

# 2020 Japan Tax Reform Proposals

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## In brief

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On December 12, 2019, the ruling parties in Japan published their 2020 Tax Reform Proposals (the "Proposals"). The Cabinet approved the Proposals on December 20, 2019.

One major proposed change to the domestic corporate tax rules is elimination of the current Japanese consolidated group rules and introduction of a new "Group Tax Relief" system, under which each member of a corporate group would file its own tax return, as well as other related changes. On the international tax front, a key change is the introduction of a requirement that a parent adjust its basis in certain subsidiaries' shares upon the receipt of dividends from those subsidiaries; the purpose of which is to prevent the parent from reducing any capital gain arising in a subsequent transfer of that subsidiary's shares. On the administration side of international taxation, the Proposals would allow the tax authorities a three-year extension on the current statute of limitations with regard to international transactions, if the Japanese tax authorities issue an information exchange request to the tax authorities of a tax treaty-partner country.

It is expected that most of the items contained in the Proposals will be passed into law in March 2020. Details of these and other proposed changes are set out below.

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## In detail

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### Corporate Tax

#### **1. Abolishment of the Existing Consolidated Tax System, and Introduction of New "Group Tax Relief" Regime**

- a) Under the Proposals, the currently effective "consolidated tax system" would be eliminated and replaced with a new system of tax relief ("Group Tax Relief"). Group Tax Relief would allow domestic corporations to allocate profits and losses among companies within a 100% Japan-parented group. If passed, the new law is intended to be effective for tax years beginning on or after April 1, 2022. Measures to transition from the current consolidated tax system will also be introduced.
- b) Although the basic rules of Group Tax Relief would be largely similar to those of the consolidated tax system, under Group Tax Relief: (i) the parent corporation and each subsidiary would file their own (blue form) corporate tax returns through the e-tax system, (ii) the parent corporation would be allowed to deduct losses carried forward up to its own income amount in the same manner as its subsidiaries (currently, the parent can deduct its losses carried forward regardless of its income amount), and (iii) in principle, other members of the

group will not be required to file an amended return if one member of the group files such an amended return.

- c) Under Group Tax Relief, there will be changes to the way various items are calculated, where a company enters or exits from the group, or where Group Tax Relief is commenced or terminated, including the allocation of current profit and loss and carried forward losses to group member corporations, adjustments to the book value of subsidiary corporations and the value of assets owned, and (dis)allowance of carried forward losses.
- d) To reduce the administrative burden on group corporations, it will be possible under Group Tax Relief to calculate certain income or tax credits on a standalone-basis, rather than on a group-wide basis, as is required under the current consolidated tax system. Certain tax attributes will continue to be calculated on a group-wide basis, however, such as the amount of R&D credits and foreign tax credits.
- e) Going forward, the Ministry of Finance will also review rules relevant to the existing group taxation regime (which are the existing default rules applicable to 100% group companies), to ensure such rules align with the Group Tax Relief. The rules to be reviewed include those in connection with dividend income exclusion, donation expenses, bad debt allowances, and capital gain deductions arising from the intragroup transfer of assets.

## 2. International Tax

- a) Requirement to Reduce Basis in Affiliated Subsidiary upon the Receipt of Dividends from that Subsidiary

Under the Proposals, where a Japanese parent receives from an affiliated subsidiary<sup>1</sup> dividends that exceed in the aggregate 10% of the book value of the shares of that subsidiary in a given year, the parent must reduce its basis in the shares of the subsidiary by the amount of the dividends subject to the dividend income exclusion. This rule is designed to prevent the parent from reducing any capital gain arising on a subsequent transfer of such subsidiary's shares by first receiving dividends from the subsidiary.

Exceptions to the above general rule will apply where: (i) Japanese corporations or residents have owned 90% or more of the shares of the affiliated subsidiary from which the dividends are received since that subsidiary's establishment, (ii) the total annual amount of dividends received is less than the net increase in the retained earnings of the subsidiary since the year in which the 50% control relationship arose, (iii) the total annual amount of dividends received is JPY20 million or less, or (iv) the parent receives the dividends on or after 10 years from the date that the 50% control relationship arose.

If passed, the above rule is intended to apply with respect to tax years beginning on or after April 1, 2020.

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<sup>1</sup> An "affiliated subsidiary" is a subsidiary with which the parent has a more than 50% control relationship as of the date of the dividend resolution.

b) Japanese Controlled Foreign Corporation (“CFC”) Rules: Scope of Income Subject to Concurrent Parent-Level Taxation

Interest received by a CFC from suppliers to which the CFC provided financing will be excluded from the scope of income that is potentially subject to concurrent taxation at the parent-level. If passed, this amendment will apply to tax years beginning on or after April 1, 2020.

c) Scope of Creditable Foreign Tax Payments under the Foreign Tax Credit Regime

Foreign taxes paid under the following circumstances would no longer be creditable under Japan’s foreign tax credit system: (i) foreign taxes levied on payments between foreign corporations on the grounds that such payments were deemed to have been made to the Japanese corporation, and (ii) foreign taxes levied on a payment from a foreign permanent establishment (“PE”) to its Japanese head office or another related party as a result of the foreign tax authorities disallowing a deduction at the local level.<sup>2</sup> If passed, this amendment will apply to tax years beginning on or after April 1, 2021.

d) Amendment to Scope of Non-Deductible Interest under Earnings Stripping Rules

Where a Japanese corporation pays interest to the Japanese PE of a foreign corporation, and the parties contemplate in advance that the Japanese PE will transfer the interest received to its foreign head office, such interest would be excluded from the scope of non-deductible interest under the earnings stripping rules. If passed, this amendment will apply to tax years beginning on or after April 1, 2020.

e) Automatic Exchange of Non-Resident Banking Information

The Ministry of Finance will review the reporting system for automatic exchange of bank account information of non-residents, and potentially propose certain changes to the rules in line with global trends.

**3. Promoting Investment in Innovative Corporations, and Other Policy Measures**

a) Establishment of a Tax System to Promote Investment in Innovative Corporations

Where a corporation engaging in specified business activities acquires the shares of a venture company<sup>3</sup> through an equity investment in such company from April 1, 2020 through March 31, 2022, and accounts for that investment in a special tax account, the investor corporation (i.e., the corporate shareholder) will be eligible for a special income deduction.

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<sup>2</sup> An example of foreign taxes ineligible for the Japanese tax credit under this section of the provision would be, for example, BEAT amounts, where a US company was required to pay additional tax in the US as a result of application of the BEAT rules.

<sup>3</sup> The qualified shares are of a venture company, certified as such by the Ministry of Economy, Trade and Industry (“METI”).

Requirements for Investor	Corporation must be engaged in specified business activities; specifically, those undertaken with the goal of developing new businesses, that are expected to be highly productive, or that make use of management resources other than those of the company itself.
Requirements for Investee	i) A domestic venture company defined under the Industrial Competitiveness Enhancement Law, which has commenced business operations but is less than 10 years old. ii) Foreign corporations satisfying conditions similar to the above.
Investment method	Direct acquisition or through corporate venture capital or through an Investment Limited Partnership
Threshold investment amount	JPY100 million or more per investment, subject to an upper ceiling; (JPY500 million or more if the investee is a foreign corporation)
Tax incentive	Deduction up to 25% of the acquisition cost (deduction limited to the taxable income of the current year); however, if certain events <sup>4</sup> occur within 5 years of the acquisition date, a deduction taken previously may be partially or entirely reversed and become subject to income taxation.

b) Establishment of a Tax System to Promote the Introduction of 5G Technology

Accredited corporations will be entitled to elect either a 30% special depreciation rate or a 15% tax credit where they invest in infrastructure to promote the introduction of 5G technology, and where the corporations put such infrastructure into use. The tax benefits will be available where the accredited corporation satisfies the requirements from the effective date of the new act (the “Act to Promote Introduction of Specified Advanced Information Communication Systems”) through March 31, 2022.

c) More Stringent Thresholds for Certain Tax Incentives

The threshold investment amounts necessary to apply for certain tax incentives designed to promote investment, such as R&D tax incentives and tax credits related to improvements in productivity, will be increased for large corporations.

Tax incentive	R&D Investment, IT Investment, 5G Investment, etc.	Salary Income Increase Investment
Threshold investment amount	Investment amount must exceed 30% of taxpayer’s aggregated depreciation expenses annually (currently 10%)	Investment amount must be 95% or more of the taxpayer’s aggregated depreciation expenses annually (currently 90%)

d) Deductibility of Entertainment Expenses

The applicability of special rules permitting a 50% deduction of external entertainment expenses will be extended by two years, other than for corporations with capital amounts of greater than JPY10 billion.

e) IT Tax Incentive

<sup>4</sup> Such events would include the investor transferring the shares, the investor receiving dividends, METI revoking its certification of the investee company, etc.

The connected industries investment incentive (the “IT tax incentive”) will be abolished on March 31, 2020, one year earlier than initially legislated. To make up for the early termination of the measure, certain transitional rules will be implemented, under which the current tax treatment will continue to apply to the extent that the application for the IT tax incentive is approved by March 31, 2020 and qualified facilities are put into use by March 31, 2021.<sup>5</sup>

f) Share-Based Director’s Compensation

Changes are proposed to the taxation of share-based incentive compensation paid to directors.

- i) Taxation of share-based remuneration paid to directors will be aligned with recent amendments to the Corporate Law.
- ii) The government will review and consider whether any changes are necessary to the rules governing taxation of shares granted as consideration for the provision of services where there is no payment required and where there are restrictions on the transfer of the shares.
- iii) Formal thresholds will be established in order to determine whether or not grants of shares or share options to directors are excessive.

g) As a general matter, provisions for determining fair market value will be revised in accordance with the introduction of IFRS 13, Fair Value Measurement.

#### 4. Improvements to Tax Administration

- a) Corporations will be eligible to apply for a one month extension to the deadline for filing of final consumption tax returns. To apply for the extension, the corporation must submit an application form by the end of the tax year for which they seek the extension. If passed, this amendment will apply from tax years ending on or after March 31, 2021.
- b) Regardless of the standard statute of limitation (“SOL”) generally applicable to corporate income taxes, the SOL for tax assessments relating to overseas transactions will be extended for three years from the date that the Japanese tax authorities issue an information exchange request to the tax authority of a tax treaty-partner country. This amendment will apply to national tax returns, the filing due date of which falls on or after April 1, 2020.
- c) The interest rate applied by tax offices on delinquency tax and on refunds paid to taxpayers will be reduced from the current 1.6% p.a. to 1.1% p.a. The Proposal notes that this change was made in light of current market interest rates.
- d) Changes are proposed to tax office requirements to allow taxpayers to maintain books and records in electronic form, in order to encourage greater adoption of electronic bookkeeping by Japanese taxpayers.
- e) Changes are proposed with regard to the requirements for reporting of overseas property. Where a taxpayer does not submit the required documents to the tax authorities by the designated deadline, the taxpayer will be subject to an additional penalty tax, for failure to file the required report, even if the taxpayer is not aware of his or her obligation to file a tax return. This amendment will apply to income tax arising in 2020 and onwards.

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<sup>5</sup> For details regarding the IT tax incentive, please see the 2018 PwC Japan Tax Update “connected industries investment incentive”, available here: <https://www.pwc.com/jp/en/taxnews/pdf/jtu-20180821-en-138.pdf>.

**5. Tax Proposals related to SMEs, Regional Revitalisation, etc.**

- a) The applicability of special rules permitting deductions for entertainment expenses to SMEs will be extended for two years.
- b) The current rules relating to deductions for small depreciable assets for SMEs will be extended for two years, although the scope of corporations to which the rules apply will be narrowed. The tax measures will no longer apply to SMEs with more than 500 regular employees, or to SMEs that are members of tax consolidated groups. The two year extension will be subject to review, and will be continued subject to the strength of the regional tax system.

**Individual Income Tax**

- a) Special rules are proposed with regard to the calculation of profit and loss on real estate income of certain second-hand buildings located overseas. Certain taxpayers in Japan had applied the existing rules to reduce Japanese domestic taxable income by taking depreciation deductions in connection with such overseas real estate. Under the Proposals, depreciation expenses on certain overseas used rental property would not be permitted to generate a net rental loss; rather, the depreciation would be limited to reducing the net rental income to zero. Taxpayers would, however, be permitted to deduct depreciation expenses that were not deducted in the calculation of real estate income from their capital gain calculation where the property is sold. If passed, the proposed change would apply to income tax arising in 2021 and onwards.<sup>6</sup>
- b) The scope of listed securities eligible for special taxation rules, where held in specified brokerage accounts, will be expanded. It will also be possible to provide documentary evidence necessary in connection with securities held in such accounts to the Japanese tax authorities electronically.
- c) The scope of corporations eligible to take advantage of the “angel investor” taxation system will be expanded.<sup>7</sup>

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<sup>6</sup> For further details regarding the proposed change, please refer to the separate PwC Tokyo tax alert, “2020 Proposed Japan Individual Tax Reforms: Revised Rules on Overseas Used Rental Properties”, available here: <https://www.pwc.com/jp/en/taxnews-international-assignment/assets/gms-20191216-en.pdf>

<sup>7</sup> The “angel taxation” system provides for special tax treatment with respect to shares acquired in specified SMEs, and with regard to losses carried forward in relation to shares in specified SMEs.

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## Let's talk

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

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