Tax and Transfer Pricing
Tokyo

BAKER & McKENZIE

Client Alert

May 2012

Japan – 2012 Tax Update

Introduction

This client alert discusses the recent Japanese tax reforms, which were passed by Japan's Diet on March 31, 2012. The alert also provides an overview of significant tax developments in 2011 and discusses important developments in Japan’s tax treaty network.

Of particular note are the following:

- New Earnings Stripping Rules. Where a Japanese company's interest payments to related parties exceeds 50% of that company’s adjusted taxable income, a deduction for amounts in excess of 50% is disallowed for tax purposes.

- Requirement that Residents Declare High-Value Overseas Assets. Residents of Japan holding significant overseas assets are required to declare information regarding such assets to the Japanese authorities.

- Requirement that Foreign Subsidiaries Report the Exercise of Options or Receipt of Other Stock-Based Income. Japanese subsidiaries of overseas companies are required to file a report with the tax authorities where Japan-based directors or employees have exercised stock options, or received other income or benefits relating to company stock prices, in the previous year.

- Reduction in Effective Corporate Tax Rate. Japan's corporate tax rate, one of the highest in the world, was cut in a revision to take effect in 2012. Even though the reduction has been offset by an additional tax to fund reconstruction in Tohoku, the effective corporate rate has been reduced from about 41% to about 38%.

Among other Japan treaty developments, the following important bilateral tax treaties have come into force:

- Netherlands – New treaty came into force on December 8, 2011.

- Switzerland – Protocol amending tax treaty came into force on December 30, 2011.

- Hong Kong – New treaty came into force on August 14, 2011.

Other tax changes, and other recent treaty developments, are discussed in more detail below.

Tax Legislation Passed in 2012

The earthquake that hit the eastern coast of Japan in March 2011 forced the government to sideline some of the tax legislation many commentators had otherwise expected for the previous year in favor of measures designed to meet challenges presented by the disaster. The tax reforms described below were enacted by the Diet in 2012.

Certain interim tax measures, and laws relating to the disaster in the Tohoku region, were passed in 2011; these are discussed in more detail in the next section of this Alert.

International Tax

(a) New Earnings Stripping Rules

Japan's most recent round of tax reforms includes measures to restrict certain interest deductions, with effect from fiscal years starting on or after April 1, 2013. Specifically, any amounts in excess of 50% of a company's adjusted taxable income will be disallowed for tax purposes. "Adjusted taxable income" means the aggregate of taxable income, net interest payments to related persons, depreciation, tax exempt dividends and extraordinary profits or losses in a fiscal year.

If a company's net interest payments to related persons (i.e., interest payments to related persons less interest income relating to interest payments received from related persons) does not exceed 50% of adjusted taxable income, interest incurred in the previous seven years and disallowed in such previous years under the dividend stripping rules will be deductible in the current fiscal year, but limited to the difference between net interest payments to related persons and 50% of adjusted taxable income in that year. For this purpose, an "interest payment to a related person" does not include interest payments under a repo transaction, or interest payments that are subject to Japanese tax in the hands of the recipient.

De minimis rules under the proposed legislation provide that the earnings stripping rules will not apply to a company in a fiscal year where:

(i) net interest payments to related persons in a given fiscal year are equal to or less than JPY10 million; or

(ii) interest payments to related persons in a fiscal year do not exceed 50% of the company's total interest payments. ("Total interest payments" do not include interest payments to a related person if the interest is subject to Japanese corporation tax in the hands of the related person.)

With respect to tax consolidated groups, the earnings stripping rules will be applied on a group basis. Accordingly, disallowed interest will be calculated on the group total of interest payments to related persons outside of the group less group total interest income less 50% of the group's adjusted taxable income. The same *de minimus* thresholds noted at (i) and (ii) above also apply to the tax consolidated group on a group basis.

Guidance is provided in the rules to allow for cases where the new rules and the thin capitalization rules or the anti-tax haven rules conflict. Similarly, treatment of companies involved in tax-qualified mergers is also contemplated.

The practical effect of the new earnings stripping rules is likely to be most severely felt by Japanese operations of foreign companies that are financed by offshore group companies. Restructuring of financing arrangements should be contemplated by entities likely to be impacted by this new law.

(b) Changes to Anti-Tax Haven Rules

Legislation has been passed to prevent double taxation of aggregated income under the anti-tax haven rules in certain cases. Specifically, where a Japanese company ("JC") receives dividends from a first-tier foreign subsidiary ("FTS") consisting of income distributed by a second-tier foreign subsidiary ("STS") already aggregated into the JC's income, a portion of the dividends received by the FTS is exempt. Very generally, the exempt amount is called the "indirect specified tax amount", and is the smaller of:

(i) dividends received by the FTS from the STS within the previous three years, multiplied by the JC's direct holding ratio in the FTS; and

(ii) the STS's income which has been aggregated with the JC's income in the previous three years, multiplied by the JC's indirect holding ratio in the STS.

Individual Income Tax

(a) Employment Income

The newly passed 2012 tax legislation includes income tax measures originally proposed for 2011 tax legislation but postponed. The new laws will come into effect with respect to income tax earned after January 1, 2013 (with respect to inhabitant's tax, income earned after January 1, 2014) and include:

(i) a cap on the employment income deduction of JPY2.45 million for individuals who earn in excess of JPY15 million per year, with the result that their taxable income will increase by 5% of gross remuneration above JPY15 million; and

(ii) a new reduced cap will apply to deduction of employment-related expenses (e.g., training and qualification-related expenses).

(b) Directors' Retirement Income

Retirement income of company directors is currently calculated as 50% of the net amount of gross retirement allowances less the retirement income deduction. Under the 2012 legislation, the 50% deduction will not apply to directors with five years or less of service. This change will apply to retirement allowances arising from a retirement in 2013 or later.

(c) Reporting of Foreign Company Stock Options

To rectify the frequent incorrect reporting of stock options, the 2012 tax legislation includes provisions to clarify:

(i) the persons subject to reporting of foreign stock options or stock price-based compensation;

(ii) what is to be reported; and

(iii) the date for submission of such report.

To summarize the rules, where employees or directors residing in Japan of either

(i) a Japanese company owned 50% or more by an offshore company; or

(ii) the Japanese branch of an offshore company,

exercise stock options, or receive income or benefits relating to the value of such shares, the Japanese company or branch must file a report with the Japanese tax office.

While not explicit in the text of the current law, it would appear that the reporting requirements would apply to any benefits tied to the value of the parent's stock, including RSUs, SARs, etc.

The new reporting requirements apply to income from stock options exercised in 2012 and stock price-based compensation paid in 2012, with the first reports submitted on or after January 1, 2013.

(d) New Requirement to Declare Overseas Assets

A new measure in the tax legislation for 2012 is the requirement to declare assets held overseas by certain residents of Japan. Specifically, a Japanese resident[1] who owns assets worth more than JPY50 million located outside Japan ("Overseas Assets ") as at December 31 of the current year must declare the type, value, and number of such assets by March 15 of the year following.

The logic behind this new declaration rule is to minimize avoidance of income and inheritance taxes that would otherwise be payable in Japan. The new asset declaration rules also come with specific penalty provisions to encourage compliance. Specifically, where Overseas Assets were properly declared, but income relating to such assets was underdeclared in Japan, 5% will be deducted from the normally applicable penalty tax. If the Overseas Assets were not properly declared, and income relating to such assets was underdeclared in Japan, an additional 5% will be added to the normally applicable penalty tax.

Corporate Tax

(a) R&D Tax Credits

Changes to the R&D tax credit regime are as follows. Taxpayers will be able to take advantage of (i), and **EITHER** (ii) or (iii), below:

(i) Tax credits on total R&D expenses

As a general rule, the maximum tax credit available for R&D expenses is 20% of the corporation tax liability. As a temporary measure, the maximum tax credit was increased to 30% of corporation tax liability for tax years commencing before April 1, 2012. This temporary measure has not been extended, so the maximum

[1] Defined as an individual domiciled in Japan, or who has resided in Japan for a continuous period of one or more years.

credit will revert to 20% of corporation tax liability for tax years commencing on or after April 1, 2012.

(ii) Tax credits on incremental R&D expenses

A tax credit on incremental R&D expenses was introduced as a temporary measure for tax years commencing before April 1, 2012. The maximum amount of the credit allowed was 10% of the entity's corporation tax liability. This temporary measure has been extended to tax years beginning prior to April 1, 2014.

(iii) Tax credits on R&D expenses in excess of 10% of average sales

A tax credit on R&D expenses exceeded 10% of average sales was introduced as a temporary measure for tax years commencing before April 1, 2012. The maximum amount of the credit allowed was 10% of the entity's corporation tax liability. This temporary measure has been extended to tax years beginning prior to April 1, 2014.

Tax Legislation Passed in 2011

As discussed above, certain interim measures and laws relating to the disaster in the Tohoku region were passed in 2011. We discuss below.

Individual Income Tax

Special Reconstruction Income Tax (2.1%)

In light of the disaster in Tohoku, a Special Reconstruction Income Tax applicable to individuals was passed in November, 2011.

Under the new rule, permanent residents of Japan will be subject to a 2.1% surtax, imposed on applicable tax. Thus, for example, if an individual had been subject to tax at 20%, he or she will now be subject to tax an additional tax of 0.42% after application of the surtax going forward. Non-permanent residents will be subject to the tax with respect to Japan-source income and foreign-source income paid or remitted into Japan. Non-residents will be subject to the tax on any Japan-source income. The tax will apply from 2013 until 2037.

Corporate Tax

(a) Reduction in Corporate Tax Rates

Under legislation passed in November 2011, corporate tax rates were reduced, although the effect of the reductions is offset by the imposition of an additional 10% "reconstruction" corporate tax slated to apply to fiscal years beginning in the period commencing April 1, 2012 to March 31, 2015.

Under the new legislation, the base tax rates of companies (other than small- and medium-sized companies, ("SMEs") as defined below), have been reduced from 30% to 25.5% for fiscal years beginning on or after April 1, 2012. Such companies, however, are subject to a Special Reconstruction Corporate Tax of 10% which, as applied, increases the tax rate to 28.05% (25.5% + (25.5% * 10%)). This Special Reconstruction Corporate Tax applies to fiscal years beginning between April 1, 2012 and March 31, 2015.

SMEs are those companies with paid-in capital of JPY100 million or less as of the end of the fiscal year, except for companies owned directly or indirectly by a "large-sized company" (with paid-in capital of JPY500 million or more), or by two or more such large-sized companies, in a corporate group.

SMEs see their base rates drop from 22% to 19% on taxable income up to JPY8 million per year (or from 18% to 15%, under certain currently applicable rate reductions), and from 30% to 25.5% with regard to income in excess of JPY8 million. With the addition of the Special Reconstruction Corporate Tax, the effective tax rates for SMEs are 16.5% on income up to JPY8 million, and 28.05% on income exceeding JPY8 million.

The effective rates for a company (other than an SME) based in Tokyo, taking into account corporate tax, as described above, and business tax (*jigyouzei*), inhabitant's tax (*houjin touminzei*), and special local corporate tax (*chihou houjin tokubetsuzei*), becomes **38.01%** during the period that the Special Reconstruction Corporate Tax applies. Assuming the Special Reconstruction Corporate Tax is not extended beyond the current applicable period, and that there are no further changes to the base tax rate in the next three years, the effective rate for a company will be **35.64%** for fiscal years beginning on or after April 1, 2015.

(b) Special Reconstruction Income Tax (2.1%)

In addition to the Special Reconstruction Corporate Tax discussed above, a 2.1% surtax is applicable to income on dividends, royalties, interest, and the like. With regard to non-Japanese companies, the tax applies to Japan-sourced income, including dividends, interest, etc., but where a lower rate applies due to an applicable treaty, the treaty rate (without regard to the Special Reconstruction Income Tax) will apply.

(c) Interest, Changes to Net Operating Loss ("NOL") Carry Forward Rules

Previously, a corporation was eligible to carry forward NOLs for a period of up to seven years, and apply the NOL to shelter 100% of the corporate income.

Under a revision to the tax law enacted in November 2011, a company (other than an SME, a qualifying TMK or the like) may carry forward NOLs for up to **nine years**, but may only apply such NOLs to shelter up to **80%** of the company's income in a given year. The change regarding the cap of 80% will apply to the company's fiscal years beginning April 1, 2012, and the increase in the length of time a company can carry forward NOLs from seven to nine years will apply to NOLs incurred in fiscal years ending on or after April 1, 2008. The change in law does not affect an SME, a qualifying TMK or the like, which still must follow the law as previously in effect.

In connection with the above, companies are required to maintain account-related documents for any fiscal year in which a NOL was incurred, in order to apply the carry forward rules. Further, the statute of limitations for tax authorities to make an adjustment with regard to NOLs is extended to nine years, from the previous seven. Finally, a company may file a Request for Correction for tax losses for nine years, rather than for one year, as was the case prior to the tax revision.

(d) Foreign Tax Credits

Under current rules, where a foreign corporation is assessed at a tax rate in excess of 50%, the tax in excess of 50% is not recognized as a foreign tax for purposes of the FTC rules and thus not creditable in Japan. This threshold is reduced to 35% under this revision. This will take effect for a company's fiscal years commencing on or after April 1, 2012.

The formula for calculating creditable foreign-source income has been amended as well. The limit was formerly calculated as:

[total foreign-source income – non-taxed foreign-source income * 2/3]

Under an interim measure effective for a two-year period, the applicable formula for the limit is changed to 5/6, or

[total foreign-source income – non-taxed foreign-source income * 5/6]

After this two-year period, under the revision, the limit is amended to:

[total foreign-source income – total non-taxed foreign-source income]

(e) Extension of Period For Which Taxpayer Eligible to Apply for Request for Correction

Previously, a taxpayer could only apply to file an amended return with respect to the previous closed year if the taxpayer had overpaid the amount of taxes owed in that year. Under new regulations, a taxpayer is permitted to apply for a correction of a previous return for corporation tax, gift tax, or other purposes, going back the following number of years:

- corporation tax (NOL issues) – nine years
- corporation tax (TP issues) – six years
- corporation tax (Other issues) – five years
- gift tax – six years
- returns other than the above – five years

The period with respect to which the tax authorities can make an assessment to increase previous income will also be increased, however, to six years (for TP issues) and five years (for other issues). The period during which the authorities are eligible to make an assessment in cases of fraud remains the same as it was previously (seven years). This change is effective with respect to tax returns due on December 2, 2011 and after.

(f) Requirement that Examiners Provide Notice to Taxpayers

Under previous law, tax agents were not required to inform taxpayers that an audit was being conducted, nor were they strictly required to provide taxpayers with an explanation of any additional tax assessed as a result of the audit.

Under revisions to the law, tax agents are required **"in principle"** to inform taxpayers that an audit is being conducted, and to provide taxpayers with a written summary of their findings as a result of the audit.

This amendment will take effect with respect to audits commencing on or after January 1, 2013.

(g) Other Revisions to Tax Rules

(i) Changes to Depreciation Rates

Under the reducing-balance method of depreciation, applicable assets could be depreciated through the straight-line method at:

1/(useful life) * 250%

The new law changes the rate from 250% to 200%, as well as introduces certain other changes.

(ii) Tax Rules Allowing Deductions for Bad Debt Reserves to be Eliminated

The circumstances under which a company may take a deduction for a bad-debt reserve is reduced or eliminated. SMEs, banks and insurance companies may make use of the rules with respect to monetary bad-debts, and other companies holding monetary receivables may make use of the rules for finance lease receivables. In other cases, the rules, which allowed a corporation to take a deduction presently for anticipated bad-debt, will be phased out over three years (i.e., from April 1, 2012 – March 31, 2015). Companies will, as a general matter, still be permitted to take a deduction for bad-debt that is actually realized.

(iii) Changes to Rules Governing Deductibility of Donations

Rules relating to deductibility of donations have been changed, with the ability to take a deduction depending on the category of the recipient of the donation. To summarize, the limit on deductibility on donations to organizations registered as specified public-service promotion corporations was increased, whereas the limit on deductibility of amounts other than to such organizations was decreased.

(h) Special Measures to Support Tohoku Region

In light of the earthquake and tsunami in the Tohoku region, the government has passed tax legislation designed to support the region. On December 7, 2011 the Diet passed the *Special Reconstruction Zone Act* ("SRZA") to introduce certain legal and tax measures aimed at facilitating the reconstruction of areas affected by the March 2011 earthquake.

The SZRA includes the following four tax measures which will be extended to eligible residents of Tohoku:

(i) deferral of recognition of income from reinvestment reserves for five years;

(ii) tax credit of 10% on wages paid to people affected by the earthquake;

(iii) special depreciation and tax credits on business assets; and

(iv) special depreciation for R&D assets.

Treaty Developments

Japanese authorities were actively engaged in 2011 in the rejuvenation of Japan's treaties, and the development of new treaty relationships. The following table summarizes developments in Japan's current and proposed treaty network in 2011.

Country	Treaty Developments in 2011
Bahamas	Necessary notifications completed to give effect to previously signed Exchange of Tax Information convention (entered into force on August 25, 2011)
Cayman Islands*	Necessary notifications completed to give effect to previously signed Tax Information Exchange Agreement (entered into force on November 13, 2011)
G20	Japan signs the Convention on Mutual Administrative Assistance on Tax Matters (and Protocol)
Germany	Negotiation commenced of revision of tax treaty
Guernsey	New Tax Information Exchange Agreement signed
Hong Kong	New tax treaty signed in 2010 (entered into force on August 14, 2011)[2]
Isle of Man	Necessary notifications completed to give effect to previously signed Tax Information Exchange Agreement (entered into force August 2, 2011)
Jersey	New Tax Information Exchange Agreement signed
Luxembourg	Protocol to amend tax treaty entered into force on December 30, 2011
Netherlands	New treaty entered into force on December 8, 2011
Portugal	Agreement in principle reached on the first tax treaty between Japan and Portugal on December 19, 2011
Saudi Arabia	New tax treaty entered into force on September 1, 2011
Sultanate of Oman	Basic agreement reached on tax treaty
Switzerland	Protocol to amend tax treaty entered into force on December 30, 2011
USA	Commencement of negotiations to amend part of treaty

[2] See http://www.bakermckenzie.com/RRJapanHongKongAgreeTaxTreaty/ for details.

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