beginning on or after April 1, 2010 is aggregated, except for 3) which apply to distributions-in-kind made on or after June 30, 2011.

(3) Transfer Pricing Legislation

The June Bill in relation to transfer pricing is primarily designed to reflect in the Japanese legislation certain changes that were made to the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* in 2010 ("OECD Guidelines").

The priority between transfer pricing methods, described in Paragraph 2, Act on Special Measures Concerning Taxation Article 66-4, was eliminated by the June Bill

The previous Japanese transfer pricing legislation provides that, only when the three traditional transactional methods were not applicable, a method similar to one of the three traditional transactional methods, or a method specified by a Cabinet Order (i.e., the Profit Split method or the Transactional Net Margin Method) may be applied. However, the June Bill clearly specifies that this priority between transfer pricing methods shall be eliminated, and – reflecting the wording adopted by the OECD Guidelines – the “most appropriate method” shall be applied in order to calculate an arm's length price. This tax reform is applicable for accounting periods (business years) starting on or after October 1, 2011.

4. Financial Services

(1) Taxation of securities

The current concessionary tax rates (i.e., 10% for Japanese resident individuals and 7% for Japanese corporations and non-residents) for dividends on listed stocks and capital gains arising from the sale of listed stocks (10% for Japanese resident individuals) are extended two (2) years until December 31, 2013.

- (2) Expansion of tax exemption for interest received by foreign financial institutions entering into Saiken-Gensaki (“Japanese Repo”) transactions
 - 1) Interest on cash collateral and lending fees in relation to securities lending transactions (collateralized by cash or securities) received by foreign financial institutions will be exempt from corporate and withholding tax provided certain conditions are met (e.g., trading term is six (6) months or less, etc).
 - 2) The following securities will be added as “assets” (in addition to the current scope covering JGBs, foreign government bonds, etc.) subject to this exemption:
 - Book-entry local government bonds;
 - Book-entry corporate bonds;
 - Book-entry bond type beneficiary interest issued by Special Purpose Trusts (without entitlement to voting rights on ancillary matters); and
 - Listed stocks (when used in stock lending transactions).

These amendments will be applicable to interest and lending fees in relation to transactions commencing on or after June 30, 2011.

(3) Clarification of tax exemption rule for book-entry JGBs and corporate bonds for non-resident investors

- 1) A foreign pension fund formed as a trust based on a foreign jurisdiction’s law and treated as a pass through trust for Japanese tax purposes will be eligible to apply for the tax exemption rule on interest on book-entry JGBs and corporate bonds.
- 2) A non-resident or a foreign corporation investing in book-entry JGBs or corporate bonds through a Japanese partnership (*nin-i kumiai*) or similar foreign vehicle will be eligible to apply for the tax exemption rule on interest and redemption gains on book-entry JGBs and corporate bonds by following certain procedures.

The effective date is interest on book-entry bonds where the interest calculation period begins on or after June 30, 2011.

(4) Individual income taxation on derivatives

Income arising from over-the-counter derivative transactions earned by Japanese resident individuals (including foreign exchange and contracts for differences) will be treated at the same rate as derivative transactions listed on Japanese stock exchanges, and subject to separate taxation, at the rate of 20%. The current treatment is for progressive rates of taxation up to 50% classified as miscellaneous income. Moreover, losses arising from these transactions can be carried forward for three (3) years.

The amendment will be applicable to transactions made on or after January 1, 2012.

(5) Real Estate Investment Trust (“J-REIT”) and *Tokutei Mokuteki Kaisha* (“TMK”)

- 1) The deductible limit of the taxable base of qualifying properties acquired by TMKs or J-REITs is reduced to 3/5ths from 2/3rds of the assessed value, and extends the applicable period for the preferential treatment through March 31, 2013.
- 2) In order for a J-REIT to deduct dividends, more than 50% of the J-REIT’s shares must be offered primarily in Japan (“Domestic Offering Rule for J-REIT”). Prior to 2011 tax reform, under the test pursuant to the Enforcement Order of the Special Taxation Measures Law (“STML”), the Domestic Offering Rule for J-REIT was conducted separately for each new issue of shares.

Under the 2011 tax reform, the wording of the Enforcement Order has been changed. The test is now made on a cumulative basis. That is, if the amount of shares to be offered in Japan (including prior issuance) is more than 50% of the total issuing amount of shares issued, and certain procedural requirements are met (including the revision of by-law of the J-REIT to incorporate the change), the test is satisfied.

The above amendment applies to J-REIT fiscal years ending on or after June 30, 2011.

- 3) In order for a TMK to deduct dividends, more than 50% of the TMK's common and preferred shares must each be offered primarily in Japan ("Domestic Offering Rule for TMK"). The New Enforcement Order clarifies the interpretation of this rule.

In the past, it had been unclear whether, in the case of preferred shares, the test was conducted class by class, or whether the test was conducted based on the total amount of preferred shares issued, regardless of class. Under the New Enforcement Orders, the interpretation has now been clarified. Moving forward, the TMK's asset liquidation plan must provide that more than 50% of the common shares and more than 50% of each class of preferred shares must be offered in Japan.

The above clarification applies to TMK's fiscal years ending on or after June 30, 2011.

TMKs that issued more than one class of preferred shares before June 30, 2011 may continue to satisfy the test if more than 50% of the total amount of preferred shares was offered in Japan unless the TMK issues a report on a new asset liquidation plan defined under Asset Liquidation Law Article 11 Paragraph 2 or issues more than one class of preferred shares on or after June 30, 2011.

- 4) A foreign pension fund may now apply to be a Tax QII provided that its net assets are 10 billion yen or more at the time the application is submitted.
- (6) Islamic Finance

Specific taxation measures for Islamic Finance is introduced to attract international investors seeking opportunities to invest in Sharia compliant instruments issued in Japan in a separate reform.

5. Consumption Tax and Individual Income Tax

- (1) Amendment to the "Base Period" Rule

A small business otherwise qualifying as an exempt enterprise under the "base period" rule will be required to become a taxpayer in any year immediately following the year in which the taxpayer has at least 10 million yen of taxable revenue during the first 6 months of the year.

The amendment is effective for exempt periods beginning on or after January 1, 2013.

- (2) Amendment to the 95% Rule

The previous rule which allowed full input credit for taxpayers where the taxable sales ratio is at least 95% is only applicable to an enterprise whose annual taxable sales for the period is 500 million yen or less (if a taxable year is shorter than 12 months, the taxable sales will need to be annualized). For other enterprises, an input credit is allowed based on either the percentage of taxable revenue method or the attributable method.

The amendment is effective for taxable periods beginning on or after April 1, 2012.

- (3) Income Tax Deferral from Exercising the Qualified Stock Options Granted by a Designated Foreign Corporation

Taxation on the income realized when exercising a qualified stock option granted by designated corporation pursuant to the Special Measures Law ("SML") to promote establishment of the Asian Headquarters or R&D centers is deferred until the shares are transferred by the individual.

The above amendment applies to the qualified stock options exercised when the SML takes effect.

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

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