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KPMG Japan tax newsletter

Outline of the 2013 Tax Reform Proposals



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The ruling coalition (the Liberal Democratic Party and New Komeito) agreed on an outline of the 2013 tax reform proposals (Proposal) on 24 January 2013. The announcement was one month later than usual years due to the change in government.

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 and the succeeding amended tax laws, cabinet orders and ministerial ordinances. Please note that the final tax reform could differ from the Proposal depending on the outcome of discussions in the Diet.

I. CORPORATION TAX

1. Tax Credits for Salary Growth

In order to raise the general level of personal income, tax credits for salary growth which encourage companies to increase their employees' salary will be newly introduced.

Where a blue-return filing company pays salary to its employees in fiscal years commencing between 1 April 2013 and 31 March 2016, the company will be able to apply the tax credit discussed in (2) below provided all of the conditions in (1) below are met.

Note that this tax credit system is not applicable where the tax credit for job creation described in 2. below is applied.

(1) Conditions

(i)	[Salary payments ^(*) in the current year] ≥ [Salary payments in the base year ^(*)] x 105%
(ii)	[Salary payments in the current year] ≥ [Salary payments in the preceding year]
(iii)	[Average of salary payments in the current year] ≥ [Average of salary payments in the preceding year]

^(*) 'Salary payments' refers to salary paid to employees (excluding directors and employees who have a special relationship with directors) working at offices located in Japan, which are deductible in calculating the company's income for each fiscal year.

^(*) 'Base year' refers to the fiscal year preceding the first fiscal year commencing on or after 1 April 2013.

(2) Tax credit

$\left[\begin{array}{c} \text{Salary payments in} \\ \text{the current year} \end{array} - \begin{array}{c} \text{Salary payments in} \\ \text{the base year} \end{array} \right] \times 10\%$			
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The credit is limited to 10 percent (20 percent for small and medium-sized companies^(*)) of the corporation tax liability amount for the fiscal year.

^(*) Although not clarified in the Proposal, it is presumed that 'small and medium-sized companies' for the purposes of this rule will be the same as those described in 2. below.

2. Tax Credits for Job Creation

With respect to the tax credit for job creation introduced as a temporary 3-year measure for fiscal years commencing between 1 April 2011 and 31 March 2014, the amount of the tax credits will be increased.

Under this tax credit system, a blue-return filing company which submits a job creation plan to a public job placement agency will be able to apply the tax credit discussed in (2) below provided all of the conditions in (1) below are met.

Note that this tax credit system is not applicable where the new tax credit system discussed in 1. above is applied.

(1) Conditions

(i)	The number of insured persons under the national employment insurance scheme at the end of the current fiscal year has increased by 10 percent or more (ratio test) and by 5 employees or more (for small and medium-sized companies ^(*) , 2 employees or more) (quantity test), when compared to the preceding year end.
(ii)	Zero terminations in the current year and the preceding fiscal year.
(iii)	$\begin{aligned} &[\text{Salary payments in the current year}] - [\text{Salary payments in the preceding year}] \geq \\ &[\text{Salary payments in the preceding year}] \times [\text{Percentage increase in the number of employees}] \times 30\% \end{aligned}$

^(*) Small and medium-sized companies for the purpose of this rule are defined as follows:

- Companies with paid-in capital of JPY100 million or less (as at the end of the fiscal year), excluding the following cases:
 - (i) at least 50 percent of the shares are held by one large-scale company (a company whose paid-in capital is over JPY100 million); or
 - (ii) at least two-thirds of the shares are held by two or more large-scale companies
- Companies with no capital whose number of regular employees is 1,000 or less

(2) Tax credit

Under the 2013 tax reform, the maximum amount of tax credit will be doubled as follows:

Current tax law	Net increase in the number of employees insured under the national employment insurance scheme	x	JPY200,000
Proposal	Net increase in the number of employees insured under the national employment insurance scheme	x	JPY400,000

The credit is limited to 10 percent (20 percent for small and medium-sized companies) of the corporation tax liability amount for the fiscal year.

In addition to the above, the Proposal provides that the scope of employees will be amended.

3. Special Measures for Promotion of Investment in Production Facilities

New special measures will be introduced with the aim of strengthening industrial competitiveness through renewal of production facilities.

If a blue-return filing company acquires production facilities and puts them into use for business in Japan during the fiscal years commencing from 1 April 2013 to 31 March 2015, the company will be able to apply either special depreciation or the tax credit described in (2) below provided all of the conditions in (1) below are met.

(1) Conditions

(i)	[Total acquisition cost of production facilities ^(*) in the current year]	>	[Total depreciation cost of depreciable assets recorded in the current year]
(ii)	[Total acquisition cost of production facilities in the current year]	>	[Total acquisition cost of production facilities in the preceding year] x 110%

^(*) 'Production facilities' means facilities consisting of depreciable assets directly used for manufacturing businesses or other businesses. For example, a head office building and welfare facilities would not be treated as production facilities.

(2) Special depreciation/Tax credit

Special depreciation	Acquisition cost of machinery (attributable to the acquired production facilities) x 30%
Tax credit	Acquisition cost of machinery (attributable to the acquired production facilities) x 3% (capped at 20% of the corporation tax liability for the fiscal year)

4. Green Investment Tax Incentives

In order to promote further introduction and development of renewable energy and energy-saving equipment, the Green Investment Tax Incentives will be amended as follows:

[Current tax law]

Eligible equipment		Designated period & Special depreciation (Depreciable limit)
New energy utilization equipment	Solar power generation equipment Wind power generation equipment	Designated period: From 29 May 2012 to 31 March 2013 Special depreciation (Depreciable limit): [Acquisition cost] – [Ordinary depreciable limit] (i.e. total acquisition costs can be expensed upfront)
	Biomass utilization equipment	
CO2 discharge control equipment (including cogeneration equipment)		Designated period: From 30 June 2011 to 31 March 2014 Special depreciation (Depreciable limit): Acquisition cost x 30%
Energy utilization rationalization equipment		
Energy utilization control equipment		

[Proposal]

Eligible equipment ^(*)		Designated period & Special depreciation (Depreciable limit)
New energy utilization equipment	Solar power generation equipment Wind power generation equipment	Designated period: From 29 May 2012 to 31 March 2015 (extended for 2 years) Special depreciation (Depreciable limit): [Acquisition cost] – [Ordinary depreciable limit] (i.e. total acquisition costs can be expensed upfront)
	Cogeneration equipment	
CO2 discharge control equipment	Certain equipment (e.g. stationary capacitor equipment) will be added.	Designated period: From 30 June 2011 to 31 March 2016 (extended for 2 years) Special depreciation (Depreciable limit): Acquisition cost x 30%
New energy utilization equipment (Biomass utilization equipment, etc.)		
Energy utilization rationalization equipment		
Energy utilization control equipment		

^(*) Equipment acquired with subsidies will be excluded from equipment eligible for special depreciation.

5. Tax Credits for R&D Costs

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

Tax credits for R&D costs	Current tax law	Proposal
(1) Tax credit on total R&D costs R&D costs x 8-12%	Permanent measure Maximum tax credit: Corporation tax liability x 20%	The maximum tax credit will be increased from 20% of corporation tax liability to 30% for 2 years as a temporary measure ^(*) .
(2) Additional tax credits(i) or (ii): (i) Tax credit on incremental R&D costs Incremental R&D costs x 5% (ii) Tax credit on the excess of R&D costs over 10% of average sales proceeds [R&D costs — Average sales proceeds x 10%] x Tax credit ratio	Temporary measures (applied for fiscal years commencing prior to 1 April 2014) Maximum tax credit: Corporation tax liability x 10%	No changes

^(*) Although a temporary measure to increase the maximum tax credit to 30 percent of the corporation tax liability for fiscal years commencing prior to 1 April 2012 expired, the same temporary measure will be introduced again under the 2013 tax reform.

In addition to the above, the scope of specified R&D costs (e.g. R&D costs for R&D activities carried out with national R&D institutions or universities) will be expanded to include R&D costs for R&D activities carried out with other companies based on certain contracts. The specified R&D costs are treated preferentially; i.e. 12 percent of total R&D costs is available as a tax credit.

6. Special Measures to Stimulate Small and Medium-Sized Companies Operating Certain Businesses

A new political measure to stimulate small and medium-sized companies will be introduced.

If a blue-return filing small and medium-sized company^(*) receives advice on improving its operations from an organization such as the Chamber of Commerce and Industry, etc. and acquires equipment and puts it to use in designated businesses during the period from 1 April 2013 to 31 March 2015 (renewal of stores, etc.) in accordance with such advice, the company will be able to apply either special depreciation or the tax credit described in (3) below.

^(*) Although it is not clarified in the Proposal, it is presumed that 'small and medium-sized companies' for the purpose of this rule will be the same as those described in 2. above.

(1) Designated businesses

Wholesale; retail; service businesses; or agriculture, forestry and fisheries

(2) Eligible equipment

- Instruments and fixtures (where the acquisition cost is more than JPY300,000 per unit)
- Facilities attached to buildings (where the acquisition cost is more than JPY600,000 per unit)

(3) Special depreciation/Tax credit

Special depreciation	Acquisition cost of eligible equipment x 30%
Tax credit ^(*)	Acquisition cost of eligible equipment x 7% (capped at 20% of the corporation tax liability for the fiscal year)

^(*) Only small and medium-sized companies whose paid-in capital is JPY30 million or less are eligible for the tax credit. If there is an excess amount over the limitation, such amount can be carried forward to the following year.

7. Entertainment Expenses

Entertainment expenses for a fiscal year in excess of the base amounts are disallowable under the tax law.

Pursuant to the Proposal, the deductible limit of entertainment expenses for small and medium-sized companies^(*) will be raised as follows:

Size of company	Base amount	
	Current tax law	Proposal
A small and medium-sized company	Lower of JPY5.4 million or 90% of actual payment	JPY8 million
Other than small and medium-sized company	Zero	Zero (No change)

^(*) Small and medium-sized companies for the purpose of this rule are defined as follows:

Companies with paid-in capital of JPY100 million or less (at the end of a fiscal year), excluding the following cases:

- 100 percent of the shares are directly or indirectly held by one large-sized company (a company whose paid-in capital is JPY500 million or more); or
- 100 percent of the shares are held by two or more large-sized companies in a 100 Percent Group

II. INTERNATIONAL TAXATION

1. Anti-Tax Haven Rules (CFC Rules)

Where a Japanese company aggregates income of a Specified Foreign Subsidiary (SFS) whose head office is located in a country which does not impose tax on income, if such income is taxed in a country other than the country of the head office, the aggregated income will not be treated as non-taxable foreign source income in calculating the creditable limit of foreign tax^(*) for the Japanese company (i.e. will no longer detrimentally affect the calculation).

$$(*) \quad \text{Creditable limit of foreign tax} = \frac{\text{Japanese corporation tax amount for the fiscal year}}{\text{Total taxable income for the fiscal year}} \times \frac{\text{Foreign source income for the fiscal year}}{\text{Total taxable income for the fiscal year}}$$

Non-taxable foreign source income is not included in foreign source income in the above calculation.

2. Earnings Stripping Rules

The following amendments are proposed for the earnings stripping rules which were introduced under the 2012 tax reform and will be applied for fiscal years beginning on or after 1 April 2013. (Please refer to our earlier newsletter 'Japanese Earnings Stripping Rules' issued on 6 September 2012 for further details on the rules.)

(1) Corporation tax

Under the current tax law, if both the thin capitalization rules (to restrict the deductibility of interest payments on excessive debt compared to capital) and the earnings stripping rules (to restrict the deductibility of interest payments that are excessive compared to income) are applicable in a fiscal year, only the larger of the disallowed amounts under either approach is applied to prevent double taxation of the same interest payments. The Proposal indicates this rule will be amended, although it does not provide details.

(2) Business tax (size-based business tax)

The calculation of the current year income/loss which is included in the tax base of the added value component of size-based business tax will be amended in relation to the earnings stripping rules.

3. Transfer Pricing

The berry ratio (i.e. ratio of gross profit to operating expenses) which is included as a profit level indicator (PLI) in the OECD Transfer Pricing Guidelines as amended in July 2010 will be provided for as a PLI in calculating arm's length prices for tax purposes.

4. Overseas Assets Reporting

Pursuant to the 2012 tax reform, a new reporting requirement for overseas assets was introduced, whereunder Japanese permanent residents who own overseas assets valued at over JPY50 million as of the end of a calendar year must submit a 'Statement of Overseas Assets' to report their overseas assets. (Please refer to our earlier newsletter 'New Reporting Requirement for Overseas Assets' issued on 7 December 2012 for more details.)

Overseas assets generally refer to assets located outside Japan. For example, the deemed location of securities is determined based on the location of the head office of the entity issuing the securities. In the Proposal, the following

amendments to the scope of overseas assets for securities have been proposed:

- Domestic securities (shares/bonds issued by a Japanese company, etc.) managed in an account established with an overseas office of a financial institution will be treated as overseas assets.
- Foreign securities (shares/bonds issued by a foreign company, etc.) managed in an account established with a Japanese office of a financial institution will be excluded from the scope of overseas assets.

The above amendments will be applied to the 'Statement of Overseas Assets' to be submitted on or after 1 January 2014, which should be the first statement submitted (due on 17 March 2014) under these new rules.

III. J-REITs

1. Tax Qualifying Requirements

Profit distributions paid by a Tōshū Houjin (J-REIT) are deductible in calculating taxable income for the J-REIT provided the tax qualifying requirements are satisfied. The following amendments to the tax qualifying requirements are proposed.

(1) Investments in foreign real estate through foreign SPCs

While a J-REIT is technically permitted to hold foreign real estate under the Act on Investment Trusts and Investment Corporations ('J-REIT Law'), the law which governs J-REITs, it has been difficult historically for J-REITs to make investments in foreign real estate in practice. This is because the J-REIT Law and the tax qualifying requirements have essentially made it impossible for a J-REIT to utilize a wholly owned SPC for such investments; the J-REIT Law does not allow a J-REIT to hold more than 50 percent of the voting shares in another company, and one of the conditions to be tax qualifying requires that it not hold 50 percent or more of the outstanding shares in another company.

Consequently, J-REITs have been unable to make investments via SPCs in order to mitigate the potential risks of direct investment in foreign real estate or to satisfy any relevant local legal restrictions.

Accordingly, as part of the amendments to the J-REIT Law currently in progress, the aforementioned J-REIT Law provision will be amended such that a J-REIT will be able to hold more than 50 percent of the voting shares in a foreign SPC provided that holding the SPC is deemed to be equivalent to making a direct investment in the foreign real estate.

Moreover, an accompanying amendment to the aforementioned tax qualifying requirement for J-REITs has also been proposed; i.e. the 50 percent limitation on shareholding will not apply where a J-REIT acquires shares in a foreign SPC that was established merely to hold foreign real estate and satisfies certain conditions, including the requirement that holding the shares in the SPC is deemed to be equivalent to making a direct investment in the foreign real estate.

(2) 90 percent test (where capital gain rollover rules are applied)

One of the tax qualifying requirements for a J-REIT is the '90 percent test'; i.e. the amount of dividend payments made by a J-REIT in a fiscal year must exceed 90 percent of its distributable profit in such fiscal year.

The Proposal includes an amendment to the 90 percent test considering cases where a J-REIT applies a capital gain rollover (which is available for certain types of transactions) and accumulates a reserve for the deferred capital gains via appropriation of retained earnings. In such cases, the 90 percent test will be applied after reducing the distributable amount by the amount of the reserve (subject to certain conditions) such that the J-REIT does not need to make a cash distribution of the deferred capital gains amount to meet the 90 percent test.

2. Registration Tax/Real Property Acquisition Tax

The special measures for registration tax and real estate acquisition tax that are applicable to real estate acquired by certain J-REITs by 31 March 2013 will be extended for 2 years until 31 March 2015. The same measures available to Tokutei Mokuteki Kaisha (TMKs) will also be extended for 2 years until 31 March 2015.

IV. INCOME TAX

1. Increase in the Maximum Individual Income Tax Rate

In order to mitigate the income gap and restore one of the functions of individual income tax, i.e. income redistribution, the highest tax rate will be raised from 40 percent to 45 percent for persons recognizing taxable income in excess of JPY40 million from 2015.

Taxable income		Income tax rate	
		Current tax law	Proposal
In excess of -	Not over JPY1,950,000	5%	No change
JPY1,950,000	JPY3,300,000	10%	
JPY3,300,000	JPY6,950,000	20%	
JPY6,950,000	JPY9,000,000	23%	
JPY9,000,000	JPY18,000,000	33%	
JPY18,000,000	JPY40,000,000	40%	45%
JPY40,000,000	-		

(Note that the above tax rates are progressive tax rates. Special reconstruction income tax is imposed on the income tax discussed above at 2.1 percent and inhabitant tax is also imposed on taxable income at a flat rate of 10 percent.)

2. Special Tax Credits for Housing Loans

The special tax credits for housing loans which are due to expire at the end of 2013 will be extended for 4 years and the maximum amount of tax credit will be raised alongside the increase in the consumption tax rate from 1 April 2014.

(1) Maximum tax credit (National income tax)

The current tax system will be extended until 31 March 2014, and then the maximum tax credit will be increased from 1 April 2014.

The maximum balance of housing loans available for credit at the end of a year and the annual maximum amount of tax credit are as follows:

[Ordinary Home]

	Year of residence	Credit period	Maximum loan balance at end of year for determining credit	Credit rate	Maximum tax credit (annual amount)
Current tax law	Until 31 December 2013	10 years	JPY20 million	1.0%	JPY0.2 million
Proposal	From 1 January 2014 to 31 March 2014	10 years	JPY20 million	1.0%	JPY0.2 million
	From 1 April 2014 to 31 December 2017		JPY40 million ^(*)		JPY0.4 million

^(*) If the consumption tax rate on acquisition costs of an ordinary home is not 8 percent or 10 percent, the amount will be JPY20 million.

[Certified High Quality Home/Certified Low-Carbon Home]

	Year of residence	Credit period	Maximum loan balance at end of year for determining credit	Credit rate	Maximum tax credit (annual amount)
Current tax law	Until 31 December 2013	10 years	JPY30 million	1.0%	JPY0.3 million
Proposal	From 1 January 2014 to 31 March 2014	10 years	JPY30 million	1.0%	JPY0.3 million
	From 1 April 2014 to 31 December 2017		JPY50 million ^(*)		JPY0.5 million

^(*) If the consumption tax rate on acquisition costs of a certified home is not 8 percent or 10 percent, the amount will be JPY30 million.

(2) Maximum tax credit (Local inhabitant tax)

Under the current law, where the amount of tax credits for a given year exceeds the national income tax liability for that year, the excess will be deducted from the local inhabitant tax liability for the following year up to JPY97,500. The ceiling on the deduction is proposed to be raised in the 2013 tax reform as follows:

	Year of residence	Maximum tax credit (annual amount)
Current tax law	Until 31 December 2013	Total taxable income for national income tax x 5% (up to JPY97,500)
Proposal	From 1 January 2014 to 31 March 2014	Total taxable income for national income tax x 5% (up to JPY97,500)
	From 1 April 2014 to 31 December 2017	Total taxable income for national income tax x 7% (up to JPY136,500 ^(*))

^(*) If the consumption tax rate on acquisition costs of a home is not 8 percent or 10 percent, the amount will be up to JPY97,500.

V. TAXATION OF FINANCIAL TRANSACTIONS

1. Revision of Taxation Methods and Expansion of the Offsetting Rules

In order to promote the integration of taxation methods of financial transactions, the tax treatment of bonds and shares for resident individuals will be amended as indicated in (2) below:

(1) Current tax law for resident individuals (Principle tax treatment for major financial instruments)

Major financial instruments	Taxation methods		Offset capital losses against dividends
	Interest/Dividends	Capital gains/losses	
<ul style="list-style-type: none"> Listed shares Publicly-offered stock investment trusts 	Dividend income (Separate self-assessment taxation ^(*))	Capital Gains (Separate self-assessment taxation)	Applicable (3-year carryover of losses is available.)
<ul style="list-style-type: none"> Bonds Bond investment trusts 	Interest income (Separate withholding taxation)	Non taxable	Not applicable

(*) Instead of applying separate self-assessment taxation, a taxpayer is allowed to declare dividend income as their ordinary income or settle their tax liability on the dividends via withholding tax without declaring in their tax return. In these cases, the dividend income cannot be offset using capital losses.

The tax rate under separate self-assessment taxation is 20.315 percent (15 percent national tax, 0.315 percent special reconstruction income tax and 5 percent inhabitant tax). However, a reduced tax rate of 10.147 percent (7 percent national tax, 0.147 percent special reconstruction income tax and 3 percent inhabitant tax) is applied to listed shares, etc. until 31 December 2013.

(2) Proposal for resident individuals (Principle tax treatment for major financial instruments)

Main financial instruments	Taxation methods		Offset capital losses against interest/dividends
	Interest/Dividends	Capital gains/losses	
<ul style="list-style-type: none"> Listed shares Publicly-offered stock investment trusts 	Dividend income (Separate self-assessment taxation)	Capital Gains (Separate self-assessment taxation)	Applicable (3-year carryover of losses is available.)
Specified bonds and similar investment trusts <ul style="list-style-type: none"> Specified bonds^{(*)1} Publicly-offered bond investment trusts Publicly-offered investment trusts other than securities investment trusts 	Interest income (Separate self-assessment taxation)	Capital Gains ^{(*)2} (Separate self-assessment taxation)	
Ordinary bonds <ul style="list-style-type: none"> Bonds other than specified bonds Privately-offered bond investment trusts Privately-offered investment trusts other than securities investment trusts 	Interest income (Separate withholding taxation)	Capital Gains ^{(*)2} (Separate self-assessment taxation)	Not applicable

(^{*1}) 'Specified bonds' include the following:

- National government bonds, local government bonds, foreign national government bonds, foreign local government bonds
- Publicly-offered bonds, listed bonds
- Corporate bonds issued by a company which has submitted a Securities Report, etc. within 6 months prior to issuance
- Bonds issued on or before 31 December 2015 (except for discount bonds where tax is withheld at the time of issuance)

(^{*2}) Proceeds received due to redemption or partial cancelation will be treated as proceeds used for calculating capital gains.

The above amendments will be applied to interest on 'specified bonds and similar investment trusts' to be received on or after 1 January 2016 and transfers of 'specified bonds and similar investment trusts' and 'ordinary bonds' conducted on or after 1 January 2016.

2. Discount Bonds

Under the current tax law, discount bonds are subject to withholding tax at the time of issuance and gains from redemption are taxed as miscellaneous income by separate withholding taxation, while capital gains are non-taxable.

In line with the above amendments discussed in 1., whereby capital gains from transfers of bonds, including discount bonds, will be treated as taxable income, the following amendments for discount bonds are proposed:

Withholding Tax	<ul style="list-style-type: none"> • Withholding tax at the time of issuance will be abolished. (Applied to discount bonds issued on or after 1 January 2016.) • Certain redemption proceeds paid to individuals and foreign companies will be subject to withholding tax at the time of redemption. (Applied to redemption proceeds paid on or after 1 January 2016, except for those already withheld upon at the time of issuance.)
Redemption income/capital gains	<ul style="list-style-type: none"> • Redemption income and capital gains will be taxed as capital gains on bonds by separate self-assessment taxation. (Applied to discount bonds redeemed or transferred on or after 1 January 2016. The current tax treatment will be applied to discount bonds issued on or before 31 December 2015 and already withheld upon at the time of issuance.)

3. Tax Exemption for Small Investments in Listed Shares

The tax exemption for dividends and capital gains arising on small investments in listed shares managed in special tax exempt accounts (i.e. Japanese individual savings accounts (ISAs)) will be amended as follows:

	Current tax law	Proposal
Eligible person	Resident individuals aged over 20 years at the beginning of the year	—
Tax exempt income	Dividends and capital gains from listed shares held in ISAs	—
Tax exempt investment	The maximum acquisition cost of listed shares acquired from the date of opening an ISA with a financial institution (limited to one ISA set up per year) to the end of the year is JPY1 million.	—
Allowable period for setting up ISAs	3 years (from January 2014 to December 2016)	10 years (from January 2014 to December 2023)
Tax exempt periods	10 years from the year when each ISA is set up	5 years from the year when each ISA is set up

By virtue of this amendment, the maximum tax exempt investment amount per year will be expanded from JPY3 million (i.e. JPY1 million x 3 ISAs) to JPY5 million (i.e. JPY1 million x 5 ISAs).

4. Special Measures for Tax Exemption on Interest

(1) Withholding tax exemption on interest received by financial institutions

Under the current tax law, interest on bonds, etc. received by financial institutions such as banks having offices in Japan is exempt from withholding tax to the extent of the amount attributable to the holding period.

The Proposal indicates that the full amount of such interest will be exempt from withholding tax regardless of the holding period.

(2) Tax withholding from interest received by Japanese companies having paid-in capital of JPY100 million or more

Under the current tax law, where a Japanese company which confirms with a book-entry transfer institution that their paid-in capital is JPY100 million or more and receives interest on bonds, etc. the interest is exempt from withholding tax provided the calculation period of the interest starts within 1 year from the day of confirmation.

By virtue of the 2013 tax reform, such interest received within 1 year from the confirmation day will be exempt from withholding tax.

(3) Tax exemption for interest on book-entry bonds received by non-resident individuals or foreign companies

Under the current tax law, interest on book-entry bonds received by non-resident individuals or foreign companies is tax exempt provided certain conditions are satisfied. These special measures will be amended as follows:

- (i) The expiration date of the temporary measure to exempt book-entry corporate bonds (31 March 2013) will be eliminated in principle and it will become a permanent measure.

- (ii) Interest on book-entry bonds received by non-resident individuals or foreign companies will be fully tax exempt regardless of their holding periods.
- (iii) Withholding tax on redemption proceeds on certain book-entry discount bonds received by non-resident individuals or foreign companies at the time of redemption will be abolished, and income from the redemption proceeds will be non-taxable for income tax and corporation tax purposes provided the recipients submit application forms for exemption.
- (iv) In connection with the above amendments, other related amendments will be provided.

The above (ii), (iii) and (iv) will be applied to interest on and redemption proceeds from book-entry bonds received on or after 1 January 2016.

5. Reduced Tax Rates on Dividends and Capital Gains from Listed Shares

The Proposal confirms that the reduced tax rates on dividends and capital gains from listed shares applied to resident individuals that are available until 31 December 2013 will be abolished at the expiry date.

	Reduced tax rates (until 31 December 2013)	Standard tax rates (from 1 January 2014)
Income tax	7.147%	15.315%
Inhabitant tax	3%	5%

Although there is no indication about the reduced withholding tax rates on dividends from listed shares applicable until 31 December 2013, it is most likely that the reduced withholding tax rates will also be abolished.

[Where resident individuals receive dividends]

	Reduced tax rates (until 31 December 2013)	Standard tax rates (from 1 January 2014)
Income tax	7.147%	15.315%
Inhabitant tax	3%	5%

[Where Japanese companies/foreign companies/non-resident individuals receive dividends]

	Reduced tax rates (until 31 December 2013)	Standard tax rates (from 1 January 2014)
Income tax	7.147%	15.315%

The above income tax rates include the special reconstruction income tax (2.1 percent on income tax).

6. Others

- Local withholding tax on interest received by a Japanese company will be abolished. This will be applied to interest to be received on or after 1 January 2016.
- In line with the amendments to the tax treatment of bonds and bond investment trusts, the full amount of withholding tax imposed on bonds or bond investment trusts received by a company will become creditable against corporation tax liabilities for the company. Only the withholding tax related to its holding period is creditable under the current tax law.

VI. INHERITANCE TAX AND GIFT TAX

1. Expansion of Scope of Taxable Properties

Inheritance tax and gift tax are levied on an heir who acquired properties by inheritance and an individual (donee) who acquired properties from another individual (donor) as a gift, respectively. The scope of taxable properties depends on whether the heir/donee holds Japanese nationality and whether the heir/donee or the decedent/donor has or had a domicile in Japan.

Pursuant to the Proposal, such scope will be amended as follows in order to close a loophole that arises where children/grandchildren hold foreign nationality.

Heir Donee Decedent Donor		Domicile in Japan	No domicile in Japan		
			Japanese national		No Japanese nationality
			Domicile in Japan within past 5 years	No domicile in Japan within past 5 years	
Domicile in Japan			[A]		[B]
No domicile in Japan	Domicile in Japan within past 5 years				[C]
	No domicile in Japan within past 5 years				

[A]: All properties are subject to inheritance/gift tax. (No amendment)

[B]: Only properties located in Japan are subject to inheritance/gift tax.
(Current tax law)

→ All properties will be subject to inheritance/gift tax. (Proposal)

[C]: Only properties located in Japan are subject to inheritance/gift tax. (No amendment)

The above amendments will be applied to inheritances or gifts on or after 1 April 2013.

2. Amendments to Calculation of Inheritance Tax Liability

The inheritance tax liability for an heir that acquired properties by inheritance is generally calculated as follows:

Calculation of total inheritance tax liability	<p>(1) Calculation of total tax base (Aggregated amount of taxable value of inherited properties attributable to each heir) – (Basic exemption)</p> <p>(2) Allocation of total tax base to each statutory heir based on statutory share Amount (1) x Statutory share of each heir (Allocation is made assuming that the properties were acquired by each statutory heir in accordance with statutory shares prescribed in the Civil Law.)</p> <p>(3) Calculation of tax on (2) Amount (2) x Tax rate</p> <p>(4) Calculation of total inheritance tax liability Aggregated amount of amount (3) calculated for each statutory heir</p>
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Inheritance tax liability for each heir	$\frac{\text{Total inheritance tax liability} \times \text{Taxable value of properties attributable to each heir}}{\text{Total taxable value of properties}} - \text{Tax credits, etc.}$		
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Under the Proposal, the following amendments are proposed:

(1) Taxable value of properties

The taxable value of properties attributable to an heir is generally calculated by deducting the value of non-taxable properties, the amount of liabilities assumed from the decedent and the funeral expenses borne by the heir from the value of inherited properties. The following amendment to the value of land is proposed:

Special treatment of value of small scale land for residence

In calculating the taxable value of inherited properties, the value of small scale land (240 square meters or smaller) used as the residence of the decedent or the decedent's relatives who were dependents of the decedent may be reduced by 80 percent under certain conditions. Pursuant to the Proposal, the threshold for small scale land will be increased to 330 square meters. Moreover, other amendments, including relaxing conditions for this preferential treatment, have also been proposed.

(2) Basic exemption

The amount of the basic exemption will be reduced as follows:

[Current law] JPY50 million + JPY10 million x Number of statutory heirs

[Proposal] JPY30 million + JPY6 million x Number of statutory heirs

(3) Tax rates

Tax rates will be increased as follows:

Current law			Proposal		
Tax base for each statutory heir based on statutory share (JPY)		Tax rate	Tax base for each statutory heir based on statutory share (JPY)		Tax rate
In excess of	Not over		In excess of	Not over	
-	10 million	10%	No change		
10 million	30 million	15%			
30 million	50 million	20%			
50 million	100 million	30%			
100 million	300 million	40%	100 million	200 million	40%
-	-	-	200 million	300 million	45%
300 million		50%	300 million	600 million	50%
-	-	-	600 million	-	55%

(Note that the above tax rates are progressive tax rates.)

(4) Tax credits

The following tax credits will be amended as follows:

Credits for minors

[Current law] JPY60,000 x Number of years to reach 20 years old

[Proposal] JPY100,000 x Number of years to reach 20 years old

Credits for handicapped persons

[Current law] JPY60,000 (JPY120,000 for a severely handicapped person)
x Number of years to reach 85 years old

[Proposal] JPY100,000 (JPY200,000 for a severely handicapped person)
x Number of years to reach 85 years old

* * *

The above amendments will be applied to inheritances on or after 1 January 2015, except for the amendments to conditions for the special treatment of the value of small scale land used as residence discussed in (1), which will be applicable for inheritances on or after 1 January 2014.

3. Amendments to Calculation of Gift Tax Liability (Calendar-Year Taxation System)

The gift tax liability for a donee that acquired properties by gift is generally calculated as follows:

Tax base	Taxable value of properties — Basic exemption (JPY1.1 million) — Exemption for spouses
Gift tax liability	Tax base x Tax rate — Foreign tax credit

Under the Proposal, the following amendments are proposed:

(1) Taxable value of properties

The taxable value of properties for a donee is calculated as the value of properties acquired by gift in a given calendar year less the value of non-taxable properties. The following new measure to expand the scope of non-taxable properties will be introduced in the 2013 tax reform:

Special tax measure for education funds

A temporary measure to exempt a gift of education funds from a person to their children or grandchildren from gift tax will be introduced. An outline of the measure is as follows:

Gift of education funds from a person to their child or grandchild (donee)	<p>The gift will be exempt subject to the following conditions:</p> <ul style="list-style-type: none"> • Lineal ascendants of the donee (under 30 years old) create a trust with a financial institution and contribute money as education funds. • The maximum contribution for each donee: JPY15 million (JPY5 million for contributions where the donee will make payments to someone other than a school) • Eligible period for contribution: From 1 April 2013 to 31 December 2015 • The donee submits a report on the non-taxable education funds to the competent tax office.
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Withdrawals of the education funds	<ul style="list-style-type: none"> • The donee submits evidence of payments of education expenses to the financial institution. • The financial institution confirms the evidence, makes records and keeps the documents.
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When the donee reaches 30 years old	<ul style="list-style-type: none"> • The financial institution submits a report including the original contributed amount and withdrawn amount. • The remaining balance will be taxed, if any.
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The scope of eligible education expenses will be designated by the Minister of Education, Culture, Sports, Science and Technology.

(2) Tax rates

The gift tax rates will be amended as follows:

Current law			Proposal					
			(A) Gifts other than (B)			(B) Gifts from lineal ascendants (where the donee is 20 years old and above)		
Tax base (JPY)		Tax rate	Tax base (JPY)		Tax rate	Tax base (JPY)		Tax rate
In excess of	Not over		In excess of	Not over		In excess of	Not over	
-	2 million	10%	No change			No change		
2 million	3 million	15%				2 million	4 million	15%
3 million	4 million	20%				4 million	6 million	20%
4 million	6 million	30%				6 million	10 million	30%
6 million	10 million	40%				10 million	15 million	40%
-	-	-	10 million	15 million	45%	15 million	30 million	45%
10 million	-	50%	15 million	30 million	50%	30 million	45 million	50%
-	-	-	30 million	-	55%	45 million	-	55%

(Note that the above tax rates are progressive tax rates.)

The tax rate changes will be applied to gifts on or after 1 January 2015.

4. Integrated Gift and Inheritance Tax System

A donee who acquired properties by gift can choose the integrated gift and inheritance tax system instead of the ordinary gift taxation system (i.e. the calendar-year system discussed in 3. above) if the donor and donee for the gift meet certain conditions, which are proposed to be changed as follows:

	Current law	Proposal
Donor	65 years old or above	60 years old or above
Donee	A presumed heir who is a lineal descendant of the donor (i.e. a child of the donor) and 20 years old or above	A presumed heir who is a lineal descendant of the donor (i.e. a child of the donor) and 20 years old or above or A grandchild of the donor who is 20 years old or above

The following is an outline of the integrated gift and inheritance tax system. Generally, the system allows a donee to defer paying part of the gift tax until the time of inheritance and provides a reduction to the gift tax burden equivalent to the inheritance tax burden.

(1) At the time of gift		(2) At the time of inheritance
<u>Gift tax liability</u> {(Taxable value of properties) – (Special exemption)} x 20 % • Special exemption JPY25 million for each donor (available over two years or more)	⇒	<u>Taxable value of properties</u> Taxable value of properties of (1) is included. <u>Inheritance tax liability</u> Gift tax paid in (1) is credited in the calculation of inheritance tax liability (refunded, if not fully creditable).

This amendment will be applied to gifts on or after 1 January 2015.

5. Tax Regime to Facilitate Succession of Businesses

Special tax rules to defer and exempt inheritance/gift tax on unlisted shares when a successor of a company issuing the unlisted shares acquires the shares from the previous owner by inheritance or gift were introduced under the 2009 tax reform with the aim of facilitating succession of small and medium-sized businesses to the next generation. As these rules have not been widely utilized due to difficulties in meeting the conditions, amendments to such conditions, claw-back events and other procedures are included in under the Proposal.

An outline of the special tax rules for inheritance tax purposes and the main proposed amendments are as follows:

Inheritance from the previous owner of a qualified company to a successor	Payments of inheritance tax on 80 percent of the inherited voting shares (limited to two-third of the total outstanding voting shares) of the qualified company are deferred where certain conditions are satisfied.	
↓		
5 years from the filing due date of the inheritance tax return	<p>Grace period for payments</p> <p>In certain cases inclusive of the following, the successor has to pay all deferred inheritance tax and interest thereon:</p> <ul style="list-style-type: none"> • When the successor sells some of the shares in the qualified company. • When the successor forfeits his rights as representative of the qualified company. • When 'A' becomes smaller than 80 percent of 'B'. <p>A: Number of employees as of the base day (annual anniversary of the filing due date)</p> <p>B: Number of employees as of the commencement of the inheritance</p>	<p>← [Proposal]</p> <p>'A' will be amended to 'the average number of employees over 5 years'.</p>
↓		
After 5 years from the filing due date of the inheritance tax return	<p>Grace period for payments</p> <p>If the successor sells some of the shares in the qualified company, the successor has to pay inheritance tax relating to the sold shares and interest thereon.</p>	<p>← [Proposal]</p> <p>Interest will be exempted for the first 5 years from the filing due date of the inheritance tax return.</p>
↓		
Death of the successor	All deferred inheritance tax is exempt.	

The major conditions for application of the special rules and the main proposed amendments are as follows:

Qualified company	<ul style="list-style-type: none"> • A small or medium-sized company which obtained confirmation from the Minister of Economy, Trade and Industry (METI) before commencement of the inheritance and a certification from METI after commencement of the inheritance under the Act for Facilitating Succession of Small and Medium-sized Businesses; • An unlisted company; and • Not an asset management company. 	← [Proposal] The requirement for a confirmation from METI will be abolished. Scope of an asset management company will be amended.
Successor (heir)	<ul style="list-style-type: none"> • The heir has the right of representative for the qualified company as of 5 months after commencement of the inheritance; • The heir was a relative of the previous owner just before commencement of the inheritance; and • The heir and the heir's family members hold aggregately the majority of the voting shares in the qualified company at commencement of the inheritance and the heir holds the largest number of voting shares among those people. 	← [Proposal] This condition will be abolished.
Previous owner (decendent)	<ul style="list-style-type: none"> • The decedent had the right of representative for the qualified company; and • The decedent and the decedent's family members held aggregately the majority of the voting shares in the qualified company just before commencement of the inheritance and the decedent held the largest number of voting shares among those people (excluding the heir). 	

The special tax rules for gift tax purposes operate to defer payments of gift tax relating to voting shares (limited to two-third of the total outstanding voting shares) in a qualified company transferred from a previous owner to their successor by gift. Amendments to the rules, such as a relaxing of the conditions necessary for applying the rules, will also be proposed.

The above amendments will be applied to inheritances and gifts on or after 1 January 2015.

VII. REDUCTION IN DELINQUENCY TAX RATE

The special tax rates for delinquency tax, etc. will be reduced as follows:

			Standard tax rate	Special tax rates			
				Current tax law		Proposal	
				When [A] < 7.3%		When [B] < 7.3%	
				Tax rate	(Current tax rates)	Tax rate	(Example) (*)
Delinquency tax			14.6%	—	—	[B] + 7.3%	9.3%
Special measures	2-month period from the day following the due date		7.3%	[A]	4.3%	[B] + 1% (capped at 7.3%)	3.0%
	certain cases where tax payments are postponed		1/2 exemption (7.3%)	[A]	4.3%	[B]	2.0%
Interest tax (on delinquent or postponed tax payments for income and corporation tax purposes)			7.3%	[A]	4.3%	[B]	2.0%
Interest on refunded tax			7.3%	[A]	4.3%	[B]	2.0%

[A]: Basic Discount Rate + 4%

[B]: Average Contract Interest Rates on Loans and Discounts + 1%

'Average Contract Interest Rates on Loans and Discounts' is the average of the short-term average contract interest rates on new bank loans (which is released every month by the Bank of Japan) for the period from October of the preceding previous year to September of the previous year. The rate to be applied for a given year will be notified by the Minister of Finance on or before 15 December of the previous year.

^(*) This column indicates tax rates where the Average Contract Interest Rates on Loans and Discounts is 1 percent.

The above special tax rates will be applicable to delinquency tax, etc. corresponding to the period on or after 1 January 2014.

In addition, special tax rates of delinquency tax, etc. for local tax purposes will also be amended in a similar way.

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