

KPMG Japan tax newsletter

Draft Outline of the 2016 Tax Reform Proposals



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The tax commission of the ruling coalition (the Liberal Democratic Party and New Komeito) agreed on a draft of the 'Outline of the 2016 Tax Reform Proposals' ('Proposal') except for items related to the reduced consumption tax rates on 10 December 2015. We have set out below brief summaries of the main points of the draft of the Proposal. (We will release another newsletter for items related to the reduced consumption tax rates when the Proposal is officially released.)

Please note that the contents shown in the draft of the Proposal could differ from the Proposal officially released.

I. CORPORATE TAX RATES

1. Reduction in Effective Corporate Tax Rates

(1) Corporation tax rates

National corporation tax rates applicable for fiscal years beginning on or after 1 April 2016 will be reduced as follows:

Size of company		Current tax law	Proposal	
		Fiscal years beginning on or after 1 April 2015	Fiscal years beginning between 1 April 2016 and 31 March 2018	Fiscal years beginning on or after 1 April 2018
Large-sized companies, etc.		23.9%	23.4%	23.2%
Small and medium-sized companies ^(**2)	Taxable income up to JPY8 million per year	19% (15% ^(**1))	19% (15% ^(**1))	19%
	Taxable income in excess of JPY8 million per year	23.9%	23.4%	23.2%

^(**1) The reduced tax rate (15 percent) will be applicable for fiscal years beginning prior to 1 April 2017.

^(**2) Small and medium-sized companies for the purposes of this rule are defined as companies with stated 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 stated 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.

(2) Tax rates for business tax (income component) and special local corporation tax

Tax rates for business tax (income component) and special local corporation tax which are applicable to companies with stated capital in excess of JPY100 million (i.e. companies subject to size-based business tax) will be amended as follows.

Note that special local corporation tax which was introduced in 2008 provisionally as a means of reallocating business tax revenue among local governments in order to decrease the gaps in local tax revenue between urban and rural areas will be abolished and restored to business tax from fiscal years beginning on or after 1 April 2017. (The abolishment of special local corporation tax will be applied to not only companies subject to size-based business tax but to all companies.)

[Business tax (income component)] (Standard tax rates)

Taxable base (taxable income)		Current tax law		Proposal	
		Fiscal years beginning between 1 April 2015 and 31 March 2016	Fiscal years beginning on or after 1 April 2016	Fiscal years beginning between 1 April 2016 and 31 March 2017	Fiscal years beginning on or after 1 April 2017
In excess of	Up to				
-	JPY4 million	1.6% (3.1%)	0.9% (2.5%)	0.3% (1.9%)	1.9%
JPY4 million	JPY8 million	2.3% (4.6%)	1.4% (3.7%)	0.5% (2.7%)	2.7%
JPY8 million	-	3.1% (6.0%)	1.9% (4.8%)	0.7% (3.6%)	3.6%

- Tax rates shown in parentheses include special local corporation tax.
- The maximum tax rates are 1.2 times the standard rates. The maximum tax rates for fiscal years beginning between 1 April 2016 and 31 March 2017 will be increased up to 2 times the standard rates.
- The reduced tax rates for taxable income of JPY8 million or less are not applicable to companies that have offices in three or more different prefectures.

[Special local corporation tax]

Taxable base	Current tax law		Proposal	
	Fiscal years beginning between 1 April 2015 and 31 March 2016	Fiscal years beginning on or after 1 April 2016	Fiscal years beginning between 1 April 2016 and 31 March 2017	Fiscal years beginning on or after 1 April 2017
Taxable income x Standard rate of business tax	93.5%	152.6%	414.2%	Abolished

(3) Reduction in inhabitant tax rates and increase in local corporation tax rate

Local corporation tax was introduced in order to decrease the gaps in local tax revenue between urban and rural areas. Part of inhabitant tax is collected as local corporation tax, which is reallocated from the national government to local governments. Due to the abolishment of special local corporation tax, as one of the supplemental measures to make up for the function of such tax, the inhabitant tax rates will be reduced and local corporation tax rates will be increased for fiscal years beginning on or after 1 April 2017.

As this amendment is to adjust tax revenue between urban and rural areas, they should raise little impact on the total tax burden of Japanese corporate taxpayers.

[Current tax law]

Inhabitant tax		Local corporation tax	
Taxable base	Tax rate	Taxable base	Tax rate
Corporation tax (National tax)	Standard rate 12.9% Prefectural: 3.2% Municipal: 9.7%	Corporation tax (National tax)	4.4%
	Maximum rate 16.3% Prefectural: 4.2% Municipal: 12.1%		

[Proposal]

Inhabitant tax		Local corporation tax	
Taxable base	Tax rate	Taxable base	Tax rate
Corporation tax (National tax)	Standard rate 7.0% Prefectural: 1.0% Municipal: 6.0%	Corporation tax (National tax)	10.3%
	Maximum rate 10.4% Prefectural: 2.0% Municipal: 8.4%		

(4) Effective corporate tax rate

By virtue of the amendments discussed above, the effective corporate tax rate will be reduced as follows:

	Fiscal years beginning between 1 April 2015 and 31 March 2016	Fiscal years beginning between 1 April 2016 and 31 March 2018	Fiscal years beginning on or after 1 April 2018
Current tax law	32.11%	31.33%	
Proposal	-	29.97%	29.74%

[Details of effective corporate tax rate] (Proposal)

	Fiscal years beginning between 1 April 2016 and 31 March 2017	Fiscal years beginning between 1 April 2017 and 31 March 2018	Fiscal years beginning on or after 1 April 2018
Corporation tax	23.4%	23.4%	23.2%
Business tax	0.7%	3.6%	3.6%
Special local corporation tax	2.899% (0.7% x 414.2%)	-	-
Prefectural and municipal tax	3.019% (23.4% x 12.9%)	1.638% (23.4% x 7.0%)	1.624% (23.2% x 7.0%)
Local corporation tax	1.030% (23.4% x 4.4%)	2.410% (23.4% x 10.3%)	2.390% (23.2% x 10.3%)
Total	31.048%		30.814%
Effective tax rate	29.97% (31.048% x 100/103.6)		29.74% (30.814% x 100/103.6)

The above effective tax rates take into account the tax deductibility of special local corporation tax and business tax payments, and are calculated using the standard tax rates applied to a company whose stated capital is over JPY100 million.

The effective corporate tax rate using Tokyo tax rates applied to a company whose stated capital is over JPY100 million is currently 33.06 percent and the future tax rates will be available after the business tax rates (income component) for Tokyo are determined in the range between the standard rates and the maximum tax rates.

2. Size-Based Business Tax

Size-based business tax to be levied based on corporate business size, not on corporate income/revenue, as consideration for administration services provided by local governments was introduced in 2004. Although the amendments to size-based business tax (including increases in tax rates) were made in order to make up for lost tax revenues caused by the reduction of the effective corporate tax rates under the 2015 tax reform, further increases in tax rates are proposed under the 2016 tax reform.

(Companies subject to size-based business tax are companies with stated capital in excess of JPY100 million, excluding companies which are liable for business tax on their revenue (companies conducting electricity/gas supply business or insurance business) and Toshi-Houjin (J-REITs)/Tokutei Mokuteki Kaisha (TMKs), etc. Such scope will not be amended under the 2016 tax reform.)

(1) Increases in tax rates

Tax rates for size-based business tax will be increased as follows:

	Current tax law		Proposal
	Fiscal years beginning between 1 April 2015 and 31 March 2016	Fiscal years beginning on or after 1 April 2016	Fiscal years beginning on or after 1 April 2016
Added value component	0.72%	0.96%	1.2%
Capital component	0.3%	0.4%	0.5%

The above tax rates are the standard tax rates. The maximum tax rates are 1.2 times the standard rates.

(2) Special measures to minimize rapid increase in tax burden

Special measures to minimize a rapid increase in the tax burden due to the increase in business tax rates which were introduced under the 2015 tax reform will be amended as follows and applied for 3 years.

[Current tax law]

Eligible companies	Reduced tax burden	
	Fiscal years beginning between 1 April 2015 and 31 March 2017	
Tax base for added value component \leq JPY3 billion	A x 1/2	
JPY3 billion < Tax base for added value component < JPY4 billion	A x (JPY4 billion - the amount of added value component)/JPY2 billion	
A = (a) - (b) (a): Amount of business tax (all components) for the fiscal year (b): <u>Fiscal years beginning between 1 April 2015 and 31 March 2016</u> Amount of hypothetical business tax (all components) calculated using the tax rates as of 31 March 2015 <u>Fiscal years beginning between 1 April 2016 and 31 March 2017</u> Amount of hypothetical business tax (all components) calculated using the tax rates as of 31 March 2016		

[Proposal]

Eligible companies	Reduced tax burden		
	Fiscal years beginning between 1 April 2016 and 31 March 2017	Fiscal years beginning between 1 April 2017 and 31 March 2018	Fiscal years beginning between 1 April 2018 and 31 March 2019
Tax base for added value component \leq JPY3 billion	A x 3/4	A' x 1/2	A' x 1/4
JPY3 billion < Tax base for added value component < JPY4 billion	A x Ratio between 0 and 3/4 (depending on the amount of added value component)	A' x Ratio between 0 and 1/2 (depending on the amount of added value component)	A' x Ratio between 0 and 1/4 (depending on the amount of added value component)
A = (a) - (b) (a): Amount of business tax (all components) for the fiscal year (b): Amount of hypothetical business tax (all components) calculated using the tax rates as of 31 March 2016 A' = (a) - (b) (a): Amount of business tax (all components) for the fiscal year (b): Amount of hypothetical business tax (all components) and special local corporation tax calculated using the tax rates as of 31 March 2016			

II. CORPORATE TAXATION

1. Tax Loss Carry-Forwards

The tax loss carry-forward rules will be amended as below. The tax loss carry-forward rules cover (i) carry-forward rules for tax losses incurred by blue-return filing taxpayers, (ii) carry-forward rules for tax losses incurred through disasters by non-blue-return filing taxpayers and (iii) carry-forward rules for tax losses by tax consolidation groups.

(1) Deductible amount of tax losses

The deductible amount of tax losses brought forward will be reduced as follows:

	Fiscal years beginning between 1 April 2015 and 31 March 2016	Fiscal years beginning between 1 April 2016 and 31 March 2017	Fiscal years beginning between 1 April 2017 and 31 March 2018	Fiscal years beginning on or after 1 April 2018
Current tax law	Up to 65% of taxable income for the fiscal year		Up to 50% of taxable income for the fiscal year	
Proposal	-	Up to 60% of taxable income for the fiscal year	Up to 55% of taxable income for the fiscal year	Up to 50% of taxable income for the fiscal year

Please note that the deductible amount of tax losses brought forward for certain companies such as small and medium-sized companies^{(*)1}, newly established companies^{(*)2}, tax qualifying Tokutei Mokuteki Kaisha (TMKs) and Toshi Houjin (J-REITs) is up to the total amount of taxable income for the year.

(*)1 Same as those described in I.1.(1) above

(*)2 Newly established company (under 7 years old) does not include the following:

- 100 percent of the shares are directly or indirectly held by one large-sized company (a company whose stated 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.

(2) Timing of application for extension of tax loss carry-forward period

Under the 2015 tax reform, the tax loss carry-forward period was extended from 9 years to 10 years. The timing of application for this amendment will be pushed back as follows:

	Tax losses incurred in fiscal years ending on or after 1 April 2008	Tax losses incurred in fiscal years beginning on or after 1 April 2017	Tax losses incurred in fiscal years beginning on or after 1 April 2018
Current tax law	9 years	10 years	
Proposal	9 years		10 years

In this connection, the preservation period for accounting documents related to the application of the tax loss carry-forward rules, the statute of limitations for corrections by the tax authorities with respect to tax losses and requests for correction by taxpayers with respect to tax losses will also be extended from 9 years to 10 years for tax losses incurred in fiscal years beginning on or after 1 April 2018.

2. Depreciation Methods

In order to make up for lost tax revenues caused by the reduction of the effective corporate tax rates, it is proposed that the declining-balance method will not be available for attachments to buildings, structures and buildings for mining.

Tangible fixed assets		Depreciation methods	
		Current tax law	Proposal
Buildings		Straight-line method	Straight-line method
Attachments to buildings Structures		Straight-line method or Declining-balance method	
Machinery Ships, Aircraft Vehicles and transport equipment Tools, Furniture/fixtures			Straight-line method or Declining-balance method
Depreciable assets for mining	Buildings Attachments to buildings Structures	Straight-line method or Declining-balance method or Production output method	
	Other than the above		Straight-line method or Declining-balance method or Production output method

This amendment will be applied to attachments to buildings, structures and buildings for mining acquired on or after 1 April 2016.

3. Reduction in Fixed Asset Tax Burden for SMEs

The Proposal includes the following special measure with respect to fixed asset tax imposed on SMEs, which is contingent upon the establishment of the SME Productivity Enhancement Act (provisional title).

Eligible SMEs	<ul style="list-style-type: none"> • A company with stated capital of JPY100 million or less • A company with no capital whose number of regular employees is 1,000 or less • An individual whose number of regular employees is 1,000 or less
Conditions	An eligible SME acquires an eligible asset which is indicated in the approved Productivity Enhancement Plan as Productivity Improvement Facilities for the period from the effective date of the SME Productivity Enhancement Act to 31 March 2019
Eligible assets	Machinery and equipment meeting the following three conditions: <ol style="list-style-type: none"> It was released to the market within the previous 10 years. It makes the productivity (production volume, accuracy, energy efficiency, etc. per unit of time) increase by 1% or more on an annual basis compared to the older model. The acquisition cost is JPY1,600,000 or more per unit.
Reduction in tax burden	The tax base of an eligible asset will be reduced by 1/2 for the first 3 years.

4. Directors' Compensation

In principle, compensation paid to company directors is deductible provided that such compensation falls into one of the following three categories. Under the Proposal, the following amendments have been proposed with respect to B (fixed compensation notified in advance) and C (profit-based compensation).

Deductible directors' compensation	Proposal
<p><u>A. Fixed amount periodical compensation</u> Compensation regularly paid on a monthly/weekly/daily basis with a fixed amount through a fiscal year</p>	No change
<p><u>B. Fixed compensation notified in advance</u> Compensation fixed in the amount and timing of the payment which falls under neither A nor C and for which an advance notification is filed with the competent tax office</p>	The requirement for advance notifications with respect to certain restricted shares granted as compensation for future services performed by directors will be eliminated.
<p><u>C. Profit-based compensation</u> Compensation which is calculated based on parameters related to profits and which meets certain conditions</p>	It will be clarified that certain parameters such as ROE (Return on Equity) are available as parameters related to profits used to calculate profit-based compensation.

5. Corporate Version of Hometown Tax

This new rule is contingent upon the amendment to the Regional Revitalization Act. When a blue-return filing company pays contributions to local governments with respect to designated businesses stated in a certified Regional Revitalization Plan under the Regional Revitalization Act for the period from the effective date of the revised Regional Revitalization Act to 31 March 2020, the company will be able to take tax credits for such contributions (A) as follows:

		Fiscal years beginning on or before 31 March 2017	Fiscal years beginning on or after 1 April 2017
Business tax liability		(A) x 10% (capped at 20% of the business tax liability)	(A) x 10% (capped at 15% of the business tax liability)
Inhabitant tax levied on corporation tax liability	Prefectural	(A) x 5% (capped at 20% of the prefectural tax liability)	(A) x 2.9% (capped at 20% of the prefectural tax liability)
	Municipal	(A) x 15% (capped at 20% of the municipal tax liability)	(A) x 17.1% (capped at 20% of the municipal tax liability)
Corporation tax liability		The smaller amount of the following: <ul style="list-style-type: none"> (A) x 20% - the creditable amount for inhabitant tax purposes (A) x 10% (capped at 5% of the corporation tax liability) 	

The tax burden of a company which pays contributions discussed above (i.e. corporate version of hometown tax) could be reduced by approximately 60 percent of such contributions; i.e. (i) 30 percent of the contributions by taking a deduction for the contributions to local governments (assuming that the effective corporate tax rate for the company is 30 percent) and (ii) 30 percent of the contributions by using the above tax credit rules (assuming that the maximum amount is creditable.).

6. Special Measures for National Strategic Special Zones

(1) Income deduction

The following income deduction will be introduced, which is contingent upon the introduction of a company designation regime by amendments to the National Strategic Special Zones Act:

Eligible companies	A blue-return filing Japanese company which meets the following conditions: <ul style="list-style-type: none"> • It is established on or after the designated date of the national strategic special zones. • It has a head office or a main office in the national strategic special zones. • It is engaged exclusively in certain specified businesses. • It is a certain company designated by the Minister of State for the National Strategic Special Zones for the period from the effective date of the revised National Strategic Special Zones Act to 31 March 2018.
Applicable periods	5 years from the date of establishment
Income deduction	Income x 20%

The above income deduction will not be applicable at the same time as the tax reduction for investments in facilities in the national strategic special zones or the tax reduction for investments in facilities in the comprehensive special zones for international competitiveness.

(2) Tax reduction for investments in facilities

The tax reduction for investments in facilities in the national strategic special zones was introduced under the 2014 tax reform and the underlined parts below will be amended.

Eligible companies	Blue-return filing companies named in an approved area plan as an entity to implement a certain specified business under the National Strategic Special Zones Act			
Conditions	Blue-return filing companies acquire new eligible assets referred to in a business execution plan and put them into use for the specified business in the national strategic special zones during the period from 1 April 2014 to <u>31 March 2016</u>			
Tax Incentives	(i) or (ii)	Machinery R&D furniture/fixtures		Buildings Attachments to buildings Structures
		Certain items used for specified core business	Other than items on the left	
	(i) Special depreciation	<u>Total acquisition costs can be expensed upfront</u>	Acquisition cost x 50%	Acquisition cost x 25%
	(ii) Tax credit (capped at 20% of the corporation tax liability)	Acquisition cost x 15%		Acquisition cost x 8%

Changes

- The applicable period will be extended for 2 years.
- Special depreciation applied to 'certain items used for specified core business' (the measure that total acquisition costs can be expensed upfront) will be abolished.

Currently, if the creditable amount exceeds the maximum tax credit, the excess portion can be carried forward to the following year. Such rule will also be abolished.

7. Other Amendments

(1) Entertainment expenses

Under the current tax law, the deductible entertainment expenses for each fiscal year beginning on or before 31 March 2016 are as follows and this will be extended for 2 years.

Size of company	Deductible limit
Small and medium-sized companies ^(*)	JPY8 million or 50% of eating and drinking expenses
Companies other than small and medium-sized companies	50% of eating and drinking expenses

^(*) Same as those described in I.1.(1) above

(2) Lump-sum depreciation for small depreciable assets for small and medium-sized companies

If small and medium-sized companies (certain companies with stated capital of JPY100 million or less) acquire small depreciable assets (whose acquisition cost is less than JPY300,000 per unit) and put them into use for their business, the companies are eligible for lump-sum depreciation for the assets for the fiscal year when they put them into use for their business (capped at JPY3,000,000 per year). The rule will be amended as follows:

- A company whose number of regular employees is more than 1,000 will be excluded from the eligible companies.
- The applicable period will be extended for 2 years.

(3) Timing of deduction of costs for restricted shares

Where a company grants restricted shares to individuals as compensation for future services performed by them, costs for such services will be deductible in a fiscal year when the restricted shares are vested.

The amendment will be applied to restricted shares for which the resolutions on granting are made on or after 1 April 2016.

III. INTERNATIONAL TAXATION

1. Transfer Pricing Documentation

The Organisation for Economic Co-operation and Development (OECD) released the final package for the Base Erosion and Profit Shifting (BEPS) Project on 5 October 2015 and the transfer pricing documentation rules were presented in the report 'Action 13 - Transfer Pricing Documentation and Country-by-Country Reporting.' In accordance with the report, multinational enterprise groups will be obliged to provide (or prepare and retain) three kinds of documents (Country-by-Country report (CbC Report), master file and local file) to the tax authorities.

By virtue of the 2016 tax reform, the following documentation rules will be provided for in the domestic tax law based on the BEPS final report.

(1) Terminology

The definitions of keywords such as 'MNE Group' are as follows:

MNE Group	A collection of enterprises required to prepare consolidated financial statements for financial reporting purposes under applicable accounting principles (excluding a collection of enterprises of which the parent company is also a subsidiary of other collections of enterprises required to prepare consolidated financial statements), which includes two or more enterprises the tax residence for which is in different jurisdictions or includes an enterprise that is resident for tax purposes in one jurisdiction having a permanent establishment (PE) in another jurisdiction
Constituent Entity	<ul style="list-style-type: none"> Any separate business unit of an MNE Group of which assets and profits/losses are included in the consolidated financial statements under applicable accounting principles Any separate business unit of an MNE Group that is excluded from the MNE Group's consolidated financial statements solely on size or materiality grounds
Ultimate Parent Entity	A Constituent Entity of an MNE Group that controls the other Constituent Entities of such MNE Group
Surrogate Parent Entity	One Constituent Entity of the MNE Group that has been appointed by the Ultimate Parent Entity, as a sole substitute for the Ultimate Parent Entity, to file the CbC Report

(2) CbC Report

Outline	A reporting entity of an MNE Group shall file a CbC Report to the competent tax office by the deadline through an online system (e-Tax).
Reporting entity ((1) or (2))	<p>(1) Primary mechanism Either of the following Japanese companies which are a Constituent Entity of an MNE Group</p> <ul style="list-style-type: none"> Ultimate Parent Entity Surrogate Parent Entity <p>(2) Secondary mechanism (This mechanism will be applied where the Japanese tax authorities acknowledge that a CbC report is not provided through the jurisdiction in which the Ultimate Parent Entity or the Surrogate Parent Entity is resident for tax purposes provided that Japan has concluded a relevant agreement such as a tax treaty with the jurisdiction.) Either of the following Constituent Entities of an MNE Group</p> <ul style="list-style-type: none"> A Japanese company which is a Constituent Entity but neither the Ultimate Parent Entity nor the Surrogate Parent Entity A foreign company having a PE in Japan <p>(If there are two or more Constituent Entities falling under the above, only one of them shall file a CbC report as a representative of the entities.)</p>
Excluded MNE Group	Where total consolidated group revenue for the fiscal year immediately preceding the reporting fiscal year for an MNE Group is less than JPY100 billion, the MNE Group will be exempt from filing a CbC Report.

Items to be reported	Same as items presented in Annex III to Chapter 5 of the OECD Transfer Pricing Guidelines, the amendment to which is proposed in the BEPS Action 13 final report (e.g. revenues, profit (loss) before income tax, income tax paid, number of employees, tangible assets other than cash and cash equivalents by each tax jurisdiction)
Time for filing	No later than 1 year after the last day of the reporting fiscal year of the Ultimate Parent Entity
Language	English
Penalties	If a reporting entity fails to file a CbC report to the competent tax office by the deadline, penalties will be imposed.
Timing of application	The above rules will be applied for fiscal years of the Ultimate Parent Entity beginning on or after 1 April 2016.

(3) Master file

Outline	A reporting entity of an MNE Group shall file a master file to the competent tax office by the deadline through an online system (e-Tax).
Reporting entity	Either of the following Constituent Entities of an MNE Group <ul style="list-style-type: none"> • A Japanese company • A foreign company having a PE in Japan (If there are two or more Constituent Entities falling under the above, only one of them shall file a master file as a representative of the entities.)
Excluded MNE Group	Where total consolidated group revenue for the fiscal year immediately preceding the reporting fiscal year for an MNE Group is less than JPY100 billion, the MNE Group will be exempt from filing a master file.
Items to be reported	Same as items presented in Annex I to Chapter 5 of the OECD Transfer Pricing Guidelines, the amendment to which is proposed in the BEPS Action 13 final report (e.g. organizational structure, description of businesses, intangibles, intercompany financial activities, financial positions of the MNE Group)
Time for filing	No later than 1 year after the last day of the reporting fiscal year of the Ultimate Parent Entity
Language	Japanese or English
Penalties	If a reporting entity fails to file a master file to the competent tax office by the deadline, penalties will be imposed.
Timing of application	The above rules will be applied for fiscal years of the Ultimate Parent Entity beginning on or after 1 April 2016.

(4) Local file (Contemporaneous documentation)

Outline	A company conducting transactions with foreign affiliates shall prepare documents that are considered to be necessary for calculating the arm's length price for the transactions (local file) by the filing due date of a final tax return.
Company which must prepare a local file	A company that conducts transactions with foreign affiliates
Transactions not subject to contemporaneous documentation	A company does not have to prepare a local file with respect to transactions with a foreign affiliate for the current fiscal year by the filing due date of a final return provided that both of the following conditions are met: <ul style="list-style-type: none"> • Total transaction amount with that foreign affiliate for the previous fiscal year (the current fiscal year if the previous fiscal year does not exist) is less than JPY5 billion. • Total transaction amount for intangibles with that foreign affiliate for the previous fiscal year (the current fiscal year if the previous fiscal year does not exist) is less than JPY300 million.
Items to be reported	Under the current documentation rules (Article 22-10 (1) in the Ordinance for Enforcement of the Act on Special Measures Concerning Taxation), the following are required to be presented or submitted: <ul style="list-style-type: none"> • Document containing details of transactions with foreign affiliates • Documents used to determine the arm's length price

	Certain amendments will be made to the current documentation rules, including clarification of items to be stated in such documents. Furthermore, items presented in Annex II to Chapter 5 of the OECD Transfer Pricing Guidelines, the amendment to which is proposed in the BEPS Action 13 final report will be included in the current documentation rules.
Term and place of retention	As a general rule, a company that conducts transactions with foreign affiliates must retain local files in their offices located in Japan for 7 years from the filing due date of a final tax return. (Original documents should be preserved if they are available in Japan. The preservation of copies of documents is allowed if the originals of them are located outside of Japan.)
Presumptive assessment/ Secret comparables	The rules to give the tax authorities the power to make an assessment presumptively and the authority to inquiry and inspect third parties conducting similar trade or business (so-called secret comparables) will be reviewed.
Timing of application	The above amendments will be applied for fiscal years beginning on or after 1 April 2017.

2. Anti-Tax Haven (CFC) Rules

(1) Amendments to exception conditions for insurance companies

An insurance company operating in the UK Lloyd's market is obliged to divide its operation into a managing agent and a member under the Lloyd's Act. For this reason, it has been pointed out that companies established in conformity with the rule might not satisfy the exception conditions of the anti-tax haven (CFC) rules in Japan.

In accordance with the above issue and the reduction in the corporation tax rate in the UK, the following special provisions for the exception conditions will be introduced.

Exception conditions	Special treatment
Substance Test/ Administration and Control Test	Where B Co. satisfies the Substance Test/Administration and Control Test in the country where the main or head office of A Co. is located, A Co. will be treated as satisfying the Substance Test/Administration and Control Test.
Unrelated Party Test	Transactions between A Co. and B Co. will not be treated as transactions with related parties.

A Co: A Specified Foreign Subsidiary (SFS) all of the shares in which are held directly or indirectly by a Japanese company and which operates insurance business in the UK Lloyd's market and meets other conditions

B Co: Another SFS all of the shares in which are held directly or indirectly by the same Japanese company and which operates insurance business in the UK Lloyd's market and meets other conditions

In addition to the above, other related amendments will be provided.

(2) Amendments to calculation of foreign tax credits (FTC)

A Japanese company is able to take a foreign tax credit for foreign corporation taxes paid by its SFSs. The foreign corporation taxes subject to the foreign tax credits are calculated as follows:

Foreign corporation taxes imposed on income of SFSs	x	$\frac{\text{Income of SFSs which is aggregated to the Japanese company's income}}{\text{Income of SFSs}}$
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When an SFS receives dividends from its subsidiary (a company 25 percent or more of the shares in which are held by the SFS for at least 6 months), such dividends are included in the denominator under the current tax law. The law will be amended that such dividends which are not included in the taxable income of the SFS will not be included in the denominator.

The above amendments discussed in (1) and (2) will be applied for fiscal years of an SFS beginning on or after 1 April 2016.

3. Scope of Tax-Qualified Contributions-in-Kind

The scope of tax-qualified contributions-in-kind to foreign companies will be amended as follows:

('Qualified' in the table below means that the contribution-in-kind discussed in the cell could be a tax-qualified contribution-in-kind subject to other conditions.)

Transferred assets	Transferor company	Transferee company	Current tax law	Proposal
Japan Assets ^(*)	Japanese company or Foreign company	Foreign company	Non-qualified	[In principle] Non-qualified [Special treatment] Qualified – where a Japanese company or a foreign company transfers its Japan Assets to a PE located in Japan of another foreign company under a contribution-in-kind to make all the transferred Japan Assets directly attributable to the PE (except for where the transferred assets include specified assets ^(*) and it is expected that the specified assets will be internally transferred after the contribution-in-kind) ^(*) Specified assets means certain assets located in Japan (e.g. real estate located in Japan). When specified assets are transferred internally (e.g. from a Japanese branch to the head office of a foreign company), the internal dealing is treated as being made at book value.
			Qualified	[In principle] Qualified [Special treatment] Non-qualified – where there are the following two-step transactions: (i) A Japanese company transfers its Japan Assets to its foreign office. (Such Japan Assets become Foreign Assets.) (ii) The Japanese company transfers the Foreign Assets discussed in (i) (excluding cash, bank deposits, inventories and securities) to a foreign office of a foreign company under a contribution-in-kind within 1 year from (i) to make such assets directly attributable to the foreign office.
Foreign Assets ^(*)	Japanese company	Foreign company	Qualified	[In principle] Qualified [Special treatment] Non-qualified – where a foreign company transfers its Foreign Assets to a PE located in Japan of another foreign company under a contribution-in-kind to make such assets directly attributable to the PE
	Foreign company		Qualified	[In principle] Qualified [Special treatment] Non-qualified – where a foreign company transfers its Foreign Assets to a PE located in Japan of another foreign company under a contribution-in-kind to make such assets directly attributable to the PE

^(*) Real estate located in Japan and other assets attributable to offices located in Japan (excluding shares in a foreign company where more than 25 percent of the shares are held by the transferor company)

^(*) Assets attributable to offices located outside Japan (excluding real estate located in Japan)

4. Legislation for Japan-Taiwan Tax Agreement

On 26 November 2015, the Interchange Association (Japanese side) and the Association of East Asian Relations (Taiwanese side) signed the 'Agreement between the Interchange Association and the Association of East Asian Relations for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income' (Tax Agreement). (For details, please refer to KPMG Japan e-Tax News No.102 '[Japan-Taiwan Tax Agreement – Signed](#)' (issued on 26 November 2015).)

Legislation including provisions prescribed in the Tax Agreement, especially those related to the tax treatment of Taiwanese resident individuals or Taiwanese companies, will be established under domestic laws in order to implement the contents prescribed in the Tax Agreement.

The new legislation will be effective when necessary procedures to secure reciprocity (i.e. preferential tax treatment which is similar to that granted to Taiwanese resident individuals and Taiwanese companies under Japan's new legislation is granted to Japanese resident individuals and Japanese companies) are completed in Taiwan.

IV. CONSUMPTION TAX

1. Restriction on Application of the SME Special Measures

There are special measures applied to SMEs to reduce the administrative burden for them, i.e. the consumption tax exemption system (the measure to exempt a small business operator such as those whose taxable sales for the fiscal year 2 years prior to the current fiscal year do not exceed JPY10 million from filing and paying consumption tax) and the simplified tax credit system (the measure to allow a small business operator whose taxable sales for the fiscal year 2 years prior to the current fiscal year do not exceed JPY50 million to use assumed profit margins determined based on the kind of business in calculating the creditable consumption tax).

It is proposed that such special measures will be restricted to apply for certain cases, responding to an issue raised by the Board of Audit Japan that a person who claimed a refund on consumption tax imposed on high-value buildings applies one of the above special measures for the years when the person earns taxable sales from the rental or transfers of such buildings in order to reduce consumption tax burden.

Cases subject to the restriction	Taxable periods for which the consumption tax exemption system and the simplified tax credit system will not be applied
Where a business operator with taxpayer status purchases a high-value asset in Japan in a taxable period in which the simplified tax credit system has not been applied	Each taxable period from (a) to (b): (a) Taxable period in which the high-value asset is purchased (b) Taxable period with the day 3 years from the commencement date of the taxable period (a)
Where a business operator with taxpayer status constructs a high-value asset in Japan in taxable periods in which the simplified tax credit system has not been applied	Each taxable period from (a) to (b): (a) Taxable period in which the construction costs (excluding consumption tax) for the high-value asset reach JPY10 million (b) Taxable period with the day 3 years from the commencement date of the taxable period in which the construction of the high-value asset is completed

'High-value assets' means inventories and 'adjustable fixed assets,' whose purchase cost (excluding consumption tax) is JPY10 million or more per unit. ('Adjustable fixed assets' are certain assets other than inventories such as buildings, machinery, equipment whose purchase cost (excluding consumption tax) is JPY1 million or more per unit. The creditable amount of the input tax thereon is subject to an 'adjustment' depending on the fluctuation of taxable revenue ratios for 3 years from the purchase of the assets.)

This amendment will be applied to purchases of high-value assets on or after 1 April 2016. However, if such purchases are made based on contracts entered into on or before 31 December 2015, this amendment will not be applied to the purchases.

2. Place of Taxation for Digital Services

The place of taxation for digital services is determined by the place of the service recipient, which is defined depending on whether the recipient is an individual or a company as follows:

An individual	domicile or residence (the place where the person lives for a year or more)
A company	the place where its head office or principal office is located

The following amendment to the place of taxation for B2B digital services (digital services supplied by foreign suppliers where the recipients of the services are normally limited to business customers based on the characteristics of the services or the terms and conditions of the transactions) has been proposed:

B2B digital services for which the place of taxation will be amended	Current tax law	Proposal
B2B digital services received by a foreign permanent establishment of a domestic business customer, which are exclusively related to their supplies conducted outside Japan	Domestic supplies	Foreign supplies
B2B digital services received by a Japanese permanent establishment of a foreign business customer, which are related to their supplies conducted in Japan	Foreign supplies	Domestic supplies

This amendment will be applied to transactions to be carried out on or after 1 January 2017.

V. INDIVIDUAL TAXATION

1. Exit Tax

With respect to the exit tax regime introduced under the 2015 tax reform which started to apply on 1 July 2015, an amendment to the scope of eligible assets is proposed.

The exit tax regime is aimed at preventing avoidance of tax on capital gains in Japan by moving out of Japan with appreciated financial assets and subsequently selling those assets. As Japanese taxation rights on income arising from stock options are secured, it is proposed that both qualified and non-qualified stock options will be excluded from the scope of eligible assets for the exit tax regime.

This amendment will be applied to 2016 income and onwards.

2. Reporting Requirement for Foreign Company Stock Options

When a Japanese resident who is a director or employee of a Japanese subsidiary of a foreign company or a Japan branch of a foreign company earns stock-based compensation granted by the foreign company, the Japanese subsidiary or the Japan branch is required to submit a report by 31 March of the year following the year where such income is earned.

The scope of the persons subject to reporting will be expanded to include the following:

- A Japanese resident who was a director or employee of a Japanese subsidiary of a foreign company or a Japan branch of a foreign company
- A non-resident who is a director or employee of a Japanese subsidiary of a foreign company or a Japan branch of a foreign company (including a non-resident who was a director or employee of a Japanese subsidiary or a Japan branch) and who receives any economic benefits being treated as Japanese source income.

3. Maximum Amount of Tax Exemption for Commutation Allowances

The maximum amount of tax exemption for commutation allowances will be increased from JPY100,000 per month to JPY150,000 per month.

This amendment will be applicable to commutation allowances to be paid on or after 1 January 2016.

4. Deduction for 'Switch OTC Drug' Expenses for Promoting Self-Medication (Special Deduction for Medical Expenses)

In order to promote switching from prescription drugs to OTC drugs under proper healthcare management, a special measure for the deduction for medical expenses with respect to so-called switch OTC drug expenses will be introduced. The outline of the measure is as follows:

Applicable period	From 1 January 2017 to 31 December 2021
Eligible person	An individual who receives a medical checkup or a vaccination, etc. in order to maintain and improve their health condition and prevent diseases
Conditions	Where an eligible person pays designated switch OTC drug expenses for the person or their family members living in the same household during the applicable period, and the total amount of such expenses paid in a year exceeds JPY12,000
Special measure	The excess amount over JPY12,000, i.e. the total amount of switch OTC drug expenses less JPY12,000, will be deductible in calculating taxable income (Maximum deductible amount: JPY88,000)

Note that this special measure will not be applicable where the existing deduction for medical expenses is applied.

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