

# Japan Tax Update

## Tax Legislation Update for 2011 & 2012 Tax Reform (Part 2)

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The 2012 tax reform proposal submitted by the Cabinet Office's Tax Commission, known as *Taiko*, ("2012 Tax Reform Proposal") was released on December 10, 2011 upon approval by the Cabinet. The proposed tax law changes will be submitted to the Diet during January 2012 for consideration.

This Japan Tax Update provides a summary of the proposed changes contained in the 2012 Tax Reform Proposal.  
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### 1. Proposed tax reform for 2012 and tax legislation update

The 2012 Tax Reform Proposal contains (1) amendments to the current Special Tax Measurement Law to achieve sustainable economic growth, (2) an amendment to ensure tax neutrality, and (3) income tax amendments which were originally proposed in the 2011 tax reform proposal. For corporate taxpayers, major amendments were also proposed relating to the taxation of foreign subsidiaries of a Japanese parent company as well as interest deductions for interest paid to foreign related parties.

After the release of the 2012 Tax Reform Proposal, discussions have continued with respect to tax reform for the inheritance/gift tax and consumption tax regimes. These discussions are part of potential fundamental tax reform and changes to the social security system. Proposed changes in these areas will be the subject of a future newsletter.

## 2. Corporate taxation

### (1) R&D tax incentive

Currently, qualifying research and development (“R&D”) expenses are allowed for taxpayers to claim an R&D tax credit to offset up to 40% of a corporation’s tax liability. This preferential tax treatment will be amended so that the R&D tax credit may only offset up to 30% of the corporate tax liability, effective for tax years beginning on or after April 1, 2012.

### (2) Small to medium sized enterprises (“SMEs”) tax regime

The following tax measures applicable to SMEs will be extended for two years.

- 1) Special depreciation or tax credit for qualified assets acquired by SMEs
- 2) 100% deduction for certain depreciable assets with a low acquisition cost acquired by SMEs
- 3) Special deductions for entertainment expenses incurred by SMEs

### (3) Amendments to the tax measurement law

The following tax measures will be extended for two years.

- 1) The special reserve for outbound high-risk energy related investment
- 2) Suspension of any deduction for entertainment expenses except for SMEs
- 3) Suspension of allowance for carry back of NOLs except for the case of SMEs and corporations under liquidation

Rollover relief will be extended for three years for gains recognized from transferring qualifying assets.

## 3. International taxation

### (1) Interest expense deduction limitation

The 2012 Tax Reform Proposal restricts the deductible portion of a corporation’s Net Interest expense (as defined) to a related party to 50% of Adjusted Income. Net Interest is calculated as interest expense to related parties less corresponding interest income. Adjusted Income is defined as taxable income, adding back interest expense, depreciation expense and exempted dividend income but excluding extraordinary income or loss.

#### 1) Related parties

Related parties are defined as persons to whom a taxpayer has a direct or indirect 50% or more equity relationship, a de-facto controlling or controlled relationship with, or third party lenders who are financially guaranteed by related parties.

#### 2) Scope of net interest

For the purpose of calculating Net Interest, interest expenses in relation to related parties include:

- Interest
- Lease payments
- Guarantee payments

The following are specifically excluded:

- Interest income received from third party or non-resident borrowers (calculated by a prescribed pro-rata formula)
- Back-to-back repo interest expense
- Interest expense subject to Japanese domestic corporate taxation for the recipient related party (corporate taxes does not include withholding tax paid by foreign related parties on the interest if such foreign related parties do not have a Permanent Establishment in Japan)

#### 3) Carry forward

Where interest expense is not deductible, it may be carried forward for seven years and deducted in a fiscal year where the 50% threshold is not met, up to the 50% threshold in that fiscal year.

4) Tax consolidation rules

The interest deduction rules are applied on a consolidated group basis for taxpayers which have elected to be taxed on a consolidated basis.

5) Limitations on application

The restriction does not apply if the Net Interest expense to related parties in the fiscal year is JPY 10 million or less or if interest expense to related parties (deducting back-to-back repo interest expense but before deducting corresponding interest income from third party or non-resident borrowers) is 50% or less than the total interest expense (calculated excluding interest expenses to related parties subject to Japanese corporate taxation for the recipients).

Thin capitalisation and transfer pricing rules will still apply, and if the taxpayer is also subject to controlled foreign company ("CFC") rules, the non-deductible interest expense to the CFC shall be reduced by the amount subject to CFC taxation.

In case of a qualified merger or dissolution of a 100% subsidiary, carried forward non-deductible interest can be transferred to the merging or parent corporation.

6) Effective date

The new rules are expected to be applicable for tax years beginning on or after April 1, 2013.

(2) Amendment to CFC rules

As a relief from double taxation of previously taxed CFC income, when a Japanese corporation receives a dividend from a foreign corporation, the smaller of the following amounts is fully exempt:

- 1) the amount of the dividend that the foreign corporation received from a second tier or lower corporation in the year in which the Japanese corporation receives the dividend and the preceding two fiscal years, whose taxable retained earnings have previously been subject to Japanese tax under the CFC rules, proportionate to the Japanese corporation's indirect ownership interest in the second tier or lower corporation; or
- 2) the amount of the second tier or lower corporation's taxable retained earnings that were included in the taxable income of the Japanese corporation in the year in which the Japanese corporation receives the dividend and the preceding two fiscal years.

Under the 2012 Tax Reform Proposal, the determinant date of the equity ownership percentage for the purpose of the calculation of the amount described above as follows:

Current rule: The equity ownership as of the tax year end during which the dividend is received

Amended rule: The equity ownership as of the effective date of the dividend declaration

#### 4. Individual income taxation

(1) Limitation of salary deduction

Currently, for the income tax calculation, an individual taxpayer is allowed to claim a salary deduction from 5% to 40% depending upon the income bracket. Under the 2012 Tax Reform Proposal, the salary deduction will be limited to 2,450,000 yen, effectively increasing the tax burden for those earning an annual salary exceeding 15,000,000 yen.

The amendment is effective for income tax purposes in calendar 2013 and for inhabitants' tax purposes for residents in Japan as of January 1, 2014 (which is based upon 2013 income).

(2) Director's retirement income taxation

Currently, qualifying retirement income is subject to a favourable tax regime whereby a special deduction of 50% of qualifying retirement income is allowed. Under the 2012 Tax Reform Proposal, the 50% deduction will not apply to retirement income received by certain individuals. Persons subject to this new rule include persons who were engaged in providing services as a director as defined in the corporate tax law for less than for 5 year prior to the payment of the retirement income as well as public officers and members of the Diet.

The amendment is effective for income tax purposes in calendar 2013 and for inhabitants' tax purposes for residents in Japan as of January 1, 2014 (which is based upon 2013 income).

(3) Reporting requirements for stock option granted by a foreign parent

Currently, a domestic corporation who issues and grants stock option with respect to its own stock is obliged to report to the relevant tax office the name of the grantee (1) when a tax qualified stock option is granted or (2) when a tax non-qualified stock option is exercised. Under the 2012 Tax Reform Proposal, when a foreign parent grants a stock options to (1) the employee or directors of Japanese subsidiary (owned by 50% or more directly or indirectly by the foreign parent) or a Japanese branch or (2) the Japanese subsidiary or Japanese branch pays salary under a phantom stock option plan, the Japanese subsidiary and/or Japanese branch will be obligated to provide a report similar to the report prepared by domestic corporations to the relevant tax office. The reporting due date is March 31 of the year after the exercise of the stock option or payment under the phantom stock plan occurs.

The amendment is effective for the exercise of a stock option or any payment under a phantom stock option plan on or after January 1, 2012.

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

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