Baker & McKenzie

Client Alert

January 2014

2014 Tax Legislation Proposals

On December 12, 2013, the ruling Liberal Domestic Party, and its coalition partner in the government, the New Komeito Party, officially announced proposals for Japan's 2014 tax reform program. This Client Alert briefly summarizes certain key items proposed.

International Tax

- The latest tax reform program proposes a significant change with respect to the laws concerning permanent establishments ("PEs") in Japan. Under current domestic Japanese law, where the tax authorities deem that a PE of a foreign entity exists in Japan, all Japanese source income of this foreign entity must be recognized by the PE, regardless of whether the income is attributable to activities of the PE or not (the "entire income method").

  - ✧ Under the 2014 tax legislation proposal, only such income attributable to the Japan PE would be required to be declared by the PE in Japan (the "attributable income method"). The change from the "entire income method" to the "attributable income method" would take effect from fiscal years starting on or after April 1, 2016. Various ramifications can be expected from the change; for example, income from investments by a Japanese PE in a third country may now be subject to Japanese tax in the event the authorities find a PE of the foreign entity in Japan. In contrast, Japanese source income not attributable to aJapanese PE may not be subject to Japanese corporate tax together with the PE's taxable income in Japan (but will be subject to withholding tax, as a rule). Ramifications may vary depending on the situation, so if a PE is found an analysis will be necessary.

  - ✧ In determining the income attributable to a PE, the Japanese tax authorities have indicated they would follow the Authorized OECD Approach (the "AOA"), in line with the OECD Model Treaty announced in 2010.

- Currently, Japanese transfer pricing rules govern certain transactions with foreign related parties that take place through unrelated parties. The scope of transactions covered by these transfer pricing rules includes sales, transfers, leases, or provision of assets. Under the proposed 2014 Tax Legislation, the scope of transactions governed by the law would be broadened to include the provision of certain services to related parties through unrelated parties.

Corporate Tax

- Since 2012, a 10% special reconstruction corporate surtax has been added to the normal corporate income tax rate for the purpose of funding reconstruction efforts after the Great East Japan Earthquake and tsunami in 2011. The surtax was slated to be in effect for three years, starting from a company's first fiscal year beginning on or after April 1, 2012. Under the proposed tax reform, the tax will be abolished one year earlier than scheduled, thus reducing the effective corporate tax rate one year earlier than what was planned. It should be noted that corporate taxpayers with calendar year fiscal years will only be able to enjoy the benefit of the abolishment of the surtax from fiscal years commencing on January 1, 2015, a full nine months after the effective date of the change.

- With the purpose of transferring more tax revenue from the national level to the local level, national and local tax rates will be changed. However, this change will ultimately have very little impact on overall effective tax rates.

- Large corporate taxpayers, defined as corporations with paid-in capital of more than JPY 100 million, are currently prohibited from deducting entertainment expenses. Other corporations (*i.e.,* small and medium sized corporations) are prohibited from deducting entertainment expenses in excess of JPY 8 million. Under the proposal, large corporate taxpayers would be eligible to deduct 50% of their entertainment expenses related to meals. Internal entertainment expenses (*i.e.,* expenses relating to internal corporate functions, etc.) are excluded from this treatment. Small and medium sized corporation can elect to apply the 50% deduction limit or the JPY 8 million cap on deductions.

- Companies in National Strategic Economic Growth Areas, which may include not only a specific geographic region, but also a business sector or system, will be eligible for special depreciation allowances and tax credits for equipment they acquire, and for tax credits for R&D costs. Buildings erected in such zones should also be eligible for advantageous depreciation rules and reduced registration tax.

Individual Income Tax

- Currently, individuals who earn in excess of JPY 15 million per year are eligible for a maximum deduction of JPY 2.45 million from employment income. Under the proposal, from 2016 the cap would be changed to JPY 2.3 million for individuals who earn in excess of JPY 12 million, and from 2017 to JPY 2.2 million for individuals who earn in excess of JPY 10 million.

- Under currently existing rules applicable to holders of stock options, where the holder of a non-tax qualified stock option transfers the right to exercise the option back to the company prior to its exercise, the transferor can treat the difference between the market price and exercise price as capital gain, which is subject to separate taxation at a flat rate (currently 20.315%).

  - New rules have been proposed to apply to transfers of non-tax qualified stock options conducted on or after April 1, 2014, in order to thwart this "tax rate arbitration" behavior. Under the proposed rules, holders of such stock options would no longer be eligible for capital gain treatment on transfers of the options back to the company prior to exercise. Rather, where an individual transfers a non-tax qualified stock option to the issuing company prior to the option's exercise, he or she would be required to treat the difference between the market price and exercise price as salary income, business income, retirement allowance, temporary income or miscellaneous income, depending on the specific circumstances. Such income would thus be taxed at regular progressive rates. The top individual income tax bracket, including local tax, is currently 50.84% and is slated to be increased to 55.945% from 2015. Please note that the applicable rules apply where the non-tax qualified options are with respect to the shares of a Japanese company or a foreign parent.

Consumption Tax

- Japan's consumption tax rate will increase from 5%, which is the current flat rate, to a flat 8% from April 1, 2014. The rate is tentatively slated to further increase from 8% to 10% effective from October 1, 2015. The ruling coalition has indicated that it will finalize the decision regarding whether to implement the increase from 8% to 10% by the end of 2014. Further, the 2014 tax reform proposes the introduction of a reduced consumption tax rate system applicable to food and other consumables to be introduced with the overall increase in the rate to 10%. It is not clear at this time whether the special reduced rates would be implemented concurrently with the overall rate increase to 10% or at a later time.

- Currently a taxpayer with taxable sales of JPY 200 million or lower in its base period (*i.e.* two years prior to the current taxable year) is eligible to make use of a simplified consumption tax system. Under the system, input consumption tax to be deducted from output consumption tax in the calculation of final consumption tax liability is calculated based on deemed input tax credit rates, which vary depending on the industry. Under the 2014 reform program, the deemed input tax credit rate for companies in the financial, insurance, and real estate industries would be lowered, so that the final consumption tax liability for companies in these industries would generally be greater than would be the case under current law.

- The 2014 tax reform program notes that consumption tax on cross border services will be taken up in the 2015 tax reform program.

Tax Litigation

- Currently, in order to bring a tax matter before Japan's National Tax Tribunal, a taxpayer must first file a formal objection to the tax imposed at the local tax office or the regional taxation bureau, except in certain cases. In the 2014 tax reform program, it is proposed that a taxpayer be permitted to file a request for reconsideration directly with the National Tax Tribunal, without first having to file an objection with the local tax office or the regional tax bureau.

- Under currently effective laws, a taxpayer must file an objection to a tax assessment within two months after the authorities issue it. Under the 2014 tax reform program, it is proposed that this period be extended to three months. Where a taxpayer submits a request for reconsideration to the National Tax Tribunal, without first making an objection at the local tax office or regional tax bureau, the filing deadline would be three months from the issuance of the assessment as well.

Additional Tax Proposals Designed to Stimulate Business Investments Announced on October 1, 2013

In addition to the proposed tax reforms issued by the ruling coalition in December 2013, as described above, the ruling coalition announced on October 1, 2013 several additional tax reforms with the goal of "stimulating business investment" by the private sector. The additional proposals are to be submitted to Japan's Diet together with the 2014 Tax Legislation Proposals described above, with the goal of being passed by the end of March 2014. The October 2013 proposals include the following.

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- Introduction of tax incentives to promote capital expenditures on productivity-enhancing equipment.
- Enhancement and extension to promote capital expenditures by small and middle sized corporations
- Enhancement and extension of R&D credits.
- Introduction of tax incentives to promote venture capital investments.
- Introductions of tax incentives to promote corporate reorganizations.
- Enhancement and extension of tax incentives for companies to increase employee wages.

If you have any questions or would like to discuss, please do not hesitate to contact us.