

Japan tax bulletin

Newsletter on important tax and business developments in Japan

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In this issue

Japan's corporation tax rate reduction, 2012 Tax Reform proposals, and a recent Tokyo District Court decision

This edition of our newsletter contains an outline of the 2012 tax reform proposals, information on the corporation tax rate reduction and a brief outline of the Tokyo District Court decision that a Delaware limited partnership is a pass-through entity rather than a corporation for Japan tax purposes.



Reduction in corporation tax rates

2011 Tax Reforms

As a result of the March earthquake the introduction of some of the 2011 tax reforms was postponed for further discussion. These have since been introduced and the main corporate tax changes are discussed below.

Corporation tax rate changes

The 2011 tax reform proposals announced a reduction in the headline corporation tax rate. Following the March earthquake the implementation of this aspect of the reforms was postponed. The government has now passed the reductions and they will apply to fiscal years beginning on or after 1 April 2012. However in response to the need for additional funds to deal with the aftermath of the earthquake, a surcharge of 10% of the national corporation tax liability ("Special Reconstruction Corporation Tax") has been added to the national corporation tax rate for three years from that date. A summary of the new rates is shown below:

Type of company		Tax rate to 31 March 2012	Revised tax rate from 1 April 2012	Total tax rate including surcharge
Large company		30	25.5	28.05
Small or Medium-sized enterprise	Taxable income up to JPY 8 million	18	15	16.5
	Taxable income over JPY 8 million	30	25.5	28.05

Carried forward losses

Also proposed for 2011 was a measure to mitigate the impact of the corporation tax rate reduction. The rules relating to carried forward losses will change for periods commencing on or after 1 April

2012. The carry forward period for tax losses generated after 1 April 2008 has been extended from 7 years to 9 years. For companies that are not small or medium sized enterprises, Tokutei Mokutei Kaishas or Toushi Kaishas, the use of the losses is restricted to 80% of the taxable income for each year. Before the change, carried forward tax losses could be used against 100% of taxable income.

Effective tax rate and deferred tax

As a result of the above changes to the corporation tax rate and loss carry forward rules, companies will need to recalculate any deferred tax assets or liabilities that are recognized in the financial statements to take into account the new rates.

The effective tax rate (including local taxes) for timing differences to be reversed in fiscal years starting between 1 April 2012 and 31 March 2015 will be 38.01%. The rate for timing differences reversed in fiscal years starting after 1 April 2015 is 35.64%.



2012 Tax Reform proposals

The 2012 Tax Reform proposals

In addition to enacting some of the 2011 tax reform proposals, the government also released its 2012 tax reform proposals. These are still being discussed but an outline of the main proposals is given below.

Limitation on interest payments to foreign related parties

In addition to the existing thin capitalisation rules, a measure has been proposed to limit the deductibility of interested payments to foreign related parties.

For fiscal years beginning on or after 1 April 2013, where a company's **net interest payments to related parties** are greater than 50% of its **adjusted taxable income**, the portion in excess of 50% will not be deductible for corporation tax purposes.

Net interest payments to related parties do not include payments on which the recipient pays corporation tax in Japan. The interest limitation will not apply in years where the net interest payments are less than 10 million Yen or where less than 50% of the total interest payments are made to related parties.

Adjusted taxable income in this case is defined as taxable income with the following items added back:

- Depreciation
- Net interest payments to related persons
- Non-taxable dividends

Interest which is disallowed under these provisions can be carried forward for 7 years and used in years where the limit has not been breached. If both the

thin capitalisation rules and these provisions apply in a fiscal year, whichever disallowed amount is greater will apply.

Special depreciation and tax credits for companies operating in Fukushima

Special tax measures have been introduced to allow companies which have been designated as affected by the March disaster to apply a special depreciation expense or tax credit for assets acquired and used in their business in Fukushima.

This special depreciation allows a taxpayer to write off 100% of the capitalised acquisition cost of machinery and claim an extra 25% depreciation expense (in addition to the normal amount) for building and structures. Alternatively a tax credit of 15% of the acquisition cost of machinery (8% for buildings) can be taken, capped at 20% of the company's corporation tax liability. The measure is applicable to asset acquisitions until 31 March 2016.

Share option reporting requirements

Under the current rules, when an employee or director of a Japanese company (or Japan branch of a foreign company) is awarded shares or exercises share options in the overseas parent company of his or her employer, the individual is responsible for declaring the compensation in their annual income tax return.

Under the proposals, a representative of the Japanese employer will have to file a report by 31 March of the year following the exercise or award. The proposal is due to come into force for awards or exercises made in 2012.

Employment income deduction cap

A cap on the employment income deduction for those earning more than JPY 15 million has been

proposed. Currently employees earning over JPY 10 million are entitled to a deduction from income equal to JPY 1,700,000 plus 5% of their income.

Under the proposals the deduction will be capped at JPY 2,450,000 for those earning over JPY 15 million from 2013 onwards.

Change in the taxation of retirement income for directors

Certain payments received upon leaving an employer are considered “retirement income” and are taxed separately from bonuses and normal employment income. The taxation of retirement income is as follows:

Taxable income = (Retirement income received – retirement income deduction) x 50%

The retirement income deduction is JPY 400,000 for each year of service (up to 20 years).

This income is then taxed at progressive rates separately from other income.

Under the new proposals, directors who have fewer than 5 years’ service will not receive the 50% reduction and the income will be calculated as:

Taxable income = (Retirement income received – retirement income deduction)

This amendment will apply to income received in 2013.

Overseas assets declaration

Another proposal is that Japanese-resident taxpayers whose overseas assets are worth more than JPY 50 million will be required to declare the amount and value of the overseas assets to the tax authorities on 15 March each year. The format of the reporting requirement is unclear but it will likely be an appendix to the individual income tax return.

This proposal has been introduced to help the authorities to determine whether income from overseas assets has been fairly stated and also to help identify overseas assets for inheritance tax purposes. The first declaration will apply to assets held as of 31 December 2013.



Delaware limited partnership decision

The Tokyo District Court recently ruled in favour of taxpayers that a Delaware limited partnership is a pass-through entity for Japan tax purposes and not a corporate entity as the National Tax Agency ("NTA") had contended. A brief outline of the facts of the case is given below.

Background

Several individual taxpayers in Japan formed a limited partnership in Delaware in December 2000. The partnership acquired properties in the US and leased them out. From 2001 to 2005, the Japanese individuals included rental income and expenses from the partnership. As the properties were not newly-built the depreciation expense deduction was larger than the rental income, resulting in a loss for those years. This loss could be offset against other income resulting in reduced income tax liabilities for the individuals.

The NTA made a correction of the taxpayers' tax returns stating that the partnership was equivalent to a corporate entity and as such income would be received from it in the form of dividends in profitable years and no losses should be attributed to the members. The individuals appealed and the case reached the Tokyo District Court.

NTA position

The NTA argued that a Delaware limited partnership should be treated as a corporation because:

- The Delaware Limited Partnership Act states that a limited partnership is a separate legal entity, and

- The partnership owned the real properties, borrowed funds in its name and a party to lease agreements.

Court decision

The Court ruled that the limited partnership is not a corporation for Japanese tax purposes as:

- "entity" is the same concept as association for Japanese tax purposes and "company" is used in the US/Japan tax treaty when describing an incorporated body, and
- It was evident that profits/losses of the partnership were automatically allocated to the partners.

As a result of this, the NTA's correction was overturned and the individuals were allowed to offset the losses against their other income for those years.



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