

KPMG Japan tax newsletter

Outline of the 2012 Tax Reform Proposals



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The Japanese government released an outline of the 2012 tax reform proposals (the 'Proposal') on 10 December 2011.

Although the Proposal itself is only an indicative outline and is unclear with respect to some of the contemplated changes, we have set out in this newsletter our understanding of the main points of the tax reform indicated in the Proposal.

The details of the tax reform will be unveiled in the bills revising the tax laws (usually made public in late January or early February) and the succeeding amended tax laws, cabinet orders and ministerial ordinances (usually promulgated in late March). Please note that the final tax reform could differ from the Proposal depending on the outcome of discussions in the Diet.

I. INTERNATIONAL TAXATION

1. Introduction of Japanese Earnings Stripping Rules

A new measure to restrict interest deductions for certain companies has been proposed to prevent tax avoidance by companies which pay an amount of interest to related persons which is disproportionate to their income.

(1) Disallowed interest

When a company's Net Interest Payments to Related Persons exceed 50 percent of Adjusted Taxable Income, the portion exceeding 50 percent will be disallowed for tax purposes.

Disallowed interest	Net Interest Payments to Related Persons – (Adjusted Taxable Income x 50%)
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The definitions/scope of the relevant terms are as follows:

Adjusted Taxable Income	Taxable income for the fiscal year + Net Interest Payments to Related Persons + Depreciation, etc. + Tax exempt dividends, etc. ± Extraordinary profits/losses (e.g. bad debt losses)
Related Person	(i) a person who has a 50 percent or more direct/indirect relationship with the company (ii) a person who controls the company or who is controlled by the company in substance, or (iii) a third party who receives a guarantee from a company satisfying (i) or (ii) above
Net Interest Payments to Related Persons	Interest Payments to Related Persons – Interest Income relating to Interest Payments to Related Persons
Interest Payments	Payments of interest, interest equivalents (e.g. the interest portion of lease fees) and guarantee fees, etc. paid on debt guaranteed by Related Persons
Interest Payments to Related Persons	Interest Payments to Related Persons do not include the following: (i) interest payments under a repo transaction, etc. where the bonds borrowed under another repo transaction, etc. are lent (ii) interest payments that are subject to Japanese corporation tax in the hands of the recipient
Interest Income	Interest and interest equivalents (e.g. the interest portion of lease fees) received
Interest Income relating to Interest Payments to Related Persons	$\text{Total Interest Income} \times \frac{\text{Interest Payments to Related Persons}}{\text{Total Interest Payments}}$ <ul style="list-style-type: none"> • Where there are interest payments under a repo transaction, etc. where the bonds borrowed under another repo transaction, etc. are lent: <ul style="list-style-type: none"> • Total Interest Income should be reduced by the amount equivalent to such interest payments. • The amount equivalent to such interest payments should be excluded from Total Interest Payments. • With respect to Interest Income from Domestic Related Persons: <ul style="list-style-type: none"> • In principle, such income should not be included in Total Interest Income. • However, if a Domestic Related Person receives interest from unrelated persons or non-resident individuals/foreign companies without a permanent establishment in Japan, such interest income may be included in Total Interest Income to the extent of Interest Income from Domestic Related Persons.
Domestic Related Person	A Domestic Related Person is a Related Person who is a Japanese resident individual/Japanese company or a non-resident individual/foreign company having a permanent establishment in Japan

(2) Disallowed interest carryforward

When a company's Net Interest Payments to Related Persons do not exceed 50 percent of Adjusted Taxable Income in a given fiscal year, interest incurred in the previous 7 years and disallowed under the earnings stripping rules will be deductible for that fiscal year. The deductible amount will be limited to the difference between the Net Interest Payments to Related Persons and 50 percent of Adjusted Taxable Income in that fiscal year.

(3) De minimus rules

The earnings stripping rules will not apply to a company in a fiscal year where:

(i)	Net Interest Payments to Related Persons for the fiscal year	\leq	JPY10 million
(ii)	Interest Payments to Related Persons for the fiscal year	\leq	Total Interest Payments x 50%

Total Interest Payments in (ii) above 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.

(4) Application for tax consolidated groups

The earnings stripping rules will be applied on a group basis and not on an entity basis. The disallowed interest is calculated as follows:

Disallowed interest (group total)	Interest Payments to Related Persons (group total)
	- Interest Income relating to the above ^(*) (group total)
	- Adjusted Taxable Income ^(**) x 50% (group total)

^(*) Interest Income does not include interest received from companies belonging to the same tax consolidated group.

^(**) Adjusted Taxable Income is generally calculated based on consolidated taxable income and in the same way as discussed in (1). However, certain adjustments should also apply, e.g. no add-back of dividends received from companies belonging to the same tax consolidated group.

The de minimus rules as they apply to a tax consolidated group are as follows:

(i)	Net Interest Payments to Related Persons for the fiscal year (group total)	\leq	JPY10 million
(ii)	Interest Payments to Related Persons for the fiscal year (group total)	\leq	Total Interest Payments (group total) x 50%

Total Interest Payments in (ii) above 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.

(5) Interaction with other tax rules

(a) Thin-capitalization rules

If both the Japanese earnings stripping rules and the thin-capitalization rules apply in the same fiscal year, the total disallowed interest for that year is the larger of disallowed interest as calculated under each rule.

(b) Anti-tax haven (CFC) rules

Where a Japanese company pays interest to a foreign subsidiary and that interest is subject to both the Japanese earnings stripping rules and the anti-tax haven rules, disallowed interest under the Japanese earnings stripping rules will be reduced by the amount of aggregated income of the foreign subsidiary

under the anti-tax haven rules. This reduction will be limited to the disallowed interest paid to the foreign subsidiary.

(6) Others

- If a company with disallowed interest carryforward is part of a tax qualified merger, the disallowed interest will be assumed by the surviving company. Similarly, if a 100% subsidiary having disallowed interest carryforward is liquidated and distributes all of its residual assets to its parent company, the disallowed interest will be assumed by the parent company.
- Other related measures are contemplated for implementation going forward.

* * *

The Japanese earnings stripping rules will be applied for fiscal years starting on or after 1 April 2013.

2. Anti-Tax Haven (CFC) Rules

In order to prevent double taxation of aggregated income pursuant to the anti-tax haven rules, where a Japanese company receives dividends from a first-tier subsidiary which consist of distributed income from a second-tier subsidiary that has already been subject to aggregation at the level of the Japanese company, the dividends received from the first-tier subsidiary are fully exempt from tax at the Japanese company to the extent of the Indirect Specified Taxed Amount.

The Indirect Specified Taxed Amount is currently determined as the smaller of the following:

(i)	Dividends ^(*1) that the first-tier foreign subsidiary received from the second-tier foreign subsidiary within the past 3 years ^(*2)	x	The Japanese company's direct holding ratio in the first-tier foreign subsidiary (at the end of the dividend-receiving fiscal year of the Japanese company)
(ii)	The second-tier foreign subsidiary's income which has been aggregated with the Japanese company's income within the past 3 years	x	The Japanese company's indirect holding ratio in the second-tier foreign subsidiary (at the end of the fiscal year of the second-tier foreign subsidiary)

^(*1) Excludes certain dividends, such as those which were received in years prior to the years in which the aggregated taxable income of the second-tier foreign subsidiary was derived.

^(*2) The past 3 years refers to the fiscal year in which the Japanese company received dividends from the foreign subsidiary (the dividend-receiving fiscal year) and fiscal years beginning within 2 years prior to commencement of the dividend-receiving fiscal year.

Pursuant to the Proposal, the Japanese company's direct holding ratio in the first-tier foreign subsidiary described in (i) above is proposed to change from 'at the end of the dividend-receiving fiscal year of the Japanese company' to 'the record date (or the date equivalent to the record date) of the latest dividend that the Japanese company receives from the first-tier foreign subsidiary in the dividend-receiving fiscal year'.

3. Introduction of New Requirement for Declaring Overseas Assets

(1) Submission of overseas assets declarations

In order to facilitate proper and fair assessment and collection of individual income taxes and inheritance taxes on overseas assets, a new requirement to report overseas assets will be introduced as follows:

Persons required to declare	Items to be declared	Submission due date
Japanese residents ^(*) who own overseas assets (assets located outside Japan) valued at over JPY50 million ^(**) as of the end of a year	<ul style="list-style-type: none"> • type of overseas assets • number of overseas assets • value of overseas assets^(**) • any other required information 	15 March of the following year

^(*) A Japanese resident is an individual who has their domicile in Japan or has resided in Japan for a continuous period of 1 year or more. Note that a Japanese resident includes a non-permanent resident (i.e. an individual who does not have Japanese nationality and has lived in Japan for 5 years or less in the last 10 years).

^(**) The value of overseas assets is in principle assessed at fair market value. However, estimated values may also be acceptable.

(2) Special measures for penalty taxes

Penalty taxes are imposed where a taxpayer understates their income/inherited property in their income tax/inheritance tax returns or fails to lodge their income tax/inheritance tax returns. The following special measures in relation to penalty taxes will be introduced to encourage people to accurately declare their overseas assets.

- If the penalty tax is derived from overseas assets that have already been properly declared, the penalty tax rate will be reduced by 5 percent (for individual income tax and inheritance tax purposes).
- If the penalty tax is derived from overseas assets that have not been properly declared, the penalty tax rate will be increased by 5 percent (for individual income tax purposes).

* * *

The amendments discussed in (1) and (2) above will be applied to overseas asset declarations submitted on or after 1 January 2014 (i.e. the first declaration prepared by a Japanese resident for their overseas assets as at 31 December 2013).

II. CORPORATION TAX

1. Special Tax Measures under the Fukushima Reconstruction Act

The Japanese government is planning to formulate the Fukushima Reconstruction Act, aimed at facilitating the reconstruction of Fukushima Prefecture after the March 11 earthquake and nuclear disaster. The special tax measures in (1) and (2) below are proposed under the act.

Although there are already special tax measures for reconstruction provided for in the Special Reconstruction Zone Act passed by the Diet on 7 December 2011 and as summarized below, the proposed Fukushima Reconstruction Act serves to relax certain of these requirements and expand the scope of certain preferential treatments.

Special tax measures under the Special Reconstruction Zone Act	
(A)	Reinvestment reserves (income recognition deferral for 5 years and special depreciation)
(B)	Tax credits for job creation for disaster-affected people (10% tax credit on remuneration paid to disaster-affected people)
(C)	Special depreciation/tax credits for business assets
(D)	Special depreciation for R&D assets

(Measures (A), (B) and (C) may not be applied concurrently.)

Please see the following newsletter for more details:

KPMG Japan tax newsletter (December 2011) 'Special Reconstruction Zone Act and Amendments to the Special Tax Law for the March 11 Earthquake'
http://tax.kpmg.or.jp/knowledge/japan-tax-newsletter/2011/pdf/201112_e.pdf

(1) Special tax measures for Fukushima Prefecture

Under the Fukushima Reconstruction Act, the special tax measures ((A) to (D) above) provided under the Special Reconstruction Zone Act will be expanded to cover all municipal governments in Fukushima Prefecture.

Moreover, under the Fukushima Reconstruction Act, where special tax measure '(C) special depreciation/tax credits for business assets' is adopted by a company, the total acquisition cost of machinery or equipment can be expensed upfront until 31 March 2016. This is a 2-year extension over the date of 31 March 2014 as provided under the Special Reconstruction Zone Act.

(2) Special tax measures for former evacuation areas

The following two special tax measures will be introduced for companies recognized as disaster-affected companies^(*) by Fukushima Prefecture and as defined under the Fukushima Reconstruction Act. Measures (a) and (b) may not be applied concurrently.

^(*) A disaster-affected company means a company which had offices in evacuation areas^(**) as of 11 March 2011.

^(**) An evacuation area means an area designated by the Japanese government as an emergency evacuation standby area (this designation was lifted on 30 September 2011), a restricted area or a planned evacuation area.

(a) Special depreciation/tax credits for business assets

If a company designated as a disaster-affected company by Fukushima Prefecture acquires new depreciable assets as indicated below and puts them to use in its businesses in an evacuation area within the 5-year period commencing the day that the area's designation as an evacuation area is lifted, the company will be able to apply either special depreciation or tax credits in the fiscal year that the assets are put to use.

	Special depreciation (Depreciable limit)	Tax credits (Creditable limit) ^(*)
Machinery/ equipment	[Acquisition cost] – [Ordinary depreciable limit] (i.e. total acquisition costs can be expensed upfront.)	Acquisition cost x 15%
Buildings/ structures	Acquisition cost x 25%	Acquisition cost x 8%

^(*) The tax credit is capped at 20 percent of the corporation tax liability for the fiscal year. If the creditable amount exceeds this ceiling, such excess amount can be carried forward for 4 years.

This measure is similar to 'C) special depreciation/tax credits for business assets' under the Special Reconstruction Zone Act. However, this new measure is more preferential in that the scope of eligible companies is expanded.

(b) Tax credits for employing disaster-affected people

A new tax credit system will be introduced to promote job creation for disaster-affected people as follows:

Applicable company	A company designated as a disaster-affected company by Fukushima Prefecture in the 3-year period commencing the day that the area's designation as an evacuation area is lifted
Applicable period	The 5-year period commencing on the later of: (i) the day the company is designated as a disaster-affected company or, (ii) the day that the area's designation as an evacuation area is lifted
Condition	The company remunerates disaster-affected people ^(*) working in its offices in the evacuation area.
Creditable amount	[Total amount of remuneration paid to disaster-affected people] x 20% (capped at 20% of corporation tax liability for the fiscal year)

^(*) Disaster-affected people for the purpose of this rule are defined as follows:

- individuals who were employed in evacuation areas as of 11 March 2011, or
- individuals who lived in evacuation areas as of 11 March 2011

This measure is similar to 'B) tax credits for job creation for disaster-affected people' under the Special Reconstruction Zone Act. However, this new measure is more preferential in that the scope of applicable companies is expanded. Moreover, the creditable limit is calculated by multiplying the total amount of remuneration paid to disaster-affected people by 20 percent, as opposed to 10 percent under the Special Reconstruction Zone Act.

2. Tax Credits for R&D Costs

The rules concerning provision of tax credits for R&D costs are proposed to change as follows:

Tax credits for R&D costs	Current tax law		Proposal
(1) Tax credits on total R&D costs	Permanent measure	Maximum tax credit: Corporation tax liability x 20% (as a temporary measure , maximum tax credit has been increased from 20% of corporation tax liability to 30% for fiscal years commencing prior to 1 April 2012)	The temporary measure for maximum tax credit will not be extended.
(2) Additional tax credits: (a) Tax credits on incremental R&D costs, or (b) Tax credits on the excess of R&D costs over 10% of average sales proceeds	Temporary measures (applied for fiscal years commencing prior to 1 April 2012)	Maximum tax credit: Corporation tax liability x 10%	These temporary measures will be extended for 2 years.

3. Other Special Tax Measures

The applicable periods for the following special tax measures will be extended by another 2 years:

- exclusion of entertainment expenses from deductible expenses
- partial deduction of entertainment expenses for small and medium-sized companies
- lump-sum depreciation for small depreciable assets (whose acquisition cost is less than JPY300,000) for small and medium-sized companies
- additional taxation on concealed expenditure
- suspension of tax loss carry back for companies other than small and medium-sized companies
- reserves for losses on overseas investments
- special depreciation/tax credits for small and medium-sized companies in relation to acquisitions of certain machinery/equipment, computers and software, etc. – the scope of applicable assets will also be amended.

Moreover, the capital gain rollover rule for certain assets such as long-term held land that is applicable until 31 December 2011 under the current tax law will be extended for 3 years, though the scope of assets to be purchased will be narrowed as follows:

	Current tax law	Proposal
Transferred assets	Land, etc. buildings or structures in Japan that have been held for more than 10 years	No changes
Replacement assets	<ul style="list-style-type: none"> • Land, etc. buildings, structures or machinery/equipment in Japan • Certain transport and carriage tools used in the railroad industry in Japan 	<ul style="list-style-type: none"> → Land will be eligible only if it is used for certain buildings such as offices and is 300 square meters or larger. → Certain locomotives will not be eligible.

(When a company sells a 'transferred asset' and acquires a 'replacement asset', it is in principle possible to defer 80 percent of the taxation on the capital gain.)

III. INDIVIDUAL INCOME TAX

The following amendments that were originally proposed under the 2011 tax reform but were deleted from the final bill have been proposed again in the 2012 tax reform.

1. Employment Income

(1) Employment income deduction

According to the Proposal, a cap on the employment income deduction of JPY2.45 million will be established for people who earn gross remuneration of more than JPY15 million. Accordingly, taxable income for such people will increase by 5 percent of the amount of gross remuneration in excess of JPY15 million.

(2) Specific expense deduction

Under the current tax law, where an earner of employment income pays specific expenses (e.g. training expenses to learn skills or knowledge directly necessary for performing one's job function), and the amount of such specific expenses paid in that year exceeds the employment income deduction, the excess amount is also deductible in the calculation of employment income.

This rule will be amended as follows:

- Where specific expenses are paid, the deductible amount in the calculation of employment income will be amended as follows:

	Gross remuneration	Deductible amount in the calculation of employment income
Current law	No restriction	Specific expenses – Employment income deduction
Proposal	JPY15 million or less	Specific expenses – Employment income deduction x 1/2
	over JPY15 million	Specific expenses – JPY1,250,000

- The following expenses will be added to the scope of specific expenses:
 - expenses to obtain qualifications directly necessary for performing one's job function, e.g. lawyer, CPA, tax accountant
 - expenses necessary in performing one's job function, e.g. expenses for books, clothing and entertainment (maximum amount of JPY650,000)

The amendments (1) and (2) above will apply from 2013 for national income tax purposes (for income earned in 2013) and from 2014 for inhabitant tax purposes (for income earned in 2013).

2. Retirement Income for Directors

Under the current tax law, retirement income is calculated as 50 percent of the net amount of the gross receipt of retirement allowances less the retirement income deduction. Under the Proposal, for a director whose service period is 5 years or shorter, this 50 percent reduction will not apply, and retirement income will be calculated as the full difference between the gross receipt and the retirement income deduction.

	Recipients	Retirement income
Current law	All recipients	(Gross receipt of retirement allowances – Retirement income deduction) x 50%
Proposal	Directors whose service period is 5 years or shorter	(Gross receipt of retirement allowances – Retirement income deduction) x 50% ↑ Abolition of the 50% reduction
	Other than above	(Gross receipt of retirement allowances – Retirement income deduction) x 50%

This amendment will generally apply to retirement allowances where the retirement date is in 2013 or later.

3. Introduction of New Requirement for Foreign Company Stock Options

New requirements with respect to reporting the exercise of stock options granted by foreign companies and stock price-based compensation paid by foreign companies will be introduced due to many cases where such income was not reported properly.

Persons subject to reporting	Cases to be reported	Reporting person & Submission date
<ul style="list-style-type: none"> A Japanese resident^(*) who is a director or employee of the Japanese subsidiary of a foreign company (where 50% or more of the outstanding shares in the Japanese subsidiary are held by the foreign company) A Japanese resident^(*) who is a director or employee of the Japan branch of a foreign company 	<ul style="list-style-type: none"> A person in the column to the left exercises stock options granted by the foreign company, or A person in the column to the left receives stock price-based compensation (e.g. phantom stock options) from the foreign company 	<p>The representative of the Japanese subsidiary or the Japan branch is required to submit a declaration by 31 March of the year following the year where the stock options are exercised or the stock price-based compensation is paid.</p> <p>(Items to be included in such submissions are still uncertain.)</p>

(*) Please refer to I.3.(1) for the definition of a Japanese resident.

This new requirement will be implemented for declarations which are required to be submitted on or after 1 January 2013. Thus, the first submission should include stock options exercised in 2012 and stock price-based compensation paid in 2012.

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