Grant Thornton

Japan tax bulletin

Newsletter on important tax and business developments in Japan

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In this issue

Japan's 2011 Tax reforms and new taxation agreements

This edition of our newsletter contains updates on Japan's international tax agreements and discusses the 2011 tax reforms.

Following the March earthquake, the adoption of the 2011 Tax reform proposals was delayed. On 30 June 2011 the Diet promulgated a revised version of the reforms. The following is a summary of the main items.

2011 has seen Japan sign numerous Tax Information Exchange Agreements, revise existing treaties and enter into new ones. A broad overview is included below.

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2011 Tax reforms

The 2011 tax reforms proposed at the end of 2010 were not passed in their original form. The introduction of some of the measures has been delayed pending further discussion. Some of the measures that were passed include:

Special Taxation Measures

Incentives for job creation

In order to promote job creation, a tax credit is available until 31 March 2014 for companies that increase their number of employees. The minimum increase is 10% on the previous year's number of employees. In addition to this, for Small and Medium-sized Enterprises (apart from SMEs whose parent company's share capital is greater than JPY 100 million) the increase has to be at least 2 employees. For other companies it has to be at least 5 employees.

The company should file a plan to its local Hello Work office within two months of the start of its fiscal year detailing how it will create jobs. If the plan is accepted and its objectives are achieved, the company will be eligible for a tax credit for JPY 200,000 per additional employee capped at 10% (20% for SMEs) of its corporate tax liability.

Enhanced depreciation on energy-saving equipment

Companies filing blue tax returns which purchase specified energy-saving equipment before 31 March 2014 will benefit from enhanced depreciation on the items at a rate of 30%.

Incentives for Regional Headquarters and Research and Development centres

The reforms contained measures to improve the attractiveness of Japan as an area for inbound investment. The incentives for Regional Headquarters and Research and Development centres (reproduced below) are as described in our March tax bulletin.

In order to promote in investment into certain areas, qualifying corporations that file blue tax returns and operate in special investment zones are allowed a first year deprecation deduction of 50% of the cost of certain capital expenditure (25% for buildings), or alternatively a tax credit can be taken for 15% of the cost (8% for buildings). The credit is capped at 20% of a corporation's tax liability with the balance able to be carried forward for one year. If neither the depreciation nor the credit is taken, a qualifying company can choose to take a 20% reduction to taxable income instead.

In addition, in order to encourage foreign corporations to establish Regional Headquarters or R&D centres in Japan, corporations will benefit from a 20% reduction to taxable income for five years from the date they are designated as qualifying. In the fiscal years that the incentive is taken, no tax credits for R&D costs will be available.

Extensions of temporary measures

The following temporary measures which were due to expire on 30 June 2011 have been extended to 31 March 2012:

- The reduced corporate income tax rate of 18% on the first JPY 8 million of taxable income for Small and Medium-Sized Enterprises (SMEs).
- The temporary special tax credit available for Research and Development expenses which is worth between 8 and 12 % of a company's R&D expenditure.
- The enhanced first year depreciation (30%) or tax credit (7%) available to SMEs filing blue tax returns which purchase energy efficient equipment.

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Other measures

Valuation loss on shares of a subsidiary in liquidation

The reforms clarified that the valuation loss on the shares of a Japanese company in a 100% group is not deductible if the company is in liquidation.

Previously a parent company could take over the carried forward losses of it subsidiary if the subsidiary was in the process of liquidation. In addition it could benefit from a valuation loss on the subsidiary's shares, in effect double counting the loss. The reforms clarified that in this situation the loss on valuation would not be deductible.

SME tax reliefs

Under the old rules, SMEs were unable to benefit from special tax reliefs if they were 100% owned directly or indirectly by a large company (one with share capital greater than JPY500 million). The reforms amended this to deny the benefits in cases where the SME is 100% owned directly or indirectly by two or more large companies within a group.

Consumption Tax

Before the reform a taxpayer could take a credit for all of its input consumption tax if its taxable sales ratio was greater than 95%. For periods starting on or after 1 April 2012 this will only apply where the taxpayer has taxable sales of JPY500 million or less.

Consumption tax registration period

The threshold for mandatory payment of consumption tax is having taxable sales of more than JPY 10 million during the base period (the fiscal year two years prior to the current fiscal year).

The reforms introduced the concept of a specific period (the first six months of the previous fiscal year). For fiscal years beginning on or after 1 January 2013, a corporation or sole proprietorship will become a consumption tax payer if its taxable sales during the specific period are more than JPY 10 million. This may mean that some taxpayers have to register for consumption tax one fiscal year earlier than they would have done under the old rules.

Interim corporation tax returns

The reforms provided that an interim corporation tax return cannot be filed if the previous year's liability multiplied by 6/number of months in the previous period is either:
a) less than JPY100,000, or
b) less than the amount calculated on the interim return.

The limitation in b) above will help to reduce the number of cases where a company files an interim return with a large corporate tax liability and then obtains a refund when is final tax return shows a smaller liability. The interest rate of around 4.3% per annum received on the overpayment of tax is greater than that available on deposits with banks.

Foreign source income

Under the old tax law certain items of income could be taxed in another country under the terms of its tax treaty with Japan. However those items might also be treated as Japan source income under Japan tax laws if the treaty did not contain a provision to treat the income as foreign source.

The foreign tax credit limitation is calculated as:

Foreign tax credit limit =
Japanese corporation tax for the year x
(Foreign source income for the year/worldwide income for the year)

In the situation described above the treating the income as domestic source would result in a reduction of the limit and therefore reduce the foreign tax credit available.

The reforms announced that when income is taxed in a foreign country under its treaty with Japan in the absence of any specific provisions relating to the source of the income, that income is treated as foreign source for the purposes of calculating the creditable limit.

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New taxation agreements

Tax treaties

So far this year, Japan has been active in reaching agreements with the following countries:

Hong Kong

The Double Taxation Agreement between Japan and Hong Kong came into force on 15 July and applies to taxes from 1 January 2012. The headline rates are as follows:

Income type		Tax rate
Dividends	At least 10% shareholding	5%
	Other	10%
Interest		10%[1]
Royalties		5%

The treaty also contains provisions allowing Japan to impose tax at source on income and gains derived from a sleeping partnership (Tokumei Kumiai).

Saudi Arabia

The treaty is one of several agreed with Persian Gulf nations in recent years. It applies to taxes from 1 January 2012 and the headline rates are as follows:

Income type		Tax rate
Dividends	At least 10% shareholding	5%
	Other	10%
Interest		10%[1]
Royalties		5%[2]/10%[3]

The treaty also contains provisions allowing Japan to impose tax at source on income and gains derived from a sleeping partnership (Tokumei Kumiai).

As with the agreements signed with Brunei Darussalam and Kuwait last year, the treaty contains a clause exempting interest paid to the Public Investment Fund, a sovereign wealth fund, from taxation in Japan.

Tax Information Exchange Agreements

So far this year Japan has signed a Tax Information Exchange Agreement with the Bahamas and the Isle of Man which came into force on 2 August 2011. In addition Japan has reached basic agreements with Jersey and Guernsey.

Finally, an agreement has been reached with the Cayman Islands in relation to the exchange of tax information and the allocation of taxing rights on individuals.

Summary

As in recent years, Japan's actions in agreeing new tax treaties will help multinational companies operating abroad. The agreement with Saudi Arabia is another sign of Japan's efforts to encourage cross border investment with resource rich countries and in particular, investment into Japan from sovereign wealth funds.

In addition the Tax Information Exchange Agreements agreed with low tax jurisdictions will ensure greater transparency and help with the sharing of taxpayer information.

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[1] 0% for interest from government bodies and financial institutions
[2] For royalties relating to industrial, commercial or scientific equipment
[3] For all other royalties

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