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# KPMG Japan tax newsletter

## Outline of the 2014 Tax Reform Proposals



The ruling coalition (the Liberal Democratic Party and New Komeito) agreed on the 'Outline of the 2014 Tax Reform Proposals' ('Proposal') on 12 December 2013. We have set out below the main points of the Proposal.

Amendments indicated in the Proposal will be discussed in the ordinary session of the Diet next year together with amendments indicated in the 'Outline of Tax Reform Proposal to Stimulate Business Investment' released on 1 October 2013.

The Proposal itself is only an indicative outline and is unclear with respect to some of the contemplated changes. 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. Reduction in Effective Corporate Tax Rate (Abolition of Special Reconstruction Corporation Tax)

The Special Reconstruction Corporation Tax imposed on companies (both Japanese companies and foreign companies) will be abolished one year earlier than the original schedule.

Although details have not been announced yet, it is expected that the applicable periods for the Special Reconstruction Corporation Tax will be shortened and the effective corporate tax rate will be reduced as follows:

**[Applicable periods for Special Reconstruction Taxes]**

| | Tax base x Tax rate | | Applicable periods | |
|---|---|---|---|---|
| | | | Current tax law | Proposal |
| Special Reconstruction Corporation Tax | Japanese corporation tax liability for the fiscal year | x 10% | Fiscal years beginning from 1 April 2012 to 31 March 2015 (3 years) | Fiscal years beginning from 1 April 2012 to 31 March 2014 (2 years) |
| Special Reconstruction Income Tax | Japanese income tax (including withholding tax) | x 2.1% | From 1 January 2013 to 31 December 2037 (25 years) | No change |

**[Effective corporate tax rate]**

| | Fiscal years beginning before 1 April 2014 | Fiscal years beginning on or after 1 April 2014 |
|---|---|---|
| Corporation tax | 25.5% | 25.5% |
| Special Reconstruction Corporation Tax | 2.55% (25.5% x 10%) | - |
| Special Local Corporation Tax | 4.292% | 4.292% |
| Business tax | 3.26% | 3.26% |
| Prefectural and municipal tax | 5.28% (25.5% x 20.7%) | 5.28% (25.5% x 20.7%) |
| Total | 40.882% | 38.332% |
| Effective tax rate | 38.01% (40.882% x 100/107.55) | 35.64% (38.332% x 100/107.55) |

(The above effective tax rates take into account the tax deductibility of Special Local Corporation Tax and business tax payments, and are calculated using Tokyo tax rates currently applied to a company whose paid-in capital is over JPY100 million.)

### 2. Entertainment Expenses

Entertainment expenses for each fiscal year in excess of the deductible limit are disallowable under the tax law.

Pursuant to the Proposal, the deductible limit of entertainment expenses will be amended as indicated below:

| Size of company | Deductible limit | |
|---|---|---|
| | Current tax law | Proposal |
| Small and medium-sized companies(*) | JPY8 million | Either (1) or (2):<br>(1) JPY8 million<br>(2) 50% of eating and drinking expenses (excluding expenditures solely for the company's directors/employees) |
| Companies other than small and medium-sized companies | Zero | 50% of eating and drinking expenses (excluding expenditures solely for the company's directors/employees) |

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

### 3. Special Measures for National Strategic Economic Growth Areas

The following special measures will be introduced in accordance with the enactment of the National Strategic Economic Growth Areas Act ('NSEGA Act').

#### (1) Special depreciation/tax credits for machinery etc. in national strategic economic growth areas

When a blue-return filing company named in an approved area plan as an entity to implement a certain specified business(*) under the NSEGA Act acquires eligible assets referred to in a business execution plan and puts them into use for the specified business in the national strategic economic growth areas during the period from 1 April 2014 (or the effective date of the provisions on the area plan under the NSEGA Act, whichever comes later) to 31 March 2016, the company will be entitled to apply either special depreciation or a tax credit.

Note that this measure is not applicable where special depreciation/tax credits for machinery, etc. in comprehensive special areas for international strategy or special measures for taxation of designated specified business corporations in comprehensive special areas for international strategy are applied.

(*) 'Certain specified business' means specified businesses prescribed under the NSEGA Act that are expected to contribute to improvement in vitality and sustainable development of Japanese economic society as a business being conducive to the reinforcement of international competitiveness of industries or the formation of hubs for international business activities.

Details will be discussed by the government and the tax commission of the ruling parties.

### (a) Eligible assets

| Assets | Minimum acquisition cost requirement |
|---|---|
| Machinery | JPY20 million or more per unit |
| R&D furniture/fixtures | JPY10 million or more per unit |
| Buildings<br>Attachments to buildings<br>Structures | Total acquisition costs of a building, attachments to the building and structures of JPY100 million or more |

### (b) Special depreciation/tax credits

Depreciable limits and creditable limits are as follows:

| Type of assets | Special depreciation | | Tax credits |
|---|---|---|---|
| Machinery<br>R&D furniture/fixtures | Certain items used for specified core business(*) | [Acquisition cost] – [Ordinary depreciable limit]<br>(i.e. total acquisition costs can be expensed upfront.) | Acquisition cost x 15%<br>(capped at 20% of the corporation tax liability for the fiscal year) |
| | Other than the above | Acquisition cost x 50% | |
| Buildings<br>Attachments to buildings<br>Structures | Acquisition cost x 25% | | Acquisition cost x 8%<br>(capped at 20% of the corporation tax liability for the fiscal year) |

(*) 'Specified core business' means a core business out of certain specified businesses that is, in particular, a business which should be especially promoted in order to develop new growth areas by innovations and conducts all of the following activities:

(i) Advanced efforts to be implemented by utilizing human and material resources within the area

(ii) Efforts to improve quality of life through innovative technological developments or to create new industries/markets

(iii) Efforts to spread benefits to other areas

Note that medical fields which use state-of-the-art technology will be the first field for the specified core business. Other fields may also become available after consideration of the details of the national strategic economic growth areas is made.

### (2) Tax credits for R&D costs

When the special depreciation discussed in (1) is applied to R&D assets used for the specified core business, the depreciation expenses for the R&D assets are treated as 'specified R&D costs'(*).

(*) Under the rules for tax credits on total R&D costs, the creditable amount is calculated by multiplying total R&D costs by a certain ratio. If R&D costs are treated as 'specified R&D costs', 12 percent is applicable. Otherwise, 10 percent or less is generally applied.

### (3) Special measures for national strategic urban area revival projects

When an area plan stipulating a national strategic urban area revival project is approved by the Prime Minister under the NSEGA Act, an entity to implement the project will be regarded as getting approval for an urban area revival project plan under the Special Measures Act for Revival of Urban Areas. In this case, the buildings developed under the urban area revival project carried out based on the plan will be eligible to apply the special measures; i.e. additional depreciation and reduction of registration tax.

## 4. Tax Amendments as a consequence of the Amendments to the Companies Act

In response to the amendments to the Companies Act proposed by a bill which was submitted to the extraordinary Diet on 29 November 2013 (the bill was carried over to the 2014 ordinary session.), the following amendments are proposed.

### (1) Company with Audit and Supervisory Committee

As a new corporate governance form, a Company with Audit and Supervisory Committee will be introduced under the amended Companies Act. In accordance with this amendment, the following amendments are proposed for directors' compensation paid by such companies:

- Where a resolution regarding directors' compensation at a board of directors is supported by a majority of the Audit and Supervisory Committee members, the procedural condition for deductibility of profit-based compensation will be satisfied.
- Directors who are also members of the Audit and Supervisory Committee may not be treated as a director with employee status.

### (2) Share consolidations (*Kabushiki-Heigo*)

Under the proposed Companies Act amendments bill, dissenting shareholders with respect to a proposed share consolidation will be able to request that the share-issuing company purchase their shares. Pursuant to this amendment, a clause is scheduled to be included in the tax law such that where a company carries out a share consolidation, deemed dividends should not be recognized on share buy-backs requested by dissenting shareholders (both individuals and companies).

## 5. J-REITs

Profit distributions paid by a Toushi Houjin (J-REIT) are deductible in calculating taxable income for the J-REIT, provided the tax qualifying requirements are satisfied. One of the tax qualifying requirements for a J-REIT is the '90 percent test'; this requires the amount of dividend payments made by a J-REIT in a fiscal year to exceed 90 percent of its distributable profit in such fiscal year.

It is proposed that 70 percent of goodwill amortization will be deductible in calculating distributable profit for the purposes of the 90 percent test (with such amendment contingent upon certain amendments to the J-REIT Law). Under the current laws, where goodwill is created in a merger between J-REITs, the discrepancy between the treatment of amortization of such goodwill for accounting and tax purposes may result in the surviving J-REIT failing the 90 percent test depending on the amount of this discrepancy. This amendment is understood to be aimed at mitigating the risk of this occurring in such cases.

## II. Local Taxes imposed on Companies

In order to decrease the gaps in local tax revenue between urban and rural areas, the Inhabitant Tax rates will be reduced and Local Corporation Tax (national tax) will be newly introduced to collect the equivalent of such reduced Inhabitant Tax. Local Corporation Tax will subsequently be reallocated from the national government to local governments. Similarly, Special Local Corporation Tax (national tax), which was introduced in a previous tax reform as a means of reallocating Business Tax revenue among local governments, will also be amended via revision of the tax rates for Business Tax and Special Local Corporation Tax. As these amendments are to adjust tax revenue between urban and rural areas, they should raise little impact on the total tax burden of corporate taxpayers.

### 1. Reduction in Inhabitant Tax Rates and Introduction of Local Corporation Tax

For fiscal years beginning on or after 1 October 2014, the Inhabitant Tax rates will be reduced and Local Corporation Tax will be introduced as follows:

**[Current tax law]**

| Inhabitant Tax | | Local Corporation Tax | |
|---|---|---|---|
| Taxable base | Tax rate | Taxable base | Tax rate |
| Corporation tax (National tax) | Standard rate 17.3%<br>Prefectural: 5.0%<br>Municipal: 12.3% | – | – |
| | Maximum rate 20.7%<br>Prefectural: 6.0%<br>Municipal: 14.7% | | |

**[Proposal]**

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

### 2. Amendments to Tax Rates for Business Tax and Special Local Corporation Tax

For fiscal years beginning on or after 1 October 2014, the tax rates for Business Tax and Special Local Corporation Tax will be revised as follows:

(Notes on Business Tax rates)

- Tax rates indicated below are the standard tax rates. The maximum tax rates are 1.2 times the standard rates.
- The reduced tax rates for taxable income on JPY8 million or less are not applicable to companies that have offices in three or more different prefectures and have a total paid-in capital of JPY10 million or more.

### (1) Companies with paid in capital in excess of JPY100 million (i.e. companies subject to size-based business tax)

(other than companies indicated in (3))

**[Current tax law]**

| Business Tax (income component) | | | Special Local Corporation Tax | |
|---|---|---|---|---|
| Taxable base (taxable income) | | Tax rate | Taxable base | Tax rate |
| In excess of | Up to | | | |
| - | JPY4 million | 1.5% | Taxable income x Standard rate of Business Tax | 148% |
| JPY4 million | JPY8 million | 2.2% | | |
| JPY8 million | - | 2.9% | | |

**[Proposal]**

| Business Tax (income component) | | | Special Local Corporation Tax | |
|---|---|---|---|---|
| Taxable base (taxable income) | | Tax rate | Taxable base | Tax rate |
| In excess of | Up to | | | |
| - | JPY4 million | 2.2% | Taxable income x Standard rate of Business Tax | 67.4% |
| JPY4 million | JPY8 million | 3.2% | | |
| JPY8 million | - | 4.3% | | |

### (2) Companies with paid in capital of JPY100 million or less

(other than companies indicated in (3))

**[Current tax law]**

| Business Tax (income component) | | | Special Local Corporation Tax | |
|---|---|---|---|---|
| Taxable base (taxable income) | | Tax rate | Taxable base | Tax rate |
| In excess of | Up to | | | |
| - | JPY4 million | 2.7% | Taxable income x Standard rate of Business Tax | 81% |
| JPY4 million | JPY8 million | 4% | | |
| JPY8 million | - | 5.3% | | |

**[Proposal]**

| Business Tax (income component) | | | Special Local Corporation Tax | |
|---|---|---|---|---|
| Taxable base (taxable income) | | Tax rate | Taxable base | Tax rate |
| In excess of | Up to | | | |
| - | JPY4 million | 3.4% | Taxable income x Standard rate of Business Tax | 43.2% |
| JPY4 million | JPY8 million | 5.1% | | |
| JPY8 million | - | 6.7% | | |

### (3) Companies conducting electricity/gas supply business or insurance business

**[Current tax law]**

| Business Tax (revenue component) | | Special Local Corporation Tax | |
|---|---|---|---|
| Taxable base | Tax rate | Taxable base | Tax rate |
| Adjusted gross revenue | 0.7% | Adjusted gross revenue x Standard rate of Business Tax | 81% |

**[Proposal]**

| Business Tax (revenue component) | | Special Local Corporation Tax | |
|---|---|---|---|
| Taxable base | Tax rate | Taxable base | Tax rate |
| Adjusted gross revenue | 0.9% | Adjusted gross revenue x Standard rate of Business Tax | 43.2% |

### III. Transfer Pricing

Sales of assets, purchases of assets, service provision and other transactions with related overseas companies are subject to the transfer pricing legislation. Furthermore, the current legislation also applies to certain asset transactions with related overseas companies through unrelated parties.

The Proposal provides that certain service provision transactions, etc. with related overseas companies through unrelated parties will also be included in the scope of transactions subject to transfer pricing.

## IV. Change of International Taxation Principle

The change of the international taxation principle is proposed in the Proposal. Although this tax reform will effect taxation of individuals as well, this newsletter discusses the main points of the tax reform for companies.

This tax reform will be applied for fiscal years beginning on or after 1 April 2016 for corporation tax and corporate inhabitant/business tax purposes, from 2017 for income tax purposes and from 2018 for individual inhabitant tax purposes.

### A. Taxation of a Foreign Company

#### 1. Change of International Taxation Principle Applied to a Foreign Company

The international taxation principle applied to foreign companies under domestic tax laws will be changed from the entire income principle to the attributable income principle(*1), which is in line with Article 7 (Business Profits) of the OECD Model Tax Convention amended in 2010(*2).

(*1) Under the entire income principle, a foreign company with a permanent establishment ('PE') in Japan is liable for corporate tax on all Japanese source income (in principle) regardless of whether such income is attributable to the PE. On the other hand, under the attributable income principle, the business income attributable to the PE of such foreign company is subject to corporate tax and the Japanese source income not attributable to the PE is taxed in the same way as Japanese source income earned by a foreign company without a PE in Japan (i.e. in principle, subject to withholding tax only, except for certain capital gains, etc.).

(*2) Article 7 of the OECD Model Tax Convention and the Commentary thereon were amended in 2010 to be in line with the Authorised OECD Approach ('AOA'). The AOA is an approach to calculate income attributable to a PE, which was publicized in the 'Report on the Attribution of Profits to Permanent Establishments' released in 2008 and 2010. Under the AOA, external transactions, assets, risks and capital attributable to a PE are determined based on functions performed by the PE and other related facts, and internal dealings are recognized at an arm's length price ('ALP').

#### 2. Japanese Source Income

- Income attributable to a PE in Japan will be defined as a type of Japanese source income. (e.g. Income derived from investments into a third country by a PE will become taxable in Japan regardless of whether or not such income is taxed in the third country, which is a change from the current law.)
- The scope of capital gains of Japanese assets that are treated as Japanese source income will be confined to the scope of capital gains(*) that are taxable for a foreign company without a PE in Japan under the current tax law.

  (*) e.g. capital gains from sales of real estate located in Japan, shares in a company holding real estate located in Japan and shares in a Japanese company held by a significant shareholder

#### 3. Taxation on Income not Attributable to a PE in Japan

- Japanese source income not attributable to a PE in Japan ('income not attributable to a PE') will be taxed separately from income attributable to the PE and taxed in the same way as Japanese source income earned by a foreign company without a PE in Japan.

## 4. Income Attributable to a PE

### (1) Income attributable to a PE

- Income attributable to a PE will be the income that the PE would have earned if it were a distinct and separate enterprise from its head office.

### (2) Internal dealings

- In calculating income attributable to a PE, profits/losses derived from internal dealings will be recognized.
- The transfer pricing rules, etc. will be applied to internal dealings as follows:
  - ✓ If income attributable to a PE is less than it should be since the price of an internal dealing is not an ALP, the price should be adjusted to the ALP in the same way as a transaction with a related overseas party under the transfer pricing rules.
  - ✓ Special provision to extend the statute of limitations for corrections, rules of inquiry and inspection to third parties engaging in the same activities and the estimation clause will be applied to internal dealings in the same way as those under the transfer pricing rules.
  - ✓ The deductibility of an internal dealing will be denied in the same way as a donation to a related overseas party where the internal dealing is comparable to a donation from a PE to its head office.
- Neither internal guarantees nor internal reinsurance between a PE and its head office will be recognized in calculating income attributable to the PE.
- Internal interest for non-financial institutions and internal royalties will not be recognized if a tax treaty including a provision equivalent to Article 7 of the pre-2010 amendment OECD Model Tax Convention is applied.
- Provision of start-up funds from the head office to its PE and profit distributions from a PE to its head office will be deemed as capital transactions; i.e. such transactions will not generate profits/losses.
- Deemed payments of internal interest, etc. from a PE to its head office will not be subject to withholding tax in Japan.

### (3) Calculation of income attributable to a PE

- A provision prescribing that mere purchase by a PE of goods or merchandise for its head office does not generate any profits will be abolished. (If a tax treaty including such provision is applied, the provision of the tax treaty will be applied.)
- Where common costs incurred for businesses of both a PE and the head office are allocated to the PE based on reasonable allocation keys, such allocated costs will be allowable in the hands of the PE. Note that if evidence regarding the cost allocation is not preserved, the deductibility will be denied, in principle.
- When all assets of a PE are sold, capital gains/losses incurred from the sales will be recognized as income attributable to the PE.
- When a PE is closed, built-in gains/losses in assets attributable to the PE will be recognized as income attributable to the PE for a fiscal year including the closure day. If the PE has deferred revenue/expenses, such revenue/expenses will be realized in a fiscal year including the closure day. The tax losses carried-forward for income attributable to the PE will expire upon the closure of the PE.

### (4) Allocation of capital to a PE/Limitation on deductibility of interest expenses

- When the amount of capital of a PE is smaller than the capital attributable to the PE (capital to be attributable to the PE if the PE were a distinct and separate enterprise from its head office), interest expenses (including internal interest and interest expenses allocated to the PE) corresponding to such deficient portion will not be allowed in calculating income attributable to the PE.
- The amount of capital attributable to a PE of a foreign company will be calculated by using either of the following approaches: (The chosen approach should be applied consistently.)

(i) Capital allocation approach

$$\text{Amount of capital of the foreign company} \times \frac{\text{Amount of assets attributable to the PE}}{\text{Amount of assets of the foreign company}}$$

- In principle, the amount of 'assets of the foreign company' and 'assets attributable to the PE' will be the amount of the risk-weighted assets (i.e. the amount of assets calculated considering credit, market and operational risk, etc.). The book value of assets may be available for non-financial institutions.
- Although the amount of 'capital of the foreign company' and 'assets of the foreign company' will be, in principle, those on a stand-alone basis, the amounts on a consolidated basis will be applied for certain cases; e.g. where the capital ratio of the foreign company is extremely low.

(ii) Thin-capitalization approach

$$\text{Amount of assets attributable to the PE} \times \frac{\text{Amount of capital of a comparable company}}{\text{Amount of assets of a comparable company}}$$

- A 'comparable company' means a company carrying on business in Japan, which is similar to the PE's business in the type and scale, etc.
- The amount of 'assets of a comparable company' and 'assets attributable to the PE' will be the amount of the risk-weighted assets.
- Non-financial institutions will be allowed to use the debt-equity ratio of a comparable company instead of the capital ratio.
- When the capital ratio of a comparable company is extremely low, such ratio will not be available.

### (5) Deduction of interest attributable to a PE carrying on banking or securities business

- When the regulatory capital of a foreign company carrying on banking or securities business includes a portion being treated as debt, interest paid by the foreign company on such portion will be deductible in calculating income attributable to the PE to the extent of such interest allocated to the PE in proportion as the allocation of capital discussed in (4) above.

### (6) Application of thin-capitalization rules and earnings stripping rules

- The thin-capitalization rules will not be applied to a PE in response to the introduction of the new rule discussed in (4) above.
- Internal interest will be included in 'interest payments to related persons' subject to the earnings stripping rules.
- Even when interest allocated to a PE carrying on banking or securities business discussed in (5) includes interest paid to related persons, such interest will not be treated as 'interest payments to related persons' subject to the earnings stripping rules.

### (7) Documentation

- A foreign company with a PE in Japan must prepare the following documents and present/submit them upon a request from the tax authorities without delay. Moreover, the PE will be obliged to record internal dealings in its accounting books.

| | |
|---|---|
| External transactions | • Documents describing details of external transactions attributable to the PE |
| Internal dealings | • Documents equivalent to evidence such as order forms, receipts and invoices for internal dealings (Preserving these documents will be one of the requirements to be a blue-return filing taxpayer.)<br>• Documents describing functions performed by the PE and its head office in internal dealings and details of internal dealings<br>• Documents regarding the calculation of ALPs of internal dealings |

## 5. Taxable Base/Tax Losses Carried-forward/Declaration of Income

- Foreign company with a PE
  - ✓ Two categories of taxable base; 'income attributable to the PE' and 'income not attributable to the PE' will be established. Income from the two categories will be taxed separately. Tax losses incurred in one category will not be utilized to offset income in the other category.
  - ✓ It is required to file a corporation tax return to declare 'income attributable to the PE' (and 'income not attributable to the PE' subject to corporation tax, if any) for each fiscal year. (No filing is required if the foreign company has only Japanese source income that is exempt from corporation tax under a tax treaty, etc.)
- Foreign company without a PE
  - ✓ There will be only one category 'income not attributable to the PE' for the taxable base and tax losses.
  - ✓ It is required to file a corporation tax return to declare 'income not attributable to the PE' subject to corporation tax, if any. (No filing is required if the foreign company has only Japanese source income that is exempt from corporation tax under a tax treaty.)

## 6. Foreign Tax Credits

- A foreign tax credit system applicable to a foreign company with a PE will be newly introduced. This is because income derived in a third country will constitute taxable income in Japan under the new regime if it is attributable to the PE.

- When income attributable to a PE includes income to be treated as being derived from outside of Japan under the source rules applicable to each type of income, such portion should be categorized as foreign source income for the purpose of calculating the creditable amount (i.e. corporation tax liability x foreign source income/all income).
- The creditable foreign tax is, in principle, foreign tax that is imposed in a third country and that is attributable to a PE. If the foreign tax exceeds the amount calculated using the reduced tax rate under the tax treaty between Japan and the third country, the excess portion will not be creditable but deductible.

### 7. Other Issues

- An anti-tax avoidance provision similar to the existing anti-tax avoidance provision applied to family companies will be introduced with respect to the calculation of income attributable to a PE and taxation thereon.

## B. Taxation of a Japanese Company

### 1. Foreign Source Income for the purpose of Calculating the Foreign Tax Creditable Amount

- Although foreign source income is defined as income other than Japanese source income under the current tax law, foreign source income will be itemized by virtue of the amendment.
- Income attributable to a foreign PE will become an item of foreign source income.
- The scope of capital gains of foreign assets that are treated as foreign source income will be confined to capital gains from sales of real estate located outside of Japan, shares in a company holding real estate located outside of Japan and shares in a foreign company held by a significant shareholder, etc.

### 2. Income Attributable to a Foreign PE

- In principle, income attributable to a foreign PE should be calculated in the same way as income attributable to a PE in Japan for a foreign company. However, there are some notable points including the following:
- When the amount of capital of a foreign PE is smaller than the capital attributable to the foreign PE, interest expenses corresponding to such deficient portion will be added back to the income attributable to the foreign PE.
  - ✓ The above tax treatment will be applied only when certain requirements such as attaching calculation details to a tax return are met.
  - ✓ It is allowed for Japanese banks to calculate risk-weighted assets by using only credit risk for finance receivables in calculating the amount of capital attributable to a foreign PE in certain cases.
- When the regulatory capital of a Japanese company carrying on banking or securities business includes a portion being treated as debt, interest paid by the Japanese company on such portion will be deducted from the income attributable to its foreign PE to the extent of such interest allocated to the PE.

- Even when a foreign PE is closed, neither built-in gains/losses in assets attributable to the foreign PE nor deferred revenue/expenses will be recognized.

### 3. Documentation for Income Attributable to a Foreign PE

- If a Japanese company wishes to take a foreign tax credit for income attributable to its foreign PE, the Japanese company must prepare documents discussed in A.4.(7) above and present/submit them upon a request from the tax authorities without delay.
- A Japanese company must prepare documents regarding allocation of common costs incurred for businesses of both the head office and its foreign PEs for the calculation of income attributable to the foreign PEs.

## V. Income Tax

### 1. Employment Income Deduction

The maximum employment income deduction (currently JPY2,450,000) is scheduled to be reduced as follows:

**[Current tax law]** (JPY)

| Gross salary | | Employment income deduction |
|---|---|---|
| In excess of | Up to | |
| - | 1,800,000 | Gross salary x 40% (minimum: 650,000) |
| 1,800,000 | 3,600,000 | Gross salary x 30% + 180,000 |
| 3,600,000 | 6,600,000 | Gross salary x 20% + 540,000 |
| 6,600,000 | 10,000,000 | Gross salary x 10% + 1,200,000 |
| 10,000,000 | 15,000,000 | Gross salary x 5% + 1,700,000 |
| 15,000,000 | - | 2,450,000 (Maximum deduction) |

**[Proposal]**

| | Employment income deduction (Maximum deduction) |
|---|---|
| 2016 | JPY2,300,000 (for gross salary over JPY12,000,000) |
| 2017 onwards | JPY2,200,000 (for gross salary over JPY10,000,000) |

### 2. Transfers of Stock Options to the Issuing Company

Where an individual receives non-qualified stock options from a company and subsequently transfers these options back to the issuing company prior to their exercise, income derived from the transfer will not be treated as capital gains, but rather as business income, employment income, retirement income, occasional income or miscellaneous income.

This amendment will be applied to transfers carried out on or after 1 April 2014.

### 3. Amendment to Deduction for Casualty Losses

Where assets (excluding assets not necessary for daily life) of an individual taxpayer or certain family members thereof living in the same household are lost due to disaster, robbery or embezzlement, the following amount is deductible when calculating the individual's taxable income.

| | Deduction for casualty losses (the larger of (i) or (ii)) |
|---|---|
| (i) | (Losses incurred due to disaster, etc. + Expenditures related to disaster) – Annual income x 10% |
| (ii) | Expenditures related to disaster – JPY50,000 |

The calculation method used to determine the amount of 'losses incurred due to disaster, etc.' will be amended as follows:

| Current tax law | Proposal |
|---|---|
| Market value of the assets immediately before the disaster, etc. | Market value of the assets immediately before the disaster, etc.<br>or<br>Acquisition cost of the assets – Equivalent of the accumulated depreciation |

### 4. Expansion of the Scope of 'Assets Not Necessary for Daily Life'

Capital losses incurred from sales of 'assets not necessary for daily life' are not allowed to be used as an offset against other kinds of income, and 'assets not necessary for daily life' lost due to disaster, etc. are not covered by the deduction for casualty losses (see 3. above).

The scope of 'assets not necessary for daily life' is scheduled to be expanded as follows:

| Current tax law | Proposal |
|---|---|
| (i) Racehorses and other movables used for gaming activities<br>(ii) Real estate held primarily for hobby, leisure, recreation or aesthetic appreciation<br>(iii) Precious metals, calligraphic works, antiques, etc. whose value exceeds JPY300,000 | (i)〜(iii) Same as the current items<br>(iv) Movables held primarily for hobby, leisure, recreation or aesthetic appreciation<br>(e.g. golf-club memberships) |

This amendment will be applied to sales of assets carried out on or after 1 April 2014.

## VI. Consumption Tax

### 1. Simplified Calculation Method

The simplified calculation method is a system for calculating the amount of creditable consumption tax by multiplying the amount of consumption tax received on domestic taxable sales by an applicable deemed purchase rate which is prescribed depending on the type of business. A taxpayer whose taxable sales were JPY50 million or less during its base period (broadly, the fiscal year 2 years prior to the current fiscal year for a corporate taxpayer) is allowed to apply this method.

In relation to the deemed purchase rate under the simplified calculation method, the types of businesses will be recategorized into 6 groups, and the deemed purchase rates for financial and insurance services and real estate businesses will be amended as follows:

<table>
<tr><th colspan="2" rowspan="2">Type of business</th><th colspan="2">Deemed purchase rate</th></tr>
<tr><th>Current tax law</th><th>Proposal</th></tr>
<tr><td colspan="2">Wholesale</td><td>90%<br>(Type 1 business)</td><td>90%<br>(Type 1 business)</td></tr>
<tr><td colspan="2">Retail</td><td>80%<br>(Type 2 business)</td><td>80%<br>(Type 2 business)</td></tr>
<tr><td rowspan="4">Manufacturing, etc.</td><td>Agriculture and fishing</td><td rowspan="4">70%<br>(Type 3 business)</td><td rowspan="4">70%<br>(Type 3 business)</td></tr>
<tr><td>Mining</td></tr>
<tr><td>Construction</td></tr>
<tr><td>Manufacturing</td></tr>
<tr><td rowspan="2">Other types of businesses</td><td>Food services</td><td rowspan="2">60%<br>(Type 4 business)</td><td>60%<br>(Type 4 business)</td></tr>
<tr><td>Financial and insurance services</td><td rowspan="3">50%<br>(Type 5 business)</td></tr>
<tr><td rowspan="3">Services, etc.</td><td>Transportation and communication</td><td rowspan="3">50%<br>(Type 5 business)</td></tr>
<tr><td>Services</td></tr>
<tr><td>Real estate</td><td>40%<br>(Type 6 business)</td></tr>
</table>

The above amendment will be applied to taxable periods beginning on or after 1 April 2015.

### 2. Calculation of the Taxable Revenue Ratio

In principle, creditable consumption tax is determined via calculation of the taxable revenue ratio, which is broadly the quotient of taxable sales over the sum of all sales.

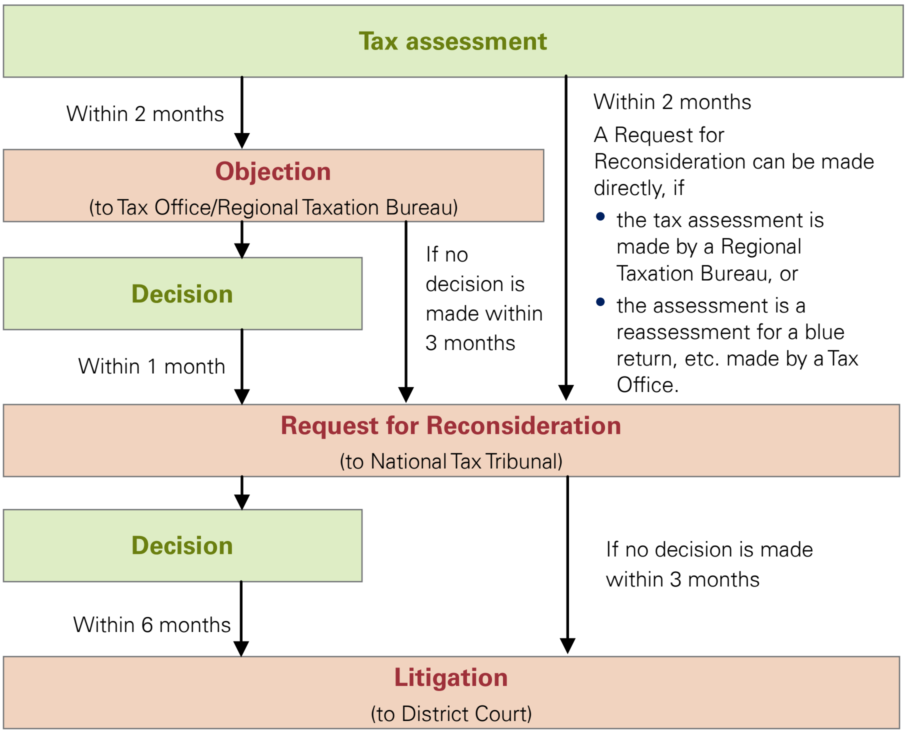
As transfers of monetary claims are treated as non-taxable sales, the full amount of the transfer value of the monetary claims is, in principle, included in the total amount of sales of assets (i.e. the denominator) in calculating the taxable revenue ratio under the current tax law. Pursuant to the Proposal, only 5 percent of the transfer value of monetary claims will be included in the denominator, as is the case in transfers of securities. This amendment should mitigate the negative impact on the taxable revenue ratio resulting from the sale of monetary claims.

This amendment will be applied to transfers of monetary claims made on or after 1 April 2014.

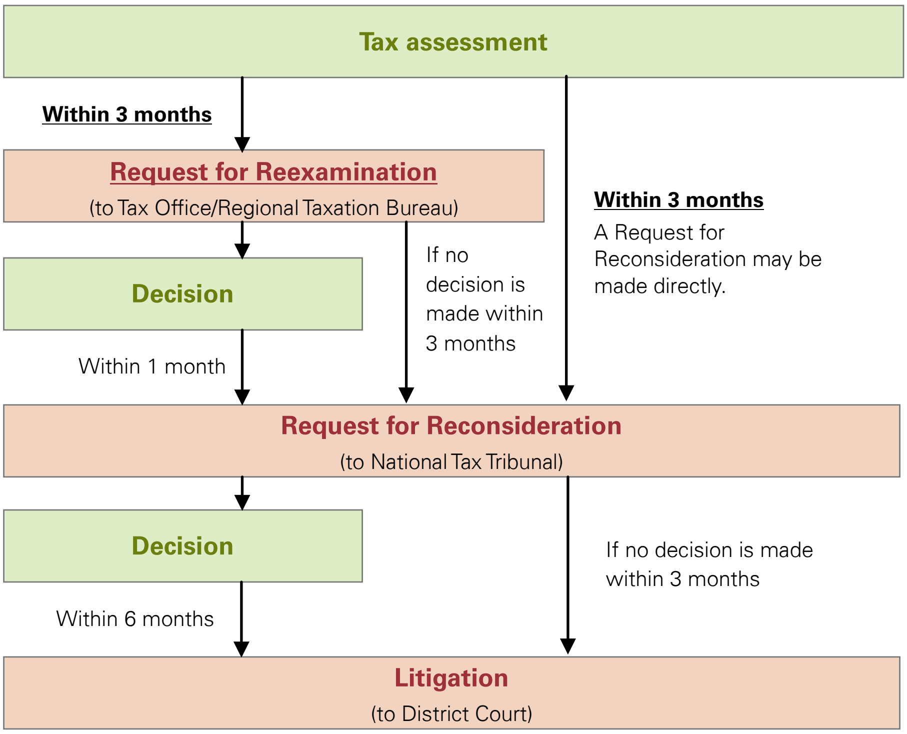
## VII. Changes to Appeal Process

The Administrative Appeal Act is slated to be amended, and consequently the Proposal provides for an amendment to the appeals system for national and local tax purposes. The illustration below outlines the amendments for national tax purposes.

**[Current tax law]**




**[Proposal]**




Furthermore, under the current tax law, during the examination process following the submission of a Request for Reconsideration, the claimants and participants are only allowed to inspect evidence submitted by the administrative agency ordering the assessment of taxation; however, pursuant to the proposed amendments, persons related to the examination (such as the claimant, participants and the administrative agency ordering the assessment of taxation) will also be allowed to inspect/copy of evidence including information collected under the appeals judges' authority.

These amendments will be applicable from the effective date of the amended Administrative Appeal Act.

**KPMG Tax Corporation**

Izumi Garden Tower,
1-6-1 Roppongi, Minato-ku,
Tokyo 106-6012
TEL : +81 (3) 6229 8000
FAX : +81 (3) 5575 0766

Osaka Nakanoshima Building 15F,
2-2-2 Nakanoshima, Kita-ku,
Osaka 530-0005
TEL :+81 (6) 4708 5150
FAX :+81 (6) 4706 3881

Nagoya Lucent Tower 30F,
6-1 Ushijima-cho, Nishi-ku,
Nagoya 451-6030
TEL : +81 (52) 569 5420
FAX : +81 (52) 551 0580

http://tax.kpmg.or.jp/
info-tax@jp.kpmg.com