2018 Japan Tax Reform Proposals

Issue 134, January 2018

In brief

On 14 December 2017, the 2018 Japan Tax Reform Proposals (“2018 Tax Proposals”) were published. Key aspects of the Tax Proposals include (i) ongoing alignment with the OECD’s BEPS Action Plan and (ii) efforts to stimulate the Japanese economy through changes to tax credits, controlled foreign entity (CFC) and reorganization rules.

1. Salary increase and investment tax credits
2. International taxation
3. Tax measures to enhance competitiveness
4. Individual income tax / Inheritance tax
5. Other proposals

In detail

1. Salary increase and investment tax credits
   a) Amendment of salary increase tax credits

   Under the 2018 Tax Proposals, the existing salary increase tax credit will be amended for large corporations so that only those corporations increasing domestic investment will be eligible for the credits.

   In the future, the salary increase tax credit will be available for corporations filing “blue form” tax returns which meet the conditions described below. The revised salary increase tax credit rules will be applicable for fiscal years beginning on or after 1 April 2018 until 31 March 2021.
## Summary of Amendment to Salary Increase Credit for Large Corporations

<table>
<thead>
<tr>
<th>Conditions</th>
<th>Current</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Increased salary payment</td>
<td>Salary payment to employees in base year ≥ 5%</td>
<td>Abolished</td>
</tr>
<tr>
<td>(2) Salary payment in the current fiscal year ≥ salary payment in the preceding fiscal year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Average salary payment in the current fiscal year ≥ 2%</td>
<td>Average salary payment in the preceding fiscal year</td>
<td></td>
</tr>
<tr>
<td>(4) N/A</td>
<td>Domestic capital expenditure ≥ 90% x total depreciation</td>
<td></td>
</tr>
</tbody>
</table>

| Tax credit | 10% of the increased salary payment plus 2% of the salary payment made in the preceding year | 15% of increased salary payment 20% if training costs have increased by 20% or more |

| Limitation on tax credit | Up to 10% of the corporate tax liability | Up to 20% of the corporate tax liability |

## Summary of Amendment to Salary Increase Credit for SMEs

<table>
<thead>
<tr>
<th>Conditions</th>
<th>Current</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Increased salary payment</td>
<td>Salary payment to employees in base year ≥ 3%</td>
<td>Abolished</td>
</tr>
<tr>
<td>(2) Salary payment in the current fiscal year ≥ salary payment in the preceding fiscal year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Average salary payment in the current fiscal year &gt; Average salary payment in the preceding fiscal year</td>
<td>Average salary payment in the preceding fiscal year</td>
<td></td>
</tr>
<tr>
<td>(4) the ratio under (3) above is 1.5%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Tax credit | 10% of the increased salary payment plus 12% of the salary payment made in the preceding year if condition ③ applicable to large corporations is met | 15% of increased salary payment 25% if the following conditions are also met: |

(4) the ratio under (3) above is 2.5% or more
(5) either (i) training costs are increased from the preceding year by 10% or more; or (ii) the SME has a certified business enhancement plan and the enhancement is certified. |

| Limitation of tax credit | Up to 20% of the corporate tax liability | Up to 20% of the corporate tax liability |
b) Introduction of tax credits for costs related to the development of certain data gathering and analytic information systems

A tax credit for costs related to the development of certain data gathering and analytic information systems under the (yet to be enacted) Special Measures Act for the Improvement of Productivity (“Productivity Act”) will be available to companies that file blue form tax returns and have obtained approval of an “innovative data utilization plan.” Companies will be eligible for the tax credit if they have acquired software or assets worth JPY 50 million or more that are used in the approved plan. The new tax credits will be applicable from the effective date of the Productivity Act until 31 March 2021.

The amount of tax credit available will be higher for companies that satisfy a “salary increase condition” (i.e., the average salary for employees of the company are increased for the year by more than 3%) as follows:

<table>
<thead>
<tr>
<th>Company Satisfies Salary Increase Condition</th>
<th>Company Does Not Satisfy Salary Increase Condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special depreciation: 30% of the acquisition cost; or Tax credit: 5% of the acquisition cost up to 20% of the corporate tax liability</td>
<td>Special depreciation: 30% of the acquisition cost; or Tax credit: 3% of the acquisition cost up to 15% of the corporate tax liability</td>
</tr>
</tbody>
</table>


c) Disallowance of certain tax credits

If a large corporation has an increase in taxable income year on year but does not meet certain salary increase or domestic investment requirements, certain tax credits for which the corporation would otherwise be eligible will be disallowed.

More specifically, a large corporation must meet one of the following conditions to avoid “losing” tax credits:

(1) Average salary payment in the current fiscal year must be greater than the average salary payment in the prior fiscal year; or

(2) Current domestic capital investment must exceed 10% of total depreciation expense

This disallowance rule will not be applicable if the corporation’s current year income is equal to or smaller than the prior year income. This disallowance rule will apply to a year in which the corporation is established or a merger occurred.

The tax credits which may be disallowed are (i) tax credits for research and development, (ii) the new tax credit for the development of information systems approved under the Productivity Act, and (iii) special depreciation or tax credits for “local” investment (i.e., credits for locating operations outside of the main urban centers in Japan).

This new requirement is applicable for tax years beginning on or after 1 April 2018 until 31 March 2021.

2. International Taxation

a) Amendments to the definition of permanent establishment (“PE”)

To align the Japanese domestic law with recommendations made in Action 7 of the OECD’s Base Erosion and Profit Shifting (“BEPS”) plan, the definition of a PE will be amended as follows for fiscal years beginning on or after 1 January 2019.
(1) Agent PE

(i) The definition of an “agent PE” will be expanded to include not only those habitually having authority to conclude contracts in Japan on behalf of a foreign corporation or non-resident individual, but also those habitually having a “principal role” in the conclusion of contracts in Japan on behalf of a foreign corporation or non-resident individual.

As a result of this amendment, companies operating under commissionaire contracts (agent for an undisclosed principal contracts or toiya in Japanese) as shown in the diagram below will be deemed to be a PE under the new agent PE definition.

(ii) The scope of the independent agent exemption will be narrowed such that companies which primarily act only on behalf of one or more closely related parties will no longer be considered “independent” for the purposes of the exemption. For this purpose, a “closely related party” is defined as a non-resident individual or foreign corporation with a direct or indirect ownership of more than 50% of the beneficial interest in the agent.

(2) Preparatory and auxiliary functions

Under the current domestic law, a PE does not include facilities used solely for the purposes of storage, display, delivery, or certain other activities. A proposed amendment under the 2018 Tax Proposals will limit this exclusion to only those facilities which have a preparatory or auxiliary function, i.e., each and every function for which the facility is used must be of a preparatory or auxiliary nature.

By way of example, if a foreign corporation owns a warehouse in which a large number of employees work, and the product storage and delivery activities performed through that warehouse are an essential part of the foreign corporation’s sales process, the warehouse will constitute a PE under the new rule because the warehouse functions would not be “preparatory or auxiliary.”
When one or more closely related parties all have PEs in Japan, and those PEs are part of a single integrated business, the exclusion for preparatory and auxiliary activities shall not apply to those PEs (so-called “anti-fragmentation rule” under BEPS Action 7).

(3) Difference in PE definitions between domestic law and tax treaties

Where the definition of a PE differs between the domestic law and a tax treaty concluded by Japan, the definition in the tax treaty will take precedence and will be applied to residents of the jurisdiction to which the tax treaty is applicable.

The changes to the PE rules will apply to fiscal years beginning on or after January 1, 2019.

b) Controlled foreign corporation (anti-tax haven) rules

(1) Certain capital gains excluded from income subject to the full-inclusion rule

Where a Japanese company acquires a foreign group and later the shares of an acquired indirect subsidiary are sold or transferred as a result of a restructuring after the acquisition, any capital gains that arise from the sale or other transfer of such shares can be excluded from income subject to the full-inclusion rule under the CFC legislation if certain requirements are met.

Specifically, the capital gain arising from the sale or other transfer of the shares can be deducted from the calculation of income subject to the full-inclusion rule if:

(i) the foreign related company that sold the shares is expected to be dissolved within two years from the date the shares were sold;

(ii) the shares were sold or transferred to the Japanese company or another foreign related company; and

(iii) the sale or other transfer takes place within a specified period and is part of a reorganization implementation plan that covers the integration of the foreign related company selling the shares.

Note that capital gains arising from the sale of shares issued by the foreign related company resulting from the merger and dissolution of the foreign affiliate where residual assets were distributed are not subject to this exclusion from the CFC full-inclusion rule.

(2) Effective tax rate for CFCs located in a “no tax” jurisdiction

The effective tax rate for a CFC located in a no tax jurisdiction will be calculated by dividing the taxes of the CFC for the fiscal year by the CFC’s income (taxable income calculated under the laws of the no tax jurisdiction with adjustments). If the CFC receives dividends, the dividend amount will be deducted from the CFC’s income to calculate the effective tax rate. If the CFC does not have income or is in a loss position, the effective tax rate will be zero.

Certain other amendments will be made to the treatment of foreign related finance subsidiaries depending on the type of foreign related finance subsidiaries (e.g., bank, insurance company, other type of finance company). The above amendments will apply to fiscal years of a CFC beginning on or after 1 April 2018.

c) Determination of “real estate holding company”

The date for determining whether a company constitutes a real estate holding company for capital gains tax purposes when sold by a foreign shareholder will be amended to any time within 365 days prior to the sale of shares by the foreign shareholder. A real estate holding
company is any company for which more than 50% of its assets consist of real estate located in Japan.

The above amendments will apply for fiscal years of the taxpayer (i.e., the selling shareholder) beginning on or after 1 April 2018.

3. Tax measures to enhance competitiveness

a) Shareholders who sell shares in a company in exchange for shares of the buying company can defer recognition of any capital gain arising from that sale if certain requirements are met. To obtain such deferral, the target corporation must have obtained approval for a special business restructuring under the amended Industrial Competitiveness Enhancement Act for the period between the effective date of the Act and 31 March 2021.

b) The requirement for continuity of control in order for a spin-off to be treated as a qualified reorganization will be relaxed. Under the 2018 Tax Proposals, where a subsequent qualified share distribution is expected, the relationship between the two corporations will now be determined immediately before the share distribution is made.

c) Similarly, the current requirements for the continuity of employees and maintenance of the existing business in order for a reorganization to be considered as tax qualified will also be relaxed. Under the 2018 Tax Proposals, these requirements will be considered satisfied even if a subsequent transfer of employees and/or the business within 100% shareholding group is anticipated after the reorganization.

d) The scope of “tax-qualified reorganizations without consideration” will be reviewed. The tax treatment for non-qualified reorganizations without consideration will also be clarified.

4. Individual Income Tax / Inheritance Tax

a) Individual income tax proposals

(1) Decrease the earned income deduction for employees by 100,000 yen and reduce the income level deduction cap to 1.95 million yen (the reduced deduction cap will not apply to taxpayers with children age 22 or younger or those taking a special disability exemption).

The earned income deductions for a permanent resident and / or non-permanent resident employee will be applicable as follows.
(2) Increase the personal exemption by 100,000 yen but reduce all personal exemptions at income levels between 24 million and 25 million yen and eliminate fully at income levels over 25 million yen.

Resident taxpayers are entitled to a personal exemption for themselves (so-called, ‘basic deduction’: currently JPY 380,000 for national tax and JPY 330,000 for local tax). There is no salary threshold to be eligible for the basic deduction and all taxpayers can take the same level of deductions.

The following changes will apply to personal exemptions. For the first time, the basic deduction will be abolished for taxpayers with total annual income over JPY 25,000,000.

(3) Decrease the public pension income deduction by 100,000 yen and cap the deduction at 1,955 million yen for seniors whose annual pension income exceeds 10 million yen. Also, reduce the public pension deduction for seniors with ‘other income’ over 10 million yen.

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**Japan Tax Update**

<table>
<thead>
<tr>
<th>Taxpayer’s annual salary</th>
<th>Earned income deduction from January 2020*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,625,000 yen or below</td>
<td>550,000 yen</td>
</tr>
<tr>
<td>over 1,625,000 yen and up to 1,800,000 yen</td>
<td>Gross income x 40% - 100,000 yen</td>
</tr>
<tr>
<td>over 1,800,000 yen and up to 3,600,000 yen</td>
<td>Gross income x 30% + 80,000 yen</td>
</tr>
<tr>
<td>over 3,600,000 yen and up to 6,600,000 yen</td>
<td>Gross income x 20% + 440,000 yen</td>
</tr>
<tr>
<td>over 6,600,000 yen and up to 8,500,000 yen</td>
<td>Gross income x 10% +1,100,000 yen</td>
</tr>
<tr>
<td>over 8,500,000 yen</td>
<td>1,950,000 yen</td>
</tr>
</tbody>
</table>

* For taxpayers with gross employment income over 8.5 million yen with children age 22 or younger or those taking a special disability exemption, the current rate (10%) will apply (up to gross employment income of 10 million yen; the deduction is capped at 2.1 million yen).

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**Taxpayer’s total annual income**

<table>
<thead>
<tr>
<th>‘Basic Deduction’ Personal exemption for national tax</th>
<th>‘Basic Deduction’ Personal exemption for local tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below 24,000,000 yen</td>
<td>480,000 yen</td>
</tr>
<tr>
<td>Over 24,000,000 yen and up to 24,500,000 yen</td>
<td>320,000 yen</td>
</tr>
<tr>
<td>Over 24,500,000 yen and up to 25,000,000 yen</td>
<td>160,000 yen</td>
</tr>
<tr>
<td>Over 25,000,000 yen</td>
<td>0 yen</td>
</tr>
</tbody>
</table>

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**Recipient’s age**

<table>
<thead>
<tr>
<th>Amount of pension received (A)</th>
<th>Public Pension Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 65</td>
<td></td>
</tr>
<tr>
<td>Below 1,300,000 yen</td>
<td>600,000 yen</td>
</tr>
<tr>
<td>Over 1,300,000 yen and up to 4,100,000 yen</td>
<td>(A) x 25% + 275,000</td>
</tr>
<tr>
<td>65 and above</td>
<td></td>
</tr>
<tr>
<td>Below 3,300,000 yen</td>
<td>1,100,000 yen</td>
</tr>
<tr>
<td>Over 3,300,000 yen and up to 4,100,000 yen</td>
<td>(A) x 25% + 275,000</td>
</tr>
<tr>
<td>All ages</td>
<td></td>
</tr>
<tr>
<td>Over 4,100,000 yen and up to 7,700,000 yen</td>
<td>(A) x 15% + 685,000</td>
</tr>
<tr>
<td>Over 7,700,000 yen and up to 10,000,000 yen</td>
<td>(A) x 5% + 1,455,000</td>
</tr>
</tbody>
</table>

* For individuals who have income other than public pension income of over 10 million yen and up to 20 million yen, the pension deduction from the table above is reduced by 100,000 yen.

** For individuals who have income other than public pension income of over 20 million yen, the pension deduction from the table above is reduced by 200,000 yen.
(4) Decrease the ‘blue form’ tax return deduction by 100,000 yen and increase the ‘blue form’ deduction by 100,000 yen for filing and maintaining tax returns and accounting documents electronically.

Blue form deductions will be reduced by 100,000 yen from the current 650,000 yen. As an incentive for taxpayers to file blue form tax returns electronically, taxpayers who do so and maintain accounting documents electronically will receive an additional 100,000 yen blue form deduction.

The above changes are expected to come into effect from January 2020.

b) Inheritance and gift taxation

(1) Repeal of the ‘5-year tail’ rule for inheritance and gift tax for ‘long-term foreigners’ departing Japan, with a claw-back provision for foreigners who return to Japan within two years of departure.

As part of the 2017 Tax Reform a “lookback” rule for inheritance and gift tax for foreign nationals departing Japan came into effect from April 1, 2017. Under this rule the transfer of foreign nationals’ worldwide assets continued to be subject to Japan inheritance and gift tax after departure from Japan until that foreign national no longer had a jusho (i.e., center of livelihood) in Japan for 10 out of the last 15 years. This meant that the transfer of assets involving foreign nationals who had had a jusho in Japan for 10 years or more could be subject to Japan gift and inheritance tax as well as potential transfer tax in another country for up to 5 years after a permanent move out of Japan.

Under the tax reform proposals, this ‘5-year tail’ rule will be repealed for gift and/or inheritance occurring on or after 1 April, 2018. The proposed change also includes a claw-back provision for foreign nationals who return to Japan within two years of departure, in which case the 10-out-of-15-years lookback rule will still apply.

5. Other proposals

• Revenue recognition rules will be aligned with IFRS 15. Certain transition measures will be introduced for taxpayers which have existing long-term instalment sale contracts or reserves for sales returns.

• Under the Consumption Tax Law, the “place of supply” rule for the transfer of securities without certificate will be revised to be the location of the book entry organization (for those transferred through the book entry system) and the location of the issuer location of the issuer (for those not registered in a book entry system).

• For fiscal years beginning on or after 1 April 2020, it will be mandatory for large corporations to adopt e-filing for all tax returns.

• A JPY 1,000 departure tax will be introduced for all individuals leaving Japan on or after 7 January, 2019, whether temporarily or permanently and whether resident or non-resident.
Japan Tax Update

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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