KPMG Japan Tax Newsletter

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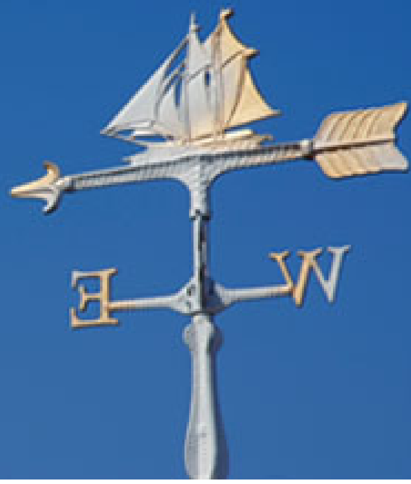

Outline of the 2019 Tax Reform Proposals

The ruling coalition (the Liberal Democratic Party and New Komeito) agreed on the 'Outline of the 2019 Tax Reform Proposals' (Proposal) on 14 December 2018. We have set out below brief summaries of the main points of the Proposal.

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. Corporate Taxation

1. Improvement of Gaps in Local Tax Revenue among Local Governments

A part of the business tax (income/revenue component) was separated out of the total business tax and special local corporation tax (national tax) was introduced in 2008 as a temporary measure until a radical overhaul of the tax system (including consumption tax reform) takes place in order to improve the gaps in local tax revenue among local governments. The special local corporation tax will be abolished and restored to business tax from fiscal years beginning on or after 1 October 2019, when the consumption tax rate will be increased to 10 percent.

The 2019 tax reform proposes that a part of the business tax (income/revenue component) is separated out of the total business tax and a new national tax named special business tax is created alternatively as a permanent measure for the improvement in the gaps in local tax revenue among local governments by the reallocation of special business tax revenue from the Japanese national government to local governments.

Although the objective of the proposal is to improve the gaps in local tax revenue among local tax governments, it may give a small impact to the tax costs and the applied effective tax rate of corporate taxpayers.

The business tax rates (income/revenue component) and the special business tax rate, which will be applied to fiscal years beginning on or after 1 October 2019, are as follows:

<table>
<tr><th colspan="4">Ordinary companies with stated capital in excess of JPY100 million (companies subject to size-based business tax)</th></tr>
<tr><th rowspan="2">Tax item</th><th rowspan="2">Taxable base</th><th colspan="2">Tax rate(*1)(*2)</th></tr>
<tr><th>Current</th><th>Proposal</th></tr>
<tr><td rowspan="3">Business tax (income component)</td><td>Taxable income up to JPY4 million per year(*3)</td><td>1.9%</td><td>0.4%</td></tr>
<tr><td>Taxable income over JPY4 million and up to JPY 8 million per year(*3)</td><td>2.7%</td><td>0.7%</td></tr>
<tr><td>Taxable income over JPY8 million per year</td><td>3.6%</td><td>1%</td></tr>
<tr><td>Special business tax(*4)</td><td>Business tax (income component) calculated by standard tax rates</td><td>-</td><td>260%</td></tr>
</table>

Ordinary companies with stated capital of JPY100 million or less			
Tax item	Taxable base	Tax rate(*1)	
		Current	Proposal
Business tax (income component)	Taxable income up to JPY4 million per year(*3)	5%	3.5%
	Taxable income over JPY4 million and up to JPY 8 million per year(*3)	7.3%	5.3%
	Taxable income over JPY8 million per year	9.6%	7%
Special business tax(*4)	Business tax (income component) calculated by standard tax rates	-	37%

Companies taxed on revenue (companies conducting the supply of electricity or gas, insurance business)			
Tax item	Taxable base	Tax rate(*1)	
		Current	Proposal
Business tax (revenue component)	Revenue	1.3%	1%
Special business tax(*4)	Business tax (revenue component) calculated by standard tax rate	-	30%

(*1) Standard tax rates are indicated.

(*2) The maximum tax rates applicable for fiscal years beginning on or after 1 October 2019 are 1.2 times the standard tax rates under the current tax law, which will be increased up to 1.7 times the standard tax rates.

(*3) 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 stated capital of JPY10 million or more.

(*4) The newly introduced special business tax is a national tax whose taxpayer is a business taxpayer, and the taxable base is the liability of business tax (income/revenue component calculated based on standard tax rates). Filing and payment of special business tax will be done with the business tax competent for prefectures.

2. Tax Credits for R&D Costs

A. Tax credits for total R&D costs

From the viewpoint of strengthening incentives for increasing R&D costs in companies, the rules concerning the tax credits for total R&D costs under which the creditable amount is calculated by multiplying total R&D costs by the creditable ratio discussed below are proposed to change as follows:

(1) Large-sized Companies

[Current tax law]

Basic rules

Increase-Decrease R&D Ratio	Creditable ratio	Maximum tax credit
More than 5%	9% + (Increase-Decrease R&D Ratio - 5%) x 0.3 (Upper limit: 14% for 2 years(*), 10% from the 3rd year onwards)	Corporation tax liability x 25%
5% or less	9% - (5% - Increase-Decrease R&D Ratio) x 0.1 (Lower limit: 6%)	

(*) Fiscal years beginning between 1 April 2017 and 31 March 2019

Temporary measures where R&D Ratio exceeds 10%

Either of the following measures is available for fiscal years beginning between 1 April 2017 and 31 March 2019.

Creditable amount	Creditable amount (under the basic rules)	+	(R&D costs - Average Sales Proceeds x 10%) x {(R&D Ratio - 10%) x 0.2} (Upper limit: corporation tax liability x 10%)
Maximum tax credit	Maximum tax credit (under the basic rules)	+	Corporation tax liability x {(R&D Ratio - 10%) x 2} (Upper limit: corporation tax liability x 10%)

[Proposal]

Basic rules

Increase-Decrease R&D Ratio	Creditable ratio	Maximum tax credit
More than 8%	9.9% + (Increase-Decrease R&D Ratio - 8%) x 0.3 (Upper limit: 14% for 2 years(*1), 10% from the 3rd year onwards)	Corporation tax liability x 25% (Certain venture R&D companies(*2): 40%)
8% or less	9.9% - (8% - Increase-Decrease R&D Ratio) x 0.175 (Lower limit: 6%)	

(*1) Fiscal years beginning between 1 April 2019 and 31 March 2021

(*2) A 'certain venture R&D company' means a company which was established within the past 10 years and has tax losses to be carried forward. A subsidiary of a large company is not eligible.

Temporary measures where R&D Ratio exceeds 10%

Both of the following measures will be available for fiscal years beginning between 1 April 2019 and 31 March 2021.

Creditable ratio (Upper limit: 14%)	Creditable ratio (under the basic rules)	+	Creditable ratio (under basic rules) x {(R&D Ratio - 10%) x 0.5 (upper limit: 10%)}
Maximum tax credit	Maximum tax credit (under the basic rules)	+	Corporation tax liability x {(R&D Ratio - 10%) x 2} (Upper limit: corporation tax liability x 10%)

(2) Small and medium-sized companies

[Current tax law]

Basic rules

Increase-Decrease R&D Ratio	Creditable ratio	Maximum tax credit
More than 5%	12% + (Increase-Decrease R&D Ratio - 5%) x 0.3(*) (Upper limit: 17%)	Corporation tax liability x 35%(*) (where either of the following temporary measures is not applied)
5% or less	12%	Corporation tax liability x 25%

(*) Applicable for fiscal years beginning between 1 April 2017 and 31 March 2019.

Temporary measures where R&D Ratio exceeds 10%

Either of the following measures is available for fiscal years beginning between 1 April 2017 and 31 March 2019.

Creditable amount	Creditable amount (under the basic rules)	+	(R&D costs - Average Sales Proceeds x 10%) x {(R&D Ratio - 10%) x 0.2} (Upper limit: corporation tax liability x 10%)
Maximum tax credit	Maximum tax credit (under the basic rules)	+	Corporation tax liability x {(R&D Ratio - 10%) x 2} (Upper limit: corporation tax liability x 10%)

[Proposal]

Basic rules

Increase-Decrease R&D Ratio	Creditable ratio	Maximum tax credit
More than 8%	12% + (Increase-Decrease R&D Ratio - 8%) x 0.3(*) (Upper limit: 17%)	Corporation tax liability x 35%(*)
8% or less	12%	Corporation tax liability x 25%

(*) Applicable for fiscal years beginning between 1 April 2019 and 31 March 2021.

Temporary measures where R&D Ratio exceeds 10%

Both of the following measures will be available for fiscal years beginning between 1 April 2019 and 31 March 2021.

Creditable ratio (Upper limit: 17%)	Creditable ratio (under the basic rules)	+	Creditable ratio (under the basic rules) x {(R&D Ratio - 10%) x 0.5 (upper limit: 10%)}
Maximum tax credit	Maximum tax credit (under the basic rules)	+	Corporation tax liability x {(R&D Ratio - 10%) x 2} (Upper limit: corporation tax liability x 10%)

[Definition of key terms]

- Large-sized companies: Companies other than small and medium-sized companies
- Small and medium-sized companies: refer to '3. Scope of Small and Medium-Sized Companies'
- Increase-Decrease R&D Ratio: (a) / (b)
  (a) [Total R&D costs in a fiscal year] - [Annual average of R&D costs for the preceding 3 fiscal years] (if the figure is negative, the negative figure is used)
  (b) Annual average of R&D costs for the preceding 3 fiscal years
- R&D Ratio: Total R&D costs in a fiscal year / Average Sales Proceeds
- Average Sales Proceeds: Average sales proceeds for the preceding 3 fiscal years and the current fiscal year

B. Tax credits for specified R&D costs

(1) Scope of specified R&D costs

Specified R&D costs are eligible for the special rules under which the creditable amount is calculated by multiplying specified R&D costs by the creditable ratio discussed below. The following indicates the scope of specified R&D costs and the underlined items will be newly treated as specified R&D costs under the 2019 tax reform.

Scope of specified R&D costs (R&D costs used for the following R&D activities)		Creditable ratio
Joint R&D	National R&D institutions	30%
	Universities	
	R&D venture companies	25%
	Private enterprises	20%
	R&D partnerships	
Consignment R&D	National R&D institutions	30%
	Universities	
	R&D venture companies	25%
	Specified small and medium-sized companies	20%
	Certain private enterprises	
Royalties on intellectual property	Specified small and medium-sized companies	20%
R&D concerning orphan regenerative medicine products		20%
R&D concerning medicine products with special use		

(2) Increase in maximum tax credit

The maximum tax credit for specified R&D costs will be increased as follows:

Current tax law	Proposal
Corporation tax liability x 5%	Corporation tax liability x 10%

3. Scope of Small and Medium-Sized Companies

Preferential tax measures for small and medium-sized companies are generally applied to small and medium-sized companies defined as follows:

(i) A company with stated capital of JPY100 million or less at the end of the fiscal year, excluding the following cases:
- at least 50% of the shares are held by one large-scale company; or
- at least two-thirds of the shares are held by two or more large-scale companies

(ii) A company with no capital whose number of regular employees is 1,000 or less

(Note that a company whose average income for the preceding 3 years is over JPY1.5 billion will be restricted to apply for certain preferential tax measures for fiscal years beginning on or after 1 April 2019.)

Under the 2019 tax reform, the scope of 'large-scale companies' used in the above will be expanded as follows: (The underlined items will be newly added.)

- A company whose stated capital is over JPY100 million
- A company with no capital whose number of regular employees is over 1,000
- A company 100% of which is held by a large company(*)
- A company 100% of which is held by two or more large companies(*) in a 100% group

(*) A 'large company' for the purposes of this rule is as follows:

- A company whose stated capital is JPY500 million or more
- A mutual company or a foreign mutual company whose number of regular employees is over 1,000
- A trustee company pertaining to a corporate taxation trust

Accordingly, for example, a company indirectly held by another company whose stated capital is JPY500 million or more will not be treated as a small and medium-sized company.

Furthermore, the treatment of treasury stock will be provided for under the 2019 tax reform. Where a company holds treasury stock, whether the company is a small and medium-sized company or not will be determined by excluding the treasury stock.

4. Virtual Currencies

On 14 March 2018, the Accounting Standards Board of Japan issued the 'Practical Solution on the Accounting for Virtual Currencies under the Payment Services Act' (Practical Solution) [*1] as part of Japanese GAAP.

Corresponding to the Practical Solution, the following provisions for virtual currencies are proposed under the 2019 tax reform of the corporation tax law:

<table>
<tr><td>(i)</td><td>Evaluation at fiscal year end</td><td colspan="2">Where an active market for the virtual currency exists[*2], such virtual currency will be evaluated by the market value at the fiscal year end, and any evaluation gain or loss is recognized.</td></tr>
<tr><td rowspan="2">(ii)</td><td rowspan="2">Gain or loss on sales</td><td>Timing of recognition</td><td>The gain or loss on sales of the virtual currency will be recognized on the contract date.</td></tr>
<tr><td>How to calculate the cost of sales (tax book value per unit)</td><td>Either method of the following:
• Moving average cost method (statutory method) or
• Weighted average cost method</td></tr>
<tr><td>(iii)</td><td>Margin transaction</td><td colspan="2">Where a company has outstanding unsettled margin transactions of virtual currency, gain or loss on the deemed settlement will be recognized given the assumption that such margin transactions were settled at the fiscal year end.</td></tr>
</table>

[*1] In principle, the Practical Solution is applied for fiscal years beginning on or after 1 April 2018.

[*2] The Practical Solution indicates that an active market exists for the virtual currency when there is a market in which transactions for the virtual currency take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

The above proposal will be applicable for fiscal years ending on or after 1 April 2019.

In case mark-to-market evaluation for virtual currencies is not applied for accounting purposes, the proposal for the above (i) and (iii) will be exempted for a company for fiscal years beginning before 1 April 2019 and ending on or after 1 April 2019.

5. Taxation on Reorganizations

(1) Squeeze-out transactions

Under the 2017 tax reform, certain types of squeeze-out transactions by the use of Shares Subject to Class-Wide Call, Consolidation of Shares and Demand for Sales of Shares became to be treated as corporate reorganizations, which are subject to various reorganization rules applied to Share-for-Share Exchanges (Kabushiki-Kokan).

The above tax reform brought taxpayers certain tax benefits. On the other hand, it also has raised an issue that a squeeze-out transaction followed by an upstream merger does not satisfy certain conditions for tax-qualification.

In light of the above issue, it has been proposed that where a tax-qualified upstream merger follows a squeeze-out transaction, the shareholding relationship condition will be tested only for the period up to the merger so that the upstream merger following the squeeze-out transaction will not jeopardize the tax-qualification of the squeeze-out transaction.

(2) Triangular reorganizations

With respect to triangular mergers, one of the conditions for tax-qualified mergers and the condition of deferral of capital gains in the hands of shareholders of the merged company will be expanded as follows:

Current tax law	Proposal
• Only shares in a company which directly holds 100% of the shares in the surviving company are distributed to shareholders of the merged company.	• Only shares in a company which directly holds 100% of the shares in the surviving company are distributed to shareholders of the merged company. • Only shares in a company which indirectly holds 100% of the shares in the surviving company are distributed to shareholders of the merged company(*).

(*) Where a triangular merger is conducted between certain companies within a corporate group, distribution of shares in certain foreign companies will not be eligible.

The above amendments will also be made to triangular corporate divisions and triangular Share-for-Share Exchanges (Kabushiki-Kokan).

II. International Taxation

1. Earnings Stripping Rules

The earnings stripping rules (ESRs) introduced under the 2012 tax reform will be amended to reflect the recommendations of Action 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments) in the final reports of the Base Erosion and Profit Shifting (BEPS) project, which was released by the Organisation for Economic Co-operation and Development (OECD) in October 2015.

A. Limitation on deductions for interest payments

The following are the main items of the amendments:

Amended item	Current tax law	Proposal
Scope of interest payments subject to the ESRs	Net Interest Payments to Related Persons	Net Interest Payments (including interest payments to third parties)
Adjusted Taxable Income	Provisions for domestic and foreign dividends exclusion from taxable income are NOT applied.	Provisions for domestic and foreign dividends exclusion from taxable income are applied.
Deductible interest payments	Adjusted Taxable Income x 50%	Adjusted Taxable Income x 20%

(1) Scope of interest payments subject to the ESRs

The final report of Action 4 recommends that all interest payments (not only those to related parties but also those to third parties) should be covered by rules to prevent base erosion through the use of interest expenses. Thus, the scope of interest payments subject to the ESRs will be amended as follows:

[Current tax law]

Net Interest Payments to Related Persons (Interest Payments to Related Persons less Eligible Interest Income)

- The term 'Interest Payments to Related Persons' means interest paid by a company to its Related Persons (e.g. a company having a 50 percent or more shareholding relationship with the first-mentioned company), excluding interest payments of which recipients are required to declare such interest receipts as income in their income tax/corporation tax returns in Japan.
- The term 'Eligible Interest Income' means interest income attributable to 'Interest Payments to Related Persons'.

[Proposal]

Net Interest Payments (Covered Interest Payments less Eligible Interest Income)

- The term 'Covered Interest Payments' means interest payments less 'Exempted Interest Payments'.
- The term 'Eligible Interest Income' means interest income attributable to 'Covered Interest Payments'.

'Exempted Interest Payments' for a company are defined as follows:

(Interest payments to a third party who provides a loan to a company under a back-to-back loan arrangement with a Related Person of the company, etc. are excluded.)

(a) Interest payments other than those in (b)	(i) Interest payments subject to income tax/corporation tax in the hands of the recipients in Japan(*) (ii) Interest payments to certain public benefit companies (iii) Interest payments under bond gensaki repo transactions, etc. in which borrowing transactions clearly match corresponding lending transactions
(b) Interest on specified bonds (Interest on bonds issued by the company and paid to third parties, excluding the case where the number of owners of the bonds is not large)	Either of the following: (this rule will be applied for each class of specified bonds) (i) Interest subject to withholding taxation at its payment, interest payments subject to income tax/corporation tax in the hands of the recipients in Japan(*), or interest paid to certain public benefit companies (ii) Either of the following, depending on the place of issuance of the bonds: ・ Bonds issued in Japan: 95% of interest payments ・ Bonds issued outside of Japan: 25% of interest payments

(*) Considering the current rules, it is reasonable to understand that 'interest payments subject to income tax/corporation tax in the hands of the recipients in Japan' means interest payments of which receipts are declared as income in income tax/corporation tax returns in Japan.

(2) Adjusted Taxable Income

The final report of Action 4 mentions that exempt dividend income should not form part of an entity's EBITDA (earnings before interest, taxes, depreciation and amortization) to be used in calculating the deductible interest payments.

The current tax law prescribes the calculation process for Adjusted Taxable Income, which is used in calculating the deductible interest payments, as below.

Under the 2019 tax reform, it has been proposed that the underlined provisions will be deleted (i.e. these provisions will be applied in calculating Adjusted Taxable Income). Furthermore, 'Net Interest Payments to Related Persons' will be replaced by 'Net Interest Payments'.

Current taxable income ←

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- Net Interest Payments to Related Persons
- Tax deductible depreciation
- Tax deductible bad debt losses

The following provisions are not applied and donation payments made in the current tax year are deducted.

- Domestic dividends exclusion from taxable income
- Foreign dividends exclusion from taxable income
- Certain valuation losses
- Disallowance of deductions for income tax credited against corporation tax
- Disallowance of deductions for foreign tax credited against corporation tax
- Deduction of carried-forward tax losses
- Deduction for dividends paid by tax qualified special purpose companies
- Thin capitalization rules
- ESRs, etc.

In addition, the calculation process for Adjusted Taxable Income of an operator under a Japanese silent partnership agreement will be newly provided.

(3) Disallowed interest payments

The final report of Action 4 recommends that where fixed ratio rules are applied, the benchmark fixed ratio should be set within the range of 10 percent to 30 percent. In light of such recommendation, the amount of disallowed interest payments under the ESRs will be amended as follows:

Current tax law	Proposal
Net Interest Payments to Related Persons - Adjusted Taxable Income x 50%	Net Interest Payments - Adjusted Taxable Income x 20%

(4) Exemption thresholds

[Current tax law]

Under the current tax law, the ESRs will not apply to a company meeting either of the following criteria:

(a)	Net Interest Payments to Related Persons ≤ JPY10 million
(b)	$\frac{\text{Interest Payments to Related Persons}}{\text{Total Interest Payments}} \leq 50\%$

[Proposal]

The above criteria will be amended as follows:

(a)	Net Interest Payments ≤ JPY20 million
(b)	$\dfrac{\text{Total of Net Interest Payments}^{(*2)}\text{ of a Japanese company and its Japanese Related Companies}^{(*1)}\text{ (Japanese group)}}{\text{Total of Adjusted Taxable Income}^{(*3)}\text{ of a Japanese company and its Japanese Related Companies}^{(*1)}\text{ (Japanese group)}} \leq 20\%$

(*1) The term 'Japanese Related Company' means a Japanese company having certain relationships (e.g. a more than 50 percent shareholding relationship) with the Japanese company which is tested by the criterion. The beginning and the end of the fiscal year of a Japanese Related Company must be the same as the beginning and the end of the fiscal year of the Japanese company which is tested by the criterion, respectively.

(*2) Where Eligible Interest Income exceeds Covered Interest Payments for a company in the Japanese group, the total of Net Interest Payments will be calculated by deducting such excess amount.

(*3) Where Net Adjusted Taxable Income of a company in the Japanese group results in a negative amount, the total of Adjusted Taxable Income will be calculated by netting such negative amount.

B. Deduction of disallowed interest payments

The treatment of disallowed interest payments incurred in the past 7 years will generally remain the same.

Current tax law	Proposal
When a company's Net Interest Payments to Related Persons are less than 50% of Adjusted Taxable Income for a given year, disallowed interest payments incurred in the past 7 years are deductible in such fiscal year up to the 50% threshold.	When a company's Net Interest Payments are less than 20% of Adjusted Taxable Income for a given year, disallowed interest payments incurred in the past 7 years are deductible in such fiscal year up to the 20% threshold.

C. Amendment to relevant provisions

The same amendments discussed above, except for A. (4) [Proposal] (b), will also be made to the ESRs under the Japanese consolidated tax return filing system.

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The above amendments will be applied for fiscal years beginning on or after 1 April 2020.

2. Controlled Foreign Company (CFC) Regime

The Controlled Foreign Company (CFC) regime was extensively amended under the 2017/2018 tax reform. Additional amendments have been proposed under the 2019 tax reform considering the corporate tax rate cut in the US.

A. Scope of Paper Companies

A Paper Company is subject to the full-inclusion rules (i.e. the total income of the company is included in its Japanese parent company's taxable income) where its effective tax rate is less than 30 percent. A Paper Company is defined as a CFC that meets neither of the following conditions:

Substance Test	The CFC maintains an office, store, factory or other fixed place of business necessary to conduct its primary business.
Administration and Control Test	The CFC functions with its own administration, control and management in the jurisdiction of its head office.

It has been proposed that a CFC falling under (1) (2) or (3) below will be excluded from the scope of Paper Companies.

(1) Shareholding CFC

(a) CFC holding shares in subsidiaries

A CFC meeting all of the following conditions:

(i)	The primary business of the CFC is the holding of shares in its subsidiaries(*).		
(ii)	Shares in its subsidiaries and certain assets such as cash/deposits	>	Total assets x 95%
(iii)	Dividends from its subsidiaries and certain bank interest	>	Total revenue x 95%

(*) Subsidiary:
A foreign company whose head office is located in the same jurisdiction as that of the head office of the CFC and which meets the shareholding requirement (e.g. 25 percent or more of shares are held by the CFC)

(b) CFC holding shares in specified subsidiaries

A CFC meeting certain conditions including the following. More conditions may be added later.

(i)	The primary business of the CFC is the holding of shares in its specified subsidiaries(*1).		
(ii)	A management controlling company(*2) located in the same jurisdiction as that of the head office of the CFC performs administration, control and management of the CFC.		
(iii)	The CFC performs functions that are essential to the business carried on by the management controlling company in the same jurisdiction.		
(iv)	Shares in its specified subsidiaries and certain assets such as cash/deposits	>	Total assets x 95%
(v)	Dividends from its specified subsidiaries, proceeds from certain transfers of shares in its specified subsidiaries and certain bank interest	>	Total revenue x 95%

(*1) Specified subsidiary:
A CFC whose head office is located in the same jurisdiction as that of the head office of the CFC (classified into (1)(b)) and which falls under either of the following:
- A Partial-Inclusion CFC (i.e. a CFC whose passive income is included in its Japanese parent company's taxable income)
- Another CFC (classified into (1)(b)) under the same management controlling company

(*2) Management controlling company:
A CFC which satisfies all of the Economic Activity Tests and whose directors or employees are engaged in all tasks normally necessary to conduct properly its primary business in the jurisdiction of its head office (This definition is also applied to a 'management controlling company' discussed in (2).)

(2) Real estate-related CFC

(a) CFC holding real estate or specified subsidiaries

A CFC meeting certain conditions including the following. More conditions may be added later.

(i)	The primary business of the CFC is either of the following: • Holding certain real estate located in the jurisdiction of its head office • Holding shares in its specified subsidiaries(*)		
(ii)	A management controlling company located in the same jurisdiction as that of the head office of the CFC performs administration, control and management of the CFC.		
(iii)	The CFC performs functions that are essential to the real estate-related business carried on by the management controlling company in the same jurisdiction.		
(iv)	Real estate (indicated in (i)), shares in its specified subsidiaries and certain assets such as cash/deposits	>	Total assets x 95%
(v)	Proceeds derived from real estate (indicated in (i))/its specified subsidiaries and certain bank interest	>	Total revenue x 95%

(*) Specified subsidiary:
Another CFC (classified into (2)(a)) under the same management controlling company

(b) CFC holding real estate used by management controlling company

A CFC meeting certain conditions including the following. More conditions may be added later.

(i)	The primary business of the CFC is the holding of real estate that is located in the jurisdiction of its head office and is used by a management controlling company located in the same jurisdiction.		
(ii)	The management controlling company performs administration, control and management of the CFC.		
(iii)	The CFC performs functions that are essential to the business carried on by the management controlling company in the same jurisdiction.		
(iv)	Real estate (indicated in (i)) and certain assets such as cash/deposits	>	Total assets x 95%

(v)	Proceeds derived from real estate (indicated in (i)) and certain bank interest	>	Total revenue x 95%

(3) Resources development project-related CFC

A CFC meeting certain conditions including the following. More conditions may be added later.

(i)	The primary business of the CFC is either of the following: • Holding shares in its specified subsidiaries(*1) • Providing funds procured from 3rd parties to its specified subsidiaries • Holding certain real estate located in the jurisdiction of its head office	
(ii)	A management controlling company(*2) located in the same jurisdiction as that of the head office of the CFC performs administration, control and management of the CFC.	
(iii)	The CFC performs functions that are essential to a resources development project(*3) carried on by the management controlling company in the same jurisdiction.	
(iv)	Shares in its specified subsidiaries, certain loan claims against its specified subsidiaries, real estate (indicated in (i)) and certain assets such as cash/deposits	> Total assets x 95%
(v)	Proceeds derived from shares in its specified subsidiaries/loan claims (indicated in (iv)/real estate (indicated in (i)) and certain bank interest	> Total revenue x 95%

(*1) Specified subsidiary:
A foreign company whose head office is located in the same jurisdiction as that of the head office of the CFC, 10 percent or more of which is held by the CFC, and which performs functions that are essential to the resources development project carried on by the management controlling company in the same jurisdiction.

(*2) Management controlling company:
A CFC which satisfies all of the Economic Activity Tests and whose directors or employees are engaged in all tasks normally necessary to conduct properly its resources development project in the jurisdiction of its head office
(including another foreign company (located in the same jurisdiction) whose directors or employees are jointly engaged in all of the above tasks.)

(*3) Resources development project:
A project for development/improvement of resources (e.g. petroleum and natural gas) or social capital.

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The above amendments will be applied for fiscal years of a Japanese company ending on or after 1 April 2019 with respect to the scope of Paper Companies for fiscal years of a CFC beginning on or after 1 April 2018.

B. Income/foreign taxes attributable to a CFC (tax consolidation member/pass-through entity)

Where a CFC is a member of a tax-consolidated group or is a pass-through entity for tax purposes, how income/foreign taxes attributable to the CFC should be calculated is not clear under the current tax law. In order to clarify the treatment, the following are proposed:

<table>
<tr><th></th><th>Rules subject to change</th><th>Proposal</th></tr>
<tr><td rowspan="2">Income</td><td>[Calculation of full-inclusion income]
‘Base Income’ where it is calculated based on provisions of the tax laws of the jurisdiction of the head office of the CFC</td><td rowspan="2">Making necessary adjustments to income calculated based on provisions of the tax laws of the jurisdiction of the head office of the CFC without using the following provisions:
• Provisions for the tax-consolidation system
• Provisions pertaining to pass-through entities</td></tr>
<tr><td>[Calculation of the effective tax rate — denominator]
‘Income’ calculated based on provisions of the tax laws of the jurisdiction of the head office of the CFC</td></tr>
<tr><td rowspan="2">Foreign taxes</td><td>[Calculation of the effective tax rate — numerator]
‘Foreign taxes’ imposed in the jurisdiction of the head office of the CFC</td><td rowspan="2">Foreign taxes calculated assuming that the CFC earned income calculated based on provisions of the tax laws of the jurisdiction of the head office of the CFC(*) without using the following provisions:
• Provisions for the tax-consolidation system
• Provisions pertaining to pass-through entities</td></tr>
<tr><td>[Calculation of foreign taxes subject to the foreign tax credits in the hands of its Japanese parent company]
‘Foreign taxes’ imposed in the jurisdiction of the head office of the CFC</td></tr>
</table>

(*) Where the jurisdiction of the head office of the CFC is a no-tax jurisdiction or a certain tax-exempted jurisdiction, if the CFC is liable for tax in another jurisdiction as a company of that jurisdiction, ‘the jurisdiction of the head office of the CFC’ will be replaced by that jurisdiction.

***

The above amendments will be applied for fiscal years of a Japanese company ending on or after 1 April 2019 with respect to the above items for fiscal years of a CFC beginning on or after 1 April 2018.

3. Transfer Pricing

The transfer pricing rules will be amended in line with the following report, guidelines and guidance released by the OECD:

- The final report of Action 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) of the BEPS project (BEPS Action 8-10 Final Report, released in October 2015)
- The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD TP Guidelines, released in July 2017)
- The Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles (HTVI Guidance, released in June 2018)

More specifically, the transfer pricing rules will be amended in order to refine the calculation method to determine an arm's length price and also establish the method to make it possible for the Japanese tax authorities to verify the reasonableness of the transaction price for Hard-to-Value Intangibles (HTVI) in consideration with the ex-post outcomes subsequent to the transactions.

(1) Definition of intangibles subject to transfer pricing rules

Intangibles subject to the transfer pricing rules will be defined as follows:

Among any assets owned by companies, assets other than physical assets or financial assets (cash, bank deposits, securities, etc.) which should be compensated for their commercial usage (sales, loan, etc.) between independent parties under ordinary terms and conditions

(2) Methods to reach arm's length price

The discounted cash flow (DCF) method is proposed to be included in the transfer pricing methods, since the OECD TP Guidelines describe that the DCF method may be useful to reach an arm's length price for intangibles where comparable transactions cannot be identified.

In connection with the introduction of the DCF method above, the transaction price calculated using the DCF method based on the information available to the Japanese tax authorities at the time of the controlled transactions with foreign related parties will be treated as the arm's length price for the purposes of a presumptive tax assessment by them, which is applicable where the required documents to determine an arm's length price are not submitted in a timely manner.

(3) Introduction of Price Adjustment Measure to HTVI

The OECD TP Guidelines reflect the recommendations of the BEPS Action 8-10 Final Report such that tax administrations can consider ex-post outcomes as presumptive evidence about the appropriateness of the ex-ante pricing arrangement for the purposes of price adjustments of HTVI transactions due to information asymmetry between the taxpayer and the tax administration. Based on these guidelines, the following measure for price adjustments will be introduced.

[Price Adjustment Measure]

In case ex-post outcomes give a result different from the ex-ante pricing arrangement for the arm's length price of HTVI(*) transactions, the Japanese tax authorities will be able to make a tax assessment based on the arm's length price measured by the most appropriate method to reach an arm's length price of HTVI transactions taking into consideration ex-post outcomes and the probability of events to bring such discrepancy. It should be noted that this measure will not be applied as far as the ratio of the difference between the above arm's length price and the original transaction price is 20 percent or less.

(*) HTVI is defined as intangibles with all of the following characteristics:

- Unique and having significant value
- Arm's length price is calculated based on the income projection.
- Assumptions used in valuing the arm's length price are uncertain.

[Conditions for exemption]

The above Price Adjustment Measure will not be applied provided the following documentation in (a) or (b) is submitted by the taxpayer within a certain period at the request of the Japanese tax authorities:

(a)	Documents for (i) Details of the projections used in valuing arm's length prices of the HTVI transactions and (ii) Evidence to prove that • The discrepancy between the projections and the ex-post outcomes is due to disaster or any other similar events that could not be foreseen at the time of the HTVI transactions, or • The arm's length price was determined taking into account the probability of events to bring such discrepancy appropriately at the time of the HTVI transactions
(b)	Evidence to prove that the ratio of the difference between the actual income and the projected income against the projected income is 20% or less in total for 5 years starting from the beginning of the fiscal year in which the first income from an unrelated party was generated for the use of the HTVI(*)

(*) The Price Adjustment Measure will not be applied after the end of the 5 years if the evidence was submitted to the Japanese tax authorities.

(4) Extension of the statute of limitations under transfer pricing rules

The HTVI Guidance includes the following:

- HTVI requires some consideration of timing issues because HTVI has a feature of taking time for its commercialization.
- The statute of limitations may not correspond with the tax audit cycle in which tax authorities can audit HTVI transactions after the emergence of ex-post outcomes.

- Some examples of countermeasures against these issues (such as 'amendment of the normal statute of limitations')

Based on this guidance, the statute of limitations under the transfer pricing rules will be extended from 6 years to 7 years.

(5) Adjustment method for differences

The so-called inter-quartile method will be allowed for the adjustment of differences where the arm's length price is calculated by reference to the profitability of uncontrolled comparable transactions in case necessary adjustments cannot be made quantitatively.

* * *

The above amendments will be applied for fiscal years beginning on or after 1 April 2020 for corporation tax purposes and from 2021 income for income tax purposes.

4. Repo Transactions by Specified Foreign Companies

There is a special measure under which interest, etc. arising from bond gensaki repo transactions conducted by Specified Foreign Companies (foreign companies other than foreign financial institutions) with Specified Financial Institutions (broadly, Japanese financial institutions) by use of book-entry JGBs, starting during the period between 1 April 2017 and 31 March 2019 with certain conditions (e.g. the transaction period does not exceed 3 months) is exempt from tax. The following amendments will be made to this measure and the applicable period will be extended by 2 years until 31 March 2021.

The scope of bonds covered by this measure will be expanded as follows:

Current tax law	Proposal
(i) Book-entry JGBs	(i) Book-entry JGBs (ii) Certain foreign government bonds or government guaranteed bonds(*) (iii) Bonds issued by foreign companies established under special laws of certain foreign countries(*)

(*) The currency of the bonds must be that of the foreign countries.

Moreover, interest arising from bond gensaki repo transactions received by Qualified Foreign Investment Trusts under the Japanese Bond Income Tax Exemption Scheme (J-BIEM), will also be exempted from income taxation under certain conditions.

The above amendments will be applied to interest, etc. received under bond gensaki repo transactions starting on or after 1 April 2019.

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