

Japan Tax Bulletin

2017 tax reform proposal in Japan

February 2017

The 2017 tax reform proposal was released on December 8, 2016. This article summarizes proposed changes, which are expected to affect businesses.

1. Corporation Tax

1.1 R&D tax credit

(1) Tax credit calculation

(i) Companies other than Small or Medium-sized Enterprises (SME)

Currently, 8% - 10% of qualifying research and development expenses are creditable against a taxpayer's corporation tax liability capped at a maximum of 25% of the liability. The 8% - 10% tax credit range has been widened to 6% - 14% under the proposal as follows:

- Where the variation ratio is higher than 5%, $9\% + ((\text{variation ratio} - 5\%) \times 0.3)$
- Where the variation ratio is 5% or higher, $9\% - ((5\% - \text{variation ratio}) \times 0.1)$
- Where the variation ratio is lower than 25%, 6%

The variation ratio is defined as (the amount of research and development expenses – the amount of comparable research and development expense) / (the amount of research and development expenses).

Comparable research and development expense is the average research and development expense amount over the 3 years beginning before the current year.

The tax credit rate is capped at 10% (14% for the first 2 years) and the maximum creditable amount is 25% of the corporation tax liability.

For the first 2 years, if the average sales amount is higher than 10% and an additional credit for high level research and development expense ratio¹ is not taken, the creditable amount is increased up to a maximum of 35% of the corporation tax liability, using the following formula:

25% of corporation tax liability + (corporation tax liability $\times$ ((research and development expense ratio – 10%) $\times$ 2))

The average sales amount is the average sales in the current year and the 3 years beginning before the current year. The research and development expense ratio is the research and development expense in the current year divided by the sales in the current year.

(ii) SME

The tax credit rate is 12%. For the first 2 years, where the increase ratio is higher than 5%, the tax credit rate is 12% + ((increase ratio – 5%) $\times$ 2) up to a maximum of 17%. The increase ratio is the same as variation ratio but with a minimum value of 0.

The creditable amount is 25% of the corporation tax liability. For the first 2 years, if the increase ratio is higher than 5% and the additional credit for high level research and development expense ratio is not taken, the creditable amount is 35% of the corporation tax liability.

Also for the first 2 years, if the research and development expense amount is higher than (10% $\times$ average sales amount) and the additional credit for high level research and development expense ratio is not taken, the creditable amount is increased up to a maximum of 35% of the corporation tax liability, using the following formula:

25% of corporation tax liability + (corporation tax liability $\times$ ((research and development expense ratio – 10%) $\times$ 2)).

(2) Scope of qualifying research and development expenses

Currently, research and development expenses are for material costs, compensation, other expenses or business consignment expenses in connection with producing products, improving technologies, designs or inventions. Under the proposal, a new category of expenses for developing services qualifies as research and development expenses.

Expenses for the following activities qualify:

- Collecting information with wholly or partly automated equipment or technologies designed for the purpose of collecting huge volumes of information

¹ Where research and development expense in the current year exceeds 10% of the average sales amount, (research development expense – average sales amount $\times$ 10%) $\times$ (research and development expense ratio – 10%) $\times$ 0.2 is additionally creditable.

- Analysis by information analysis experts with software designed to identify rules out of the accumulated information collected.
- Designing new services by using the rules identified out of analyses.
- Confirming that rules identified are reasonable and consistent with forecasts and results and services utilizing the rules, with reference to the objective of the services.

1.2 Deductibility of officer's bonus

(1) Officer's compensation linked to business performance indicators

Deductibility of officer's compensation is restricted. Officer's compensation is disallowed unless it is periodic and fixed, notified in advance to the tax office, or linked to certain profit indicators. In the proposal, officer's compensation linked to stock prices in markets or revenues indicators (revenue indicators must be used with profit indicators or stock market indicators) is deductible as well.

Further, business performance indicators may be related to future business year, points in time or periods.

Compensation may be in the form of stocks for which market prices exist, where the number of stocks is calculated based on business performance indicators and is fixed.

The proposal intends to support the management of companies to commit to mid or long term objectives.

(2) Officer's compensation notified in advance

In the proposal, compensation in the form of shares or rights to subscribe for shares delivered at a point in time and in the number notified to the tax office in advance become qualified as deductible compensation. Shares must be marketable shares issued by a company to which officers render services or a company, more than 50% owned directly or indirectly by the company. Share subscription rights must be for marketable shares issued by the company above. Compensation in the form of shares with restrictions on transfer do not qualify for this category of compensation if the restrictions are removed based on profit or other indicators.

(3) Periodical fixed amount compensation

Officer's compensation paid monthly or on a shorter periodic basis and of a fixed amount is tax deductible. Foreign expatriates who are assigned to a Japan subsidiary's in an officer capacity are sometimes guaranteed a fixed net salary amount and their gross compensation is determined after performing gross up calculations. In order to accommodate such net basis compensation packages under the proposal, if an officer's compensation is periodic and fixed after deducting payroll taxes such as withholding income tax, social insurance premiums etc., then the payments will be tax deductible for the employer.

(4) Compensation to officers upon retirement

Under the current rules, compensation on termination to officers is fully deductible unless it is unreasonably excessive. In the proposal, compensation paid upon retirement calculated based on profit indicators or other indicators (excluding years of service and compensation already paid) is disallowed unless conditions for deducting officer's compensation linked to profit indicators are satisfied. Compensation on termination in the form of share subscription rights are also disallowed unless conditions for deduction of officer's compensation linked to profit indicators or those for advance notified compensation are met.

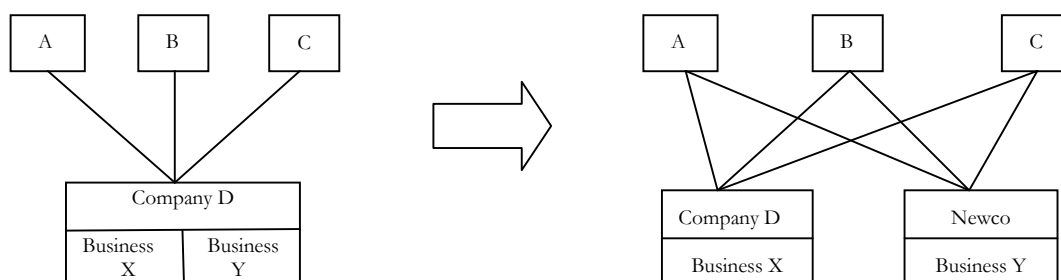
The reforms are scheduled to apply to compensation of which payment or delivery is resolved on April 1, 2017 or thereafter. For compensation on termination, shares with restrictions on transfer and share subscription rights, the reform is scheduled to apply to payments or deliveries which are resolved on October 1, 2017 or thereafter.

1.3 Reorganizations

(1) Spin-off

A corporate spin-off as depicted below becomes qualified as a tax-free reorganization.

(i) Spin-off of business segment



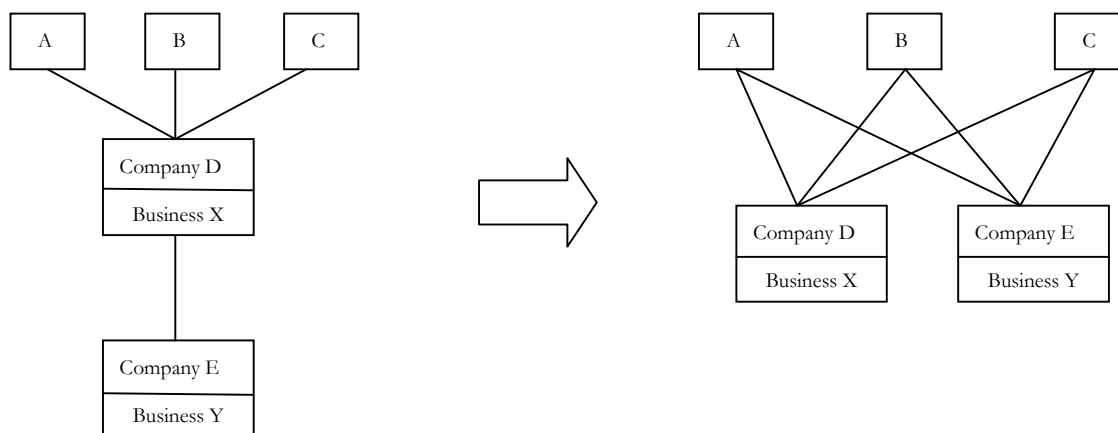
A corporation with business X and business Y sets up a new corporation to transfer business Y and distributes Newco's shares proportionally to its shareholders based on their shareholdings in the transferring corporation. Currently, in order for this type reorganization to qualify as a tax-free reorganization, the transferring corporation must be controlled by other persons. In the chart above, where shareholders A, B and C are unrelated, company D is not controlled by any persons.

In the proposal, if the following conditions are met, this type reorganization can qualify as a tax-free reorganization:

- No properties other than the transferee company's shares are distributed to the transferor company's shareholders,
- The transferor company is not controlled by other persons and the transferee company is expected to be controlled by other persons after the spin-off,
- Material assets and liabilities for the transferred business are transferred to the transferee company,
- 80% or more of employees engaged in a transferred business are expected to be engaged in the transferred business in the transferred company,
- The transferred business is expected to continue in a transferee company, and
- Officers or employees with significant roles are expected to take officer positions with management roles.

If the transaction qualifies as a tax-free reorganization, there are no taxable events for the parties involved, company D, shareholders A, B, C and Newco.

(ii) Spin-off of a 100% subsidiary



Company D distributes Company E's (a 100%-owned subsidiary) shares proportionately to its shareholders. The distribution of a wholly owned subsidiary's shares is treated as a tax-free corporate reorganization and the distributing company does not recognize gains/losses on the distribution if the following conditions are satisfied. There are no taxable events for shareholders A, B, C and Company E either.

- No properties other than the subsidiary's shares are distributed to the distributing company's shareholders,
- The distributing company is not controlled by other persons and the transferee company is expected to be controlled by other persons after the distribution,
- 80% or more of the employees of the subsidiary are expected to be engaged in the business after the distribution,
- The principal businesses of the subsidiary are expected to continue,
- Not all officers with management roles are expected to leave the subsidiary after the distribution.

(2) Squeeze out

Squeezing out minority shareholders and becoming a wholly owning shareholder can be achieved through shares wholly redeemable at the option of the company and buying out fraction of shares, reverse share splits and buying out fractions of shares or the exercise of appraisal right of a special controlling shareholder.

These actions are treated as corporate reorganizations for tax purposes in the same way as a share for share exchange. If they do not qualify as a tax-free reorganization, certain assets such as fixed assets, lands, securities etc. owned by a subsidiary are revalued to fair value.

If they qualify as a tax-free reorganization, assets owned by the subsidiary are not revalued to fair value. Further, if the subsidiary joins a tax consolidation group, its tax losses incurred before joining the group are carried forward in the consolidated tax return and can be offset against the individual income of the subsidiary.

(3) Considerations delivered for merger and share for share exchange

In order for corporate reorganization to be tax-free, consideration delivered to shareholders of the companies involved in the corporate reorganization must be in the form of shares. In other words, no assets like cash can be delivered.

Exceptional rules for a merger and a share for share exchange are proposed. For a merger, if the merging company owns 2/3 or more of the outstanding shares of the merged company, consideration delivered to the other shareholders of the merged company is disregarded in determining whether the share-only condition is satisfied.

For a share for share exchange, if the parent company in a share for share exchange owns 2/3 or more of outstanding shares of the subsidiary in a share for share exchange, consideration delivered to the other shareholders of the merged company is disregarded in determining whether the share-only condition is satisfied.

(2) and (3) will be applicable to corporate reorganizations conducted in October 2017 or thereafter.

1.4 Restriction on preferential tax treatments for SME²

SMEs are entitled to some preferential tax treatments such as preferential tax rates, fewer restrictions on the availability of tax losses, entertainment expense deductions, investment credits, R&D credit etc.

In the proposal, preferential tax treatments for SMEs provided in Special Taxation Measures Law will not be applicable to an SME if its average taxable income over the past 3 years of being an SME exceeds JPY 1.5 billion.

1.5 Extension of corporation tax filing deadline

Currently, a corporation tax return must be filed within 2 months after the end of a business year and a 1 month extension is generally allowed if applied for and approved by the Tax office district director.

Where a company appoints an accounting auditor and an annual shareholder meeting is not convened within 3 months after the end of a business year due to provisions in its articles of incorporation, a tax office district director may allow a company to extend the corporation tax return filing due date for up to 4 months.

2. International tax

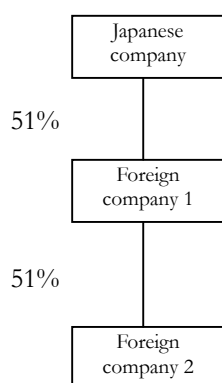
2.1 CFC rules

Reform of the CFC (Controlled Foreign Company) rules in accordance with BEPS Action 3 is proposed. It appears that the reform proposal takes the concerns expressed by business communities into account. Business communities have been concerned about taxpayer's compliance burdens due to complicated regimes. In the proposal, the CFC rules consist of three regimes, i.e. full inclusion of a CFC's income, partial inclusion of passive income and full inclusion of a specified CFC and the definition of CFC has been changed.

(1) Definition of a CFC

Currently, a CFC is a foreign company, more than 50% of which is owned by domestic companies, residents and non-residents who are specially related to the domestic companies or the resident.

(i) 50% ownership test



Under the current rule, the 50% ownership is determined by multiplying the ownership ratios at each stage for chains of ownership. Foreign company 2 is not CFC as the ownership by the Japanese company is 26.01% (51% x 51%). In the proposal, the chain of ownership is not multiplied at each stage. Foreign company 2 is CFC as each link is more than 50% and the ownership ratio by the Japanese company is 51%.

(ii) Substantial control

In the proposal, if residents or domestic companies have a relationship with a foreign company where the residents or domestic companies can request the foreign company to distribute nearly all residual properties to them, the foreign company is a CFC.

² There are a couple of definitions of SME depending on the preferential tax treatments applicable. Article 66 of the Corporation Tax Law defines SME as a corporation whose stated capital is JPY 100 million or less. Even where the stated capital is JPY 100 million or less, a corporation is not qualified as an SME if it is 100%-owned directly or indirectly by a corporation/corporations whose stated capital is JPY 500 million or more ("Large corporation").

(2) *Full inclusion of a CFC's income*

Where the effective tax rate of the CFC is lower than 20% and it fails to satisfy the economic activity test, eligible CFC income is included in 10%-or-more interest holding resident's or domestic company's taxable income in Japan.

Eligible CFC income is the CFC's income with adjustments for differences between local tax rules and Japanese tax rules and deductions of dividends from 25%/6 month subsidiaries, other CFCs, tax losses incurred in previous 7 years and corporate income tax paid or payable in a business year.

(i) *Economic activity tests*

Currently, the tests are called exclusion tests. In the proposal, they are called economic activity tests. The tests are as follows:

- **Principal business test**
The CFC's principal business is not holding shares or bonds, licensing industrial property rights, copyrights etc., leasing vessels or aircraft.
- **Substance test**
The CFC maintains offices, stores, factories or other fixed places of business necessary to conduct business in the jurisdiction where its head office is located.
- **Management and control test**
The CFC manages controls and operates its business on its own in the jurisdiction where its head office is located.
- **Business location test or unrelated party test**
- **Business location test**
The CFC conducts its principal business in the jurisdiction where its head office is located.
- **Unrelated party test**
More than 50% of the CFC's transactions are with unrelated parties.

The CFC must satisfy the first three tests regardless of the type of business it conducts. Additionally, if the CFC's business is wholesale, banking, trust business, financial instruments transactions, insurance, ocean transport or air transport it must satisfy the unrelated party test. If the CFC conducts other businesses, it must satisfy business location test.

There are some proposed changes to the economic activity tests.

- **Principal business test**
If the CFC conducts aircraft leasing and its officers and employees are engaged in all operations necessary to conduct aircraft leasing appropriately, the principal business test is satisfied.
- **Substance test/Management and control test**
If a CFC (an insurance assignor) conducts insurance business under a license in accordance with the regulations of the jurisdiction where its head office is located and the assignee in the license application satisfies the substance test or management and control test, the CFC will satisfy substance test or management and control test.
- **Business location test**
If a CFC is engaged actively in manufacturing activities through material operations in the jurisdiction where its head office is located, necessary reforms about the applicability of the test will be made³.
- **Unrelated party test**
- Where properties or services in transactions with unrelated parties are arranged in advance to be transferred to related parties, the transactions with unrelated parties are treated as transactions with related parties.
- Where a CFC conducting an insurance business is an insurance assignee, transactions with an insurance assignor are not treated as transactions with related parties.
- Where a CFC conducts aircraft leasing business, the unrelated party test is applied.

(ii) *Eligible CFC income*

When calculating CFC eligible income, dividends from companies of whom at least 25% has been owned for 6 months or more, are deducted from CFC eligible income. Where the CFC conducts business in extracting fossil fuels and has a place of extraction in a country with which Japan has a tax treaty, the 25% is reduced to 10%.

(iii) *Documentation for the economic activity test*

Where a domestic company fails to submit documents evidencing that economic activity tests are satisfied by the due date at request of tax auditors, it is presumed that economic activity tests are not satisfied.

³ There were a number of lawsuits about a contract manufacturing scheme where a Hong Kong subsidiary uses a China contract manufacturer. In this case, the Hong Kong was subject to CFC rule as manufacturing activities were not done in Hong Kong and the business location test was not satisfied. Under the proposed business location test, this company would not caught by the CFC rules.

(3) *Partial inclusion of passive income*

Where the effective tax rate of a CFC is lower than 20%, its passive income is included in the domestic taxpayer's taxable income. In the proposal, the scope of passive income is significantly enlarged.

(i) *Scope of passive income*

Under the current rules, passive income included partially is limited to dividends or gains from portfolio investments (less than 10%), interests, gains or redemption gains on bonds, royalties from intangible properties and consideration for leasing vessels or aircraft. In the proposal, the following items of income are passive income subject to partial inclusion:

Item of income	Exclusion
a. Interest income	Interest income is excluded from passive income where: ① officers or employees are engaged in operations ordinarily necessary for lending money appropriately in the jurisdiction where the company's head office is located, ② another CFC that is related to the CFC which satisfies ① lends money to the CFC satisfying ①, or ③ the CFC conducts a money lending business in compliance with the regulations of the jurisdiction where its head office is located and officers or employees are engaged in operations ordinarily necessary for a money lending business in the jurisdiction where its head office is located.
b. Dividends	Dividends from a company 25% or more of which is owned by the CFC for 6 months or more (10% for a CFC conducting fossil fuel extraction in a tax treaty partner country)
c. Consideration for lending securities	None
d. Gains/losses from transferring securities	Gains/losses from transferring securities in a company, 25% or more of which owned by the CFC are excluded.
e. Gains/losses from derivative transactions	Gains/losses from derivative transactions are excluded where: ① it is evident that they are from hedging transactions, ② the CFC conducts a commodity futures transaction business or similar business in compliance with the regulations of the jurisdiction where its head office is located and officers or employees are engaged in operations ordinarily necessary to conduct the commodity futures transaction business appropriately in the jurisdiction where its head office is located,.
f. Foreign exchange gains/losses	Foreign exchange gains/losses are excluded where ① They are from ordinary business conducted by the CFC. The purpose of business may not be to earn gains from foreign exchange fluctuations.
g. Income similar to a. to f. arising from properties producing these types of income	
h. Consideration for leasing tangible property	Consideration for leasing tangible property is excluded where: ① It is from leasing tangible properties which are used in the jurisdiction where the CFC's head office is located, or ② Officers or employees are engaged in operations ordinarily necessary for leasing tangible properties appropriately in the jurisdiction where its head office is located,
i. Royalties from licensing intangible properties	Royalties from intangible properties, which the CFC developed, acquired for a reasonable consideration, or was licensed and utilizes for business purposes.
j. Gains/losses from transferring intangible properties	Gain/losses from transferring intangible properties, which the CFC developed, acquired for a reasonable consideration, or was licensed and utilizes for business purposes.
k. Excess residual profit The total of items a. to i.- (total assets + accumulated depreciation + payroll costs) x 50%	

(ii) *Calculation of partial inclusion income*

Passive income subject to partial inclusion is the total of:

- ① $a+b+c+h+i+k$ and
- ② $d+e+f+g+j$ (0 where negative)

Where there are losses incurred in the previous 7 years beginning before the first day of the CFC's current business year for ②, the losses can be deducted when calculating ②.

(iii) *Special rules for a finance subsidiary*

A finance subsidiary is one which conducts banking, financial instrument transactions or insurance business in compliance with the regulations of the jurisdiction where its head office is located and officers or employees are engaged in operations ordinarily necessary for these businesses in the jurisdiction.

For a finance subsidiary, the larger of income generated from overcapitalization (not defined in the Proposal) or $h+i+j+k$ of (ii) above is subject to partial inclusion.

Where there are losses incurred in the previous 7 years beginning before the first day of the CFC's current business year for h , the losses can be deducted when calculating h .

(iv) *De minimis rule*

Where income subject to partial inclusion is JPY 20 million or less (currently JPY 10 million), the income is disregarded.

(4) *Full inclusion rule for a specified CFC*

This is the new regime included in the proposal. If a CFC falls under one of the following categories and its effective tax rate is less than 30%, CFC eligible income is subject to full inclusion.

- Paper company
A CFC, which does not satisfy both of the conditions below:
- The CFC has a fixed place of business to conduct its principal business (for a CFC conducting insurance business, situations equivalent to having a fixed place of business is sufficient),
- The CFC manages, controls and operates its business on its own in the jurisdiction where its head office is located (for a CFC conducting insurance business, situations equivalent to managing, controlling and operating business on its own is sufficient),
- Cash box company
A CFC of which $(\text{securities} + \text{loan receivables} + \text{intangible properties}) / \text{Total assets}$ is more than 50% and $(\text{total of a. to k. in (3)(i)}) / \text{Total assets}$ is more than 30%
- Black list company
A CFC whose head office is located in a jurisdiction which the Minister of Finance designates as one that is non-cooperative in the exchange of information on taxes.

(5) *Financial statements of a CFC*

Financial statements of a CFC must be attached to the tax returns of the domestic taxpayers if the effective tax rate of the CFC is less than 20% (30% if (4) is applicable).

(6) *Adjustment for double taxation*

Where Japan income taxes are levied on a CFC, the income taxes corresponding to the CFC income subject to inclusion are credited against the domestic taxpayer's corporate income taxes.

The reform is scheduled to apply from business years beginning on April 1, 2018 or thereafter.

2.2 *Distribution of a 100%-owned subsidiary's shares to foreign shareholders*

Where a 100%-owned subsidiary is a Japanese company, conditions for applying the share transfer equivalent to the business transfer rule⁴ will be proposed.

Where the 100%-owned subsidiary is a foreign company and only the foreign company's shares are distributed, exchange gains for old shares surrendered are recognized and taxed in Japan.

2.3 *Mutual agreement procedures*

It is proposed that necessary measures are taken for residents in treaty partner countries to apply for both mutual agreement and arbitration procedures to the Commissioner of National Tax Agency.

⁴ Under the current rules, if 25% or more of a Japanese company is owned by a foreign shareholder and special related persons at any time in a year when a transfer of shares takes place or in the 3 prior years from the end of a year when the transfer of shares takes place and the foreign shareholder and special related persons transfer 5% or more of a Japanese company, the foreign shareholder is subject to income tax in Japan for gains realized.

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