
2017 Tax Reform Proposal

December 2016

In brief

On December 8, 2016, the Japan ruling party coalition (LDP and Komeito) issued the 2017 Tax Reform Proposal with the objective to help expand the Japanese economy. The 2017 Tax Reform Proposal includes corporate tax measures which are intended to support investments and to reward companies for raising employee salaries. In addition, the 2017 Tax Reform Proposal includes amendments consistent with the BEPS recommendations with the stated purpose to support the healthy expansion of Japanese companies into growing global markets while limiting tax avoidance. Finally, measures are proposed to support the local economy through “local Abenomics” measures and to revise the spousal deduction in order to encourage women to increase their participation in the work force. The 2017 Tax Reform Proposal is expected to be submitted to the Diet in January 2017 and is expected to be approved by the end of March 2017 (subject to Diet amendments).

In detail

This newsletter will outline the 2017 Tax Reform Proposal as follows:

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1. Stated policy targets for the 2017 Tax Reform Proposal

The 2017 Tax Reform Proposal includes measures to support the Japanese economy through innovation and workstyle changes taking into account a slowdown in the world economy and political changes such as the recent US election and Brexit.

To support workstyle changes, amendments are proposed to modify the spousal deduction to reduce incentives for working spouses to limit their work hours.

To support the overall economy and to combat deflation, amendments are proposed to modify the R&D credit to increase the competitiveness of Japanese corporations and to increase credits for increasing employee salaries. In addition, measures to enhance corporate governance through more flexible tax filings and to allow for greater flexibility in corporate reorganizations are included.

To enhance Abenomics at a national level and to continue the economic expansion, measures are included to support the expansion of Japanese companies into foreign markets and, at the same time, to reduce international tax avoidance by enacting the BEPS agreements into the domestic law.

To bring Abenomics to the local economy, measures building on the 2015 Tax Reform are introduced to support investments by SMEs as well as to support the transfer of business operations to locations outside of major metropolitan areas.

The increase of the consumption tax rates from the current 8% to 10% was delayed by the law passed in the Diet on November 18, 2016. However, the 2017 Tax Proposal states clearly that the consumption tax rates will be increased to 10% from October 1, 2019 in order to reduce the government deficit.

2. General corporate tax proposals

(1) R&D tax credits

Pursuant to the 2015 Tax Reform, the R&D tax credit system was amended whereby the credit limit was increased and the “Open Innovation” type R&D credit was expanded. The 2017 Tax Reform Proposal builds on these changes as follows:

- (i) The credit rates will increase in line with an increase of R&D expenditures.
- (ii) R&D expenditures to develop certain kinds of new service-type businesses will be brought within the scope of the R&D tax credit in order to support the development of new business opportunities from the “Internet of Things” (“IoT”), “Big Data”, Artificial Intelligence (“AI”), etc.
- (iii) Conditions for claiming the “Open Innovation” type of R&D credit will be relaxed.

(2) Salary Increase Tax Credit

In order to strengthen the “virtuous cycle” whereby expanded corporate profits result in more employment and salary which leads to further consumption and investments, the 2017 Tax Reform Proposal provides further incentives for corporate taxpayers to increase employee salaries. In particular, SMEs are provided even more incentives than large corporations.

	Current	2017 Tax Reform Proposal	
		Large corporations	SMEs
Conditions			
(1)		$\frac{\text{Salary increase compared to base year}}{\text{Salary in base year}} \geq 5\%$ (3% for SMEs)	
(2)		Salary in current year \geq Salary in previous year	
(3)	Average salary in current year > Average salary in previous year	$\frac{\text{Average salary increase compared to previous year}}{\text{Average salary in previous year}} \geq 2\%$	Average salary in current year > Average salary in previous year
Tax Credit	10% of salary increase compared to base year (maximum 10% of corporate tax liability (20% for SMEs))	10% of salary increase compared to base year PLUS additional 2% on the increase from previous year (maximum 12%)	10% of salary increase compared to base year (maximum 20% of corporate tax liability) PLUS If condition (3) for large corporations is met, additional 12% of the increase from previous year (maximum 22%)

The salary increase benefits contained within the sized based enterprise tax will also be amended accordingly.

(3) Director bonus and stock compensation

In order to support corporate governance reform, measures were adopted to allow for tax deductions for restricted stock compensation in the 2016 Tax Reform. In the 2017 Tax Reform Proposal, changes are made to facilitate performance based director compensation in order to enable corporations to incentivize management to create corporate value in the mid to long term.

Generally, for companies who make Japanese public filings (e.g., listed companies), there are proposed changes which allow more flexible cash or stock based compensation (including retirement allowances).

Also, technical changes are proposed to the “restricted stock” rules regarding “prior notice compensation” which are too detailed to consider here.

Finally, technical changes are proposed so that “fixed payments” (which are not considered “director’s bonuses”) can be computed on a “gross” or “net” basis which “ignore” variations in tax and social security withholdings.

(4) Filing due date of the corporate tax returns

Under the current law, a Japanese corporation must file its corporate tax returns within 2 months of its fiscal year end. However, if the financial statements ordinarily cannot be finalized within 2 months because of a financial audit by external auditors etc., the Japanese corporation can apply for a one-month extension of the filing due date (i.e., tax return due within three months of the fiscal year end).

In order to strengthen the corporate governance and enrich the discussions between a corporation and investors, if a corporation with an external financial auditor cannot ordinarily hold the annual general shareholder’s meeting within 3 months of the fiscal year end because of a clause in the articles of incorporation etc., a maximum of a 4 month extension of the filing due date (i.e., tax return due within six months of the fiscal year end) may be allowed. Similar measures will also be introduced for local enterprise tax purposes.

3. Corporate tax proposals related to reorganizations

(1) Corporate Spin-offs

a) Corporate demerger

Under the current law, a corporate demerger by a corporation with many shareholders where the shares in the new company are given to the shareholders does not qualify as a tax qualified demerger. These rules are being relaxed under the 2017 Tax Reform Proposal whereby a spin-off of a specific business by a corporation without a controlling shareholder will be tax qualified under certain conditions.

b) Distribution in kind

Under the current law, a distribution in kind by a corporation with many shareholders is not tax qualified. Under the 2017 Tax Reform Proposal, a spin-off conducted as a distribution in kind of shares in a 100% subsidiary will be tax qualified under certain conditions.

The general conditions for a tax qualified demerger or distribution in kind are outlined in the following table.

Conditions for tax qualification	Corporate demerger	Distribution in kind
Consideration	Shares in the demerged corporation only are distributed to shareholders	Shares in the 100% subsidiary only are distributed to shareholders
Control	Demerging company is not controlled by any “group” of persons before the demerger and demerged corporation is not expected to be controlled by any group of persons after the demerger	Parent company is not controlled by any “group” of persons before the distribution and the subsidiary is not expected to be controlled by any group of persons after the distribution
Transfer of major assets and liabilities	The major assets and liabilities of the demerged business has been transferred to the demerged corporation	Not applicable.
Employees	Approximately 80% or more of the employees of the demerged business is expected to be employed by the demerged corporation.	Approximately 80% or more of the employees of the subsidiary is expected to continue to be employed by the subsidiary.
Business continuation	Demerged business is expected to be continued by the demerged corporation	Subsidiary’s main business is expected to be continued.
Specified directors	A director or an important employee of the demerging corporation is expected to become the specified director of the demerged corporation	Not all of the specified directors of the subsidiary retire because of the distribution in kind

- c) Distribution in kind of the shares in a 100% subsidiary to a foreign corporation or non-resident individual.

The following measures will be introduced to align the taxation of non-resident shareholders with that of corporate demerger:

- Conditions on the 25/5 rule will be amended to apply to a distribution in kind so that such a transaction may be considered to be a taxable sale of stock by a non-resident shareholder.
- If the foreign shareholder keeps the shares in the Japanese parent corporation at its permanent establishment in Japan, capital gain taxation will not apply. If shares in foreign subsidiary are distributed and the foreign shareholder no longer keeps the shares at its permanent establishment in Japan, it would be deemed as an “internal dealing” between the permanent establishment and the head office (and likely a taxable event from a Japanese tax perspective).

(2) Minority Shareholder Squeeze-outs

Currently, in order to squeeze out minority shareholders, the following methods are used: merger, share-for-share transfer, shares with compulsory acquisition rights, share consolidation, request to sell back shares, etc.

Under the 2017 Tax Reform Proposal, creating a 100% subsidiary through a squeeze out process using shares with compulsory acquisition rights, share consolidation, and a request to sell back shares, will be considered a type of corporate reorganization. As part of bringing such squeeze outs within the corporate reorganization framework, special measures will be introduced including mark-to-market rules and the special rules on consolidated taxation.

In a merger or share-for-share transfer, if the merging corporation or the 100% parent corporation owns 2/3 or more of the merged corporation or the 100% subsidiary, consideration other than shares can be provided to minority shareholders without disqualifying the corporate reorganization.

Other amendments will be made to tax qualified conditions, loss limitation rules and mark-to-market rules.

4. Corporate tax proposals for small to medium size enterprises (“SMEs”)

(1) Investment incentives for local *chukaku* corporations

If an SME qualifies under the Local Future Investment Enhancement Law as a “*chukaku*” corporation, special depreciation or tax credit on the assets acquired can be claimed.

(2) Investment tax credits for SMEs

The scope of the assets available for special investment tax credit for SMEs will be expanded to include equipment and building improvements.

(3) Limitation of the scope of SMEs eligible for Special Taxation Measures

The applicability of the Special Taxation Measures for SMEs is currently determined based on only the paid-in capital amount of the company. Under the 2017 Tax Reform Proposal, another condition will be added so that if the average income of the past three years exceeds JPY 1.5 billion, the Special Taxation Measures for SMEs will no longer be applicable.

Note: Other definitions regarding what constitutes an SME for Corporate Tax Law purposes (reduction in the tax rates, utilization of tax loss carried forwards without “haircut”, etc.) remains the same.

5. Amendments to the controlled foreign corporation (“CFC”) and “tax haven” rules

Japanese CFC rules are generally based on the “entity approach” whereby income earned by a foreign controlled subsidiary are taxed to the Japanese shareholder if (a) the foreign tax rate is lower than a “trigger” rate AND (b) the main business of the foreign controlled subsidiary is not “active” (as defined). Certain amendments in the 2010 Tax Reform introduced elements of an “income approach” whereby certain types of passive income would be taxable to a Japanese shareholder even if the “main business” of the foreign controlled subsidiary was “active”. Since 2010, there have been reforms made on the “active business” criteria and the trigger rate.

In the 2017 Tax Reform Proposal, major changes are proposed considering the BEPS recommendations to shift to a more of an income based approach (although elements of the entity approach remain).

Under the 2017 Tax Reform Proposal, income earned by a foreign subsidiary is “aggregated” (i.e., included within Japanese taxable income) in three different ways:

- (a) Entity based aggregation where all of the income of a CFC is taxable to a Japanese shareholder if (a) the main business of the foreign controlled subsidiary is not “active” (as defined) AND (b) the foreign tax rate is lower than a 20% “trigger” rate.
- (b) Entity based aggregation where all of the income of a CFC is taxable to a Japanese shareholder if (a) the CFC fails certain “substance” and “administration and control” tests and is thereby treated as a “paper company” or “cash box company” AND (b) the foreign tax rate is lower than a 30% “trigger” rate.
- (c) Income based aggregation where even if the entity based aggregation rules do not create income inclusion on an entity basis that the relevant income of a CFC is taxable to a Japanese shareholder if (a) income of the CFC includes certain “passive” categories of income AND (b) the foreign tax rate is lower than a 20% “trigger” rate.

The new rules will apply for fiscal years of foreign subsidiaries starting on or after April 1, 2018.

i) Changes to the definition of a CFC

The 2017 Tax Reform Proposal includes more foreign companies which are controlled “in substance” in the definition of a CFC for Japanese tax purposes by making the following changes.

Holding ratio	Indirect holdings in a foreign corporation will be counted to the extent the shares of the foreign corporation are owned by another foreign corporation which is owned more than 50% by Japanese corporations. Comment: Previously, in determining a CFC, the total Japanese ownership of an indirect subsidiary was determined on a “mechanical” percentage basis. Under this test, effective control is evaluated.
Claims on residual assets	Foreign corporations where almost all of its residual assets can be claimed by resident individual or Japanese corporation

In addition, for purposes of CFC definition, a company is considered a “CFC” even if the rate of tax is more than a “trigger rate” (although as discussed elsewhere, “trigger rates” are still relevant in terms of entity or income aggregation).

ii) Changes to general entity based aggregation rules

- Business Purpose Test: aircraft leasing companies can be considered “active” businesses for CFC purposes as far as directors/employees conduct all of the activities which are ordinarily necessary to manage the business in the jurisdiction where the head office is located.
- Insurance companies which outsource their business to a related party based on the approval by the regulator at the time of license application will meet the Substance Test and the Administration & Control Test. In these circumstances, the outsourcing will not be treated as a related party transaction.
- Manufacturing companies which proactively engage in manufacturing need to meet the Local Country Test.
- If a transaction with third party is pre-determined to be subsequently transferred to a related party, then the transaction is deemed to be conducted between the related parties.
- Unrelated Party Test will apply to aircraft leasing companies.
- If the tax authorities ask for documents showing that the foreign related party meets the Economic Activity Test (former Active Business Exemption Test) and such documents are not forthcoming, then the foreign related party is deemed not to meet the exemption.
- Dividend exclusion (25% or more) will be lowered to 10% or more for fossil fuel mining companies.
- If the tax rate of the foreign related party is 20% or more then it is exempt from the entity based aggregation (essentially the trigger rate).

iii) Entity based aggregation of “specified” CFCs (i.e., paper companies and cash box)

The following companies are defined as specified CFCs:

- (1) Foreign related company which meet neither of the following:
 - a) It owns a fixed place of business to carry on its main business
 - b) It manages, controls and operates its business at its head office location by itself;
- (2) Securities, loans and intangible assets consist of more than 50% of its total assets and the passive income other than extraordinary profit (both as defined below) exceeds 30% of its total assets;
OR
- (3) Head office is located in a jurisdiction designated by the Minister of Finance as non-cooperative jurisdiction on tax information exchange.

If the tax rate of the foreign related party is 30% or more, then it is exempt from the entity based aggregation of specified CFCs (essentially the trigger rate).

iv) Income based aggregation

Certain passive income of the following companies will be aggregated (i.e., taxable for Japanese tax purposes for the Japanese shareholder).

(a) Non-financial services CFCs

Passive income is broadened as follows (please note that only the important exceptions are listed):

- (1) Interest income. There are exceptions for certain kinds of interest earned by “treasury centres” as well as for licensed non-bank (money lender) interest, in both cases as far as

directors/employees conduct all of the activities which are ordinarily necessary to manage the business in the jurisdiction where the head office is located .

- (2) Dividends. Dividends earned from corporations with 25% or more ownership are excluded (10% for fossil fuel mining companies).
- (3) Securities lending consideration.
- (4) Capital gains/losses on securities. Capital gains/losses from the transfer of shares in corporation with 25% or more ownership is excluded.
- (5) Gain/loss from derivatives. There is an exception if the CFC has a license to conduct certain activities. Hedging transactions are also excluded.
- (6) Foreign exchange gain/loss. FX gains/losses in the ordinary course of business are excluded.
- (7) Other similar income. Hedging transactions are excluded.
- (8) Considerations on leasing fixed assets. Generally, lease income from leased assets which are used mainly in the head office jurisdiction and the lease income earned by a company whose directors/employees conduct all of the activities which are ordinarily necessary to manage the business in the jurisdiction where the head office is located are excluded.
- (9) Royalty on intangible assets. Royalties for self-developed intangibles are excluded as well as certain kinds of IP acquired on an arm's length basis.
- (10) Capital gain/loss on intangible assets (with same exceptions as royalties)
- (11) Other extraordinary profits. Profit of the current year minus total of (1)-(10) above minus 50% of (total assets + aggregated depreciation + HR costs). Comment: This is mechanical calculation which appears to be intended to pick up "extraordinary" profit which is subject to a low rate of tax but are not aggregated using the above income categories.

If there are losses in categories (4), (5), (6), (7) and (10) above, the losses cannot offset other income but carried forward for 7 years.

Exemptions from partial aggregation of passive income:

- a) The foreign CFC tax rate is 20% or more
- b) The total passive income for the CFC is JPY 20 million or less (currently JPY 10 million) or the ratio of gross passive income to net income before tax is 5% or less.

(b) Financial services CFCs

Financial services subsidiary means foreign related corporations conducting banking, securities, or insurance business based on the law of the jurisdiction of the head office of the subsidiary, and directors/employees conduct all of the activities which are ordinarily necessary to manage the business in the jurisdiction where the head office is located.

Passive income subject to tax at a financial services CFC is the greater of the following income (1) or (2):

- (1) Consideration on leasing fixed assets, royalties on intangible assets, capital gain/loss on intangible assets and other extraordinary profits as discussed above for non-financial services CFCs.
- (2) Income earned from an extraordinary level capital of the financial services subsidiary (it is not clear from the 2017 Tax Proposal what level is intended to be extraordinary).

If there are losses related to the transfer of intangible assets, the losses cannot offset other income but carried forward for seven years.

Exemptions from partial aggregation of passive income as the same as for non-financial services CFCs.

v) requirement to attach the financial statements of CFC to corporate tax returns

The financial statements of the following CFCs will be required to be attached to the corporate tax returns.

- (a) CFC with corporate tax rate of less than 20%
- (b) Specified CFC with corporate tax rate of less than 30% (which do not qualify for the exemption)

6. Consumption tax proposals related to virtual currency

Accompanying the revision of the Act on Settlement of Funds, where virtual currency falls within the definition of an instrument of payment, transfers of virtual currencies will be treated as non-taxable sales for Japanese consumption tax purposes.

The amendments are scheduled to be effective for the sale and purchase of virtual currencies made on or after July 1, 2017.

7. Tax compliance

The original filing requirements for foreign tax credit and R&D tax credit, etc., will be made clear and if the requirements are met, the credit amount can be changed, i.e., the tax office can make an upward assessment of the tax credit when the underlying income increases. Similar amendments will be made to the local tax credit rules as well.

8. Individual tax

For details regarding changes made to the spousal deduction, taxation of non-permanent residents and inheritance tax as applied to foreign nationals resident in Japan, please see [the GMS newsletters](#).

Let's talk

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

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