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Japan's 2018 Tax Reform Proposal

On December 14, 2017, the Japanese government issued the 2018 tax reform proposal ("Proposal"). It is expected that a tax reform bill incorporating the Proposal will be submitted at the next ordinary session of the Diet, scheduled to take place some time in late January, and passed in late March 2018.

In this alert we briefly touch on certain proposed changes that may be of interest to multinational companies with operations or interests in Japan. We will follow later with a more detailed discussion of these and other proposed changes set out in the Proposal, and the possible impact of such changes to taxpayers.

Important Proposed Changes for 2018 Include the following.

1. Revisions to Japanese Domestic Permanent Establishment ("PE") Rules

Under the proposal, the definition of a PE under Japanese domestic rules would be amended along the lines of language in BEPS Action Item 7, the OECD Model Convention and the Multilateral Convention To Implement Tax Treaty-Related Measures To Prevent Base Erosion And Profit Shifting ("MLI"). These provisions will take effect for income tax for 2019 (starting on January 1, 2019) and onward, with respect to corporate income tax for fiscal years beginning on January 1, 2019 and onward.

(A) Adoption of Provisions to Prevent Artificial Avoidance of PE

A person who engages in activities "relating to" the conclusion of a contract regarding the transfer of the ownership of the assets of a foreign company has been added to the scope of "agent PE". This provision appears to expand the scope of agent type PE to cover a person who is not necessarily a *bona fide* agent (e.g., a contract concluding agent) and, in a practical sense, appears to be aimed at capturing so-called "commissionaires", the use of which has been identified as a serious problem in the BEPS discussions.

In addition to the above, a person who works mostly or exclusively for one or two "closely related" (defined as having a greater than 50% relationship) principals will be excluded from the scope of the "independent agent" exception.

Activities such as storage, display, and delivery are currently excluded from the scope of a fixed place PE in Japan. Under the tax proposal, where such activities go beyond the nature of preparatory and auxiliary with respect to a foreign company carrying out its business activities in Japan, such activities will constitute a PE in Japan of that foreign business. This revision appears to be targeting taxpayers that perform significant functions in Japan through the use of a warehouse.

Finally, in the case of a construction site PE, where a taxpayer seeks to avoid creating a PE by splitting up a single contract into multiple shorter contracts, the tax authorities will consider whether there is a PE by adding together the shorter contracts. This is clearly in line with the MLI, which contains a similar provision.

(B) Treatment Where Domestic Definition of PE Differs from that Under Treaty

Domestic law clarifies that where a PE rule under domestic law differs from that of a treaty applicable to a taxpayer, the PE provision under the applicable treaty will apply to that taxpayer in Japan. This is the so-called "treaty override doctrine", which has traditionally been applied for Japanese tax purposes by virtue of the operation of Article 98(2) of the Constitution of Japan. Thus, it just means to confirm or clarify the traditional policy taken by the Japanese tax authorities for the prioritization rule between the domestic tax law and applicable tax treaty. The inclusion of this provision may also be aimed at clarifying the relevant PE standards for taxpayers in Japan, in light of the fact that some of Japan's bilateral tax treaties will be covered by the MLI, and may incorporate the MLI's PE standards, while other tax treaties (including the US-Japan tax treaty), will either not be covered by the MLI, or even if they are covered, will not incorporate the MLI's PE standards. Thus, taxpayers may be subject to either domestic PE rules, to a treaty's PE rules, or a treaty's PE rules plus the relevant MLI PE provisions.

(C) Impact of Changes

This change may be considered important for foreign multinationals operating in Japan. As a result of this tax legislation, it may be necessary for a taxpayer to consider changing its business model in Japan, especially if it operates in Japan through a commissionaire-type structure. In such a case, not only a PE analysis, but a TP analysis may be recommended in order to recognize an appropriate and reasonable level of income in Japan. In addition, simultaneously, it may also be necessary to perform an analysis of whether treaty benefits are available under a relevant treaty in the context of the so-called "Principal Purpose Test ("PPT") under the MLI, especially if there are multiple intermediaries located in countries other than where the ultimate parent company is located.

2. Special Rules Allowing Tax Qualified Share Transfers

A new provision would allow a buyer to obtain the shares of a target in exchange for buyer's own shares, while allowing target's parent to be able to defer gain on the transfer until a subsequent recognition event. This is a temporary measure, to be in effect for around a three-year period, beginning from the date that the Industrial Competitiveness Enhancement Act ("ICEI") becomes effective, until March 31, 2021. Where a buyer wishes to make use of the provision, it is first necessary for the buyer in the proposed transaction to obtain certification from Japan's Ministry of Economics, Trade and Industry ("METI") that the proposed transaction qualifies as a "Special Restructuring Plan ("SRP")" under the ICEA. Basically, after obtaining certification, buyer ("B") can issue its own shares to target's parent ("P"), in exchange for shares in target ("T"). After this transfer, P will be a shareholder in B, which will own T. In this case, P can obtain a transferred basis in the shares of B that it received (in exchange for the shares of P's subsidiary T), and P can defer recognition of income (or of any loss) on the transaction until a subsequent recognition event (such as P's subsequent transfer of the shares in B).

At this stage, the impact of this new proposed legislation is uncertain. Subject to confirmation of the details of the new rule, which should be available after the tax legislation is enacted in 2018, it appears that, while it will depend on the timeline for the process, the necessity of obtaining certification from METI (*i.e.,* qualification as a "SRP") in advance, in order to determine the tax consequence of the M&A deal, may be problematic. This would especially be the case for M&A deals between unrelated parties, which normally proceed on a strictly confidential basis. Thus, it appears that the benefits from this tax legislation may be limited to friendly M&A deals or group reorganizations.

3. Changes to Inheritance Tax Rules Affecting Long-Term Foreign Nationals who Leave Japan

Last year, Japanese inheritance tax rules were amended such that, where a foreign national had lived in Japan for 10 years (in the aggregate) out of the last 15, died outside of Japan, the foreigner national's heirs would be subject to Japanese inheritance tax on such foreign national's assets located both in Japan and elsewhere (a similar rule also applies for gift tax purposes).

The above rule resulted in a situation where the heirs of a foreign national who had left Japan would potentially be subject to Japanese inheritance tax on the foreign national's worldwide assets for up to five years after such foreign national had left Japan. The fact that Japanese inheritance tax could "follow" a foreign national for up to five years after such person had left Japan caused great concern among Japan's expatriate community, and threatened to derail the Japanese government's efforts at attracting successful foreign talent to live and work in Japan.

In this year's tax reform, the Japanese government indicates that it will abolish the above rule applying to foreign nationals[1], subject to a certain anti-avoidance countermeasures in the context of gift tax. This change will be available for inheritance taxable events on or after April 1, 2018. This change to the inheritance tax provisions should aid Japan in its efforts to show Japan to be an attractive location for successful foreign executives to reside long-term.

4. New Tax Deductions Available to Corporations

The government has proposed introducing new tax incentives to encourage Japanese companies to pay higher wages, provide increased training and development opportunities for employees, and to invest in facilities.

[1] Although the heirs of a foreign national who had resided in Japan long-term would no longer be subject to inheritance tax with respect to non-Japan *situs* assets after the non-resident leaves Japan under the 2018 tax proposal, the proposal does *not* contemplate eliminating gift or inheritance tax in those circumstances with respect to Japan-*situs* assets.

A. Special Tax Incentives for Increasing Employees' Wages

A special incentive program will be instituted under which, where a large-sized corporation[2] that files a "blue return",[3] both increases employee wages and makes investments in facilities, such company may receive a special tax credit amounting to 15% of the increased amount of the employee wages.

The first step in determining whether the credit is available is to consider employees' salaries. The company must look at the average of employee salaries in the current year versus that of the previous year. Essentially, this is calculated by adding together all employee's salary amounts for the current year, and dividing the total by the number of employees, thus resulting in a single, average employee salary amount. This average employee salary amount is compared with that of the previous year (which is calculated in the same way). Where the average salary amount in the current year has increased by at least 3% over that of the previous year, this salary increase prong of the test is satisfied.

Next, to receive the credit, the company must satisfy the facility investment prong of the test. Where the amount that the company invested in domestic facilities in the current year is more than 90% of the total depreciation costs that the company recorded in that year, this prong of the test is satisfied.

Where both the salary increase prong, and the facility investment prong are satisfied, the company is eligible for the special tax credit, which is equal to 15% of the amount of the increase in average employee wages in the current year over the last.

The above described 15% credit may be increased to 20% where a large-sized company satisfies a third prong; specifically, where the company spends more on employee education and training in the current year than the last. Specifically, where the amount that a company spends for employee education and training in one year increases by 20% or more over that of the previous year, this prong is satisfied. A company satisfying all three prongs (employee salary increase, investment in facilities, and employee training) may obtain a special tax credit equal to 20% of the amount of the increase in average employee wages in the current year over the last.

Finally, a small- or medium-sized corporation that satisfies certain conditions is eligible for a maximum credit of up to 25% of the amount of the increase in average employee wages in the current year over the last. Specifically, a small or medium company that increase average employee wages by 1.5% over the average from the previous year is eligible for a tax credit equal to 15% of the increased salary amount. A company that increases average employee wages by 1.5%, AND

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[2] A large-sized corporation is one with paid-in capital of JPY 100 million or more.

[3] Japanese companies may apply for "blue return" tax filing status (as opposed to the standard "white return" tax filing status). Blue return tax filing status accords the filer certain advantages, such as the ability to carry forward NOLs and a one month extension to file annual returns.

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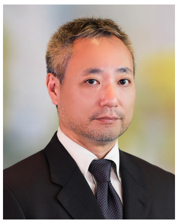
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increases the amount spent on training on employee development by 10% over the previous year is eligible for a credit of 25% of the increase in the average employee salary amount from the previous year.

These incentives will be available for a three-year period for tax years beginning on or after April 1, 2018.

At this stage, the impact of such new legislation is uncertain. In contrast to corporate tax cuts that were implemented in past years, which were not necessarily beneficial to salaried workers, the proposed legislation requires corporations (employers) to give a direct benefits (increase in wages) to their employees; it is expected that due to the increase in wages, this temporary incentive will contribute to Japan's economic expansion, including with respect to the domestic consumer market. Critically, this corporate incentive may also be characterized as a temporary "buffer" with respect to the individual income tax increase mentioned in 5 below.

B. Special Tax Incentives for Investments in Information Technology

Where a "blue return" taxpayer company implements certain changes to increase productivity by making investments in data connectivity or development, if conditions are satisfied, the company is eligible for special depreciation with respect to 30% of the acquisition cost, or a special tax credit of 5% of the cost, at the choice of the taxpayer.

This is a three-year temporary provision.

C. Additional Reverse-Incentive (Where Employee Wages are Not Increased)

To facilitate the incentives in A and B above, where large-sized corporations have *neither* increased employee wages nor made investments in new facilities (as judged by comparing the amount invested in new facilities with the amount of depreciation costs the company took), such companies will be barred from taking advantage of special tax deductions in connection with increased productivity, such as R&D tax incentives, for which they would otherwise have been eligible.

This is a three-year temporary provision.

D. Tax Incentive for Small- and Medium-Sized Companies to Invest in Facilities

Where small- and medium-sized corporations make certain investments in facilities, they can enjoy a 50 to 100% reduction in applicable fixed asset tax.

This, as well, is a three-year temporary provision.

5. Changes to Individual Income Tax Amounts

The tax reform package contains proposed changes to two standard deductions taken by persons in Japan who receive salary remuneration;

specifically, changes are proposed to the "salary income deduction", and the "basic deduction".

A. Salary Income Deduction

Persons who receive salary income (salaried workers) in Japan are entitled to a standard salary income deduction based on a statutory formula. Under the 2018 proposal, the standard deduction applicable to individual salary income will be reduced across the board by JPY 100,000 (about USD 875) for all tax brackets. The standard deduction cap under current law is JPY 2.2 million, which applies to persons with yearly salary income of JPY 10 million or more. Under the 2018 proposal, the deduction cap will be reduced from JPY 2.2 million to JPY 1.95 million, which will apply to persons with salary of JPY 8.5 million or more.

B. Basic Deduction

In addition to the salary income deduction, all income earners in Japan, regardless of income amount, are entitled to a basic income deduction of JPY 380,000. This basic deduction will be increased by JPY 100,000. (This increase to the basic deduction should thus set off the JPY 100,000 decrease to the salary income deduction described above, for persons with a yearly salary of JPY 8.5 million or less.) Individuals with total income of over JPY 25 million or more, however, will no longer be eligible for the basic deduction at all.

Note that there are exceptions to the above in certain cases to households receiving nursing care, raising children, etc. The above two provisions will come into effect in 2020.

6. New Foreign Tourist Tax

Finally, Japan will institute a new "travel to a foreign country" tax of JPY 1,000, applicable each time a person leaves Japan. (This is payable by Japanese nationals or non-nationals, regardless of whether the trip is temporary or not.)

This is certain to raise revenues in light of Tokyo hosting the Olympics in 2020.

Please also note that there are other proposed tax revisions in the Proposal that may be of particular interest to Japan-headquartered multinationals, including changes to Japan's CFC rules. We will discuss these and other tax changes in a separate tax alert.

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