Client Alert

January 2015

2015 Tax Legislation Proposals

On December 30, 2014, the ruling Liberal Democratic Party, and its coalition partner in the government, Komeito, officially announced proposals for Japan's 2015 tax reform program. This Client Alert briefly summarizes certain key proposals.

Corporate Taxation

- Japan's national corporate tax rate is currently 25.5%. Taking into account local corporate taxes, the effective corporate tax rate for a company is 34.62% (35.64% for a company headquartered in Tokyo). Under the 2015 tax reform proposal, the national corporate tax rate would be reduced to 23.9%, and the effective corporate tax rate would be reduced to 32.11% (33.10% in Tokyo) for fiscal years starting on or after April 1, 2015. Additionally, due to a reduction in local enterprise tax rate on income for fiscal years starting on or after April 1, 2016, the effective corporate tax rate would be further reduced to 31.33% (32.34% in Tokyo).[1] Japan's Prime Minister Shinzo Abe has said that he would like to reduce the effective corporate tax rate to below 30% within the next few years.

- Under currently applicable rules, a corporation can carry forward net operating losses ("NOLs") for **9 years**, and can use such NOLs to shelter up to **80%** of taxable income in a given year. Under the 2015 tax reform proposal, the carry forward-period for NOLs incurred in fiscal years starting on or after April 1, 2017 would be increased to **10 years**. The amount of taxable income that can be sheltered by such NOLs would, however, be reduced. For fiscal years starting from April 1, 2015 to March 31, 2017, a corporation will only be permitted to shelter a maximum of **65%** of taxable income with NOLs, and for fiscal years starting on or after April 1, 2017, the maximum amount of taxable income that can be sheltered with NOLs will drop to **50%**.

- Currently, a Japanese parent that holds 25% or more of a domestic subsidiary is fully exempt from corporate taxes on the dividends received from that subsidiary. Where the Japanese parent has a less than 25% interest in the domestic subsidiary, 50% of the dividends received are exempt from corporate taxes. Under the 2015 tax reform proposal, the Japanese parent would be required to hold more than 1/3 of the domestic subsidiary in order to receive a full tax exemption. Where the Japanese parent's shareholding ratio in the subsidiary was "more than 5%", but not in excess of "1/3", 50% of the dividends that the Japanese parent

[1] Even where a corporation has no taxable income, a local enterprise tax based on the amount of capital and the added value (e.g. wages and interest expenses) of a corporation applies. Under the 2015 tax reform, somewhat offsetting the effect of the decrease of tax based on income discussed above, applicable rates of this factor-based local enterprise tax would increase.

received would be exempt from corporate taxes. In other cases, *i.e.* where the Japanese parent had a 5% or lower shareholding interest in the domestic subsidiary, 20% of the dividends received would be exempt from corporate taxes.

- Currently, under Japan's participation exemption rules, a Japanese corporation owning 25% or more of a foreign corporation can fully exempt dividends received from such foreign subsidiary from Japanese corporate taxes. Under the 2015 tax reform proposal, where the dividend-payer (*i.e.* the foreign subsidiary) is eligible for a local income tax deduction for the amount of dividends paid, such as in the case of the preferred stock of an Australian subsidiary, such dividends would be outside the scope of the Japanese participation exemption in the hands of the parent.

- Currently, the general R&D credit is limited to 30% of national corporate tax liability. Under the 2015 tax reform proposal, the limitation would be reduced to 25%. The scope of special R&D expenses that would be eligible for the credit would, however, generally be expanded.

- The trigger rate under Japan's Anti-Tax Haven Legislation would be reduced from "20% or less" to "less than 20%".

Consumption Taxation

- Currently, digital services provided by a service provider located outside of Japan are outside the scope of Japanese consumption tax ("JCT").[2] Such services would include, for example, the sale of e-books, the provision of music streaming services, or the provision of internet advertising services by an offshore provider. Under the 2015 tax reform proposals, the above described services would be subject to JCT if the recipient of the service is located in Japan.

  - In the case of BtoB[3] transactions, JCT would be collected by way of a reverse charge system. The transaction sales proceeds would thus be exclusive of JCT. The foreign service provider would be required to provide notice to the Japanese customer that the transaction is subject to a reverse charge, and the Japanese customer would be responsible for paying the applicable JCT to the tax authorities.

  - In the case of BtoC[4] transactions, the foreign service provider would be required to file a JCT return and pay JCT through a tax administrator located in Japan. The sales proceed would thus be inclusive of JCT.

  - Where a business enterprise receives BtoC services from an overseas service provider, the Japanese business enterprise would not be allowed to credit input JCT against output JCT unless the service provider has been registered as a "Registered Foreign Business Operator" with the National Tax Agency and the recipient of the service maintains the applicable invoice, with the registration number of the registered foreign business operator.

[2] JCT is a flat 8% tax levied on the purchase price of domestic goods or services, similar to VAT in the European context. The rate is slated to increase to 10% from April 1, 2017.
[3] BtoB services are defined as services that are obviously for business use from the viewpoint of the nature of the service, the contract terms and other factors, such as internet advertisements.
[4] BtoC services are defined as services other than BtoB services, such as e-books and music streaming services.

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- ✧ The name, address and registration number of registered foreign business operators will be posted and publicly available on the internet.
- ✧ The new rules would take effect from October 1, 2015.

Individual Income Taxation

- Japan's 2015 tax reform proposals include the introduction of a so-called "exit tax", to be payable by certain high net worth individuals that expatriate from Japan. Where an individual (i) has had a domicile in Japan for more than 5 years out of the last 10 before the expatriation, and (ii) has securities, a silent partnership (*i.e.* Tokumei Kumiai: "TK") contract, unsettled derivatives, or certain credit transactions with a combined value of JPY 100 million (approximately USD 840,000) or more, the individual would be subject to individual income tax on the value of any unrealized gain from those assets. This new rule would be applicable on or after July 1, 2015.

Tax Reforms Passed in Previous Years that Became Effective from January 1, 2015

Corporate Taxation

- A special 10% surtax that had been added to the corporate tax rate to generate funds to rebuild after the 2011 Tohoku earthquake and tsunami was abolished for fiscal years starting on or after April 1, 2014. For calendar year corporations, this 10% "special reconstruction surtax" will cease to apply from 2015. For a calendar year corporation located in Tokyo, the effective tax rate for 2014 was 38.01%; due to discontinuation of the surtax, the effective tax rate for 2015 will drop to 35.64%.

Individual Income Taxation

- The maximum individual income tax rate increased by 5%, from 40% to 45%. Taking into consideration local inhabitant's tax and a 2.1% special reconstruction surtax[5], the effective maximum individual income tax rate increased from 50.84% to 55.945%.

Inheritance Taxation

- The maximum inheritance tax rate increased by 5%, from 50% to 55%.
- Under the previous law, the basic deduction for inheritance tax purposes (after which inheritance tax will be imposed) was JPY 50 million, plus JPY 10 million multiplied by the number of legal heirs. The basic deduction has been reduced to JPY 30 million plus JPY 6 million multiplied by the number of legal heirs.

Gift Taxation

- The maximum gift tax rate increased by 5%, from 50% to 55%.

Further Updates

- The proposals summarized in this Client Alert are expected to be approved by the Diet in March 2015.

[5] This 2.1% special reconstruction surtax applies to individuals and is slated to be in effect until 2037. This surtax should not to be confused with the 10% surtax on corporate income, discussed above.