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Japan: Inbound Tax Alert

2018 Tax Reform Proposals - Announced

December 2017, No.26

On 14 December 2017, proposals for the 2018 tax reform were announced by the Liberal Democratic Party and the New Komeito Party.

Under this tax reform, among other changes, tax credits and incentives will be expanded for companies which increase wages and capital investment, while a measure to disallow certain incentives for companies which do not increase wages or capital investment will be implemented. Also, the definition of a permanent establishment ("PE") will be expanded to align Japanese tax law with the definition under the OECD's Base Erosion and Profit Shifting project. Also, significant revisions will be made to the individual income taxation.

Please see below for a list of some key items that may affect foreign companies doing business and individuals residing in Japan. It should be emphasized that these proposals have not been enacted and could change prior to becoming law.

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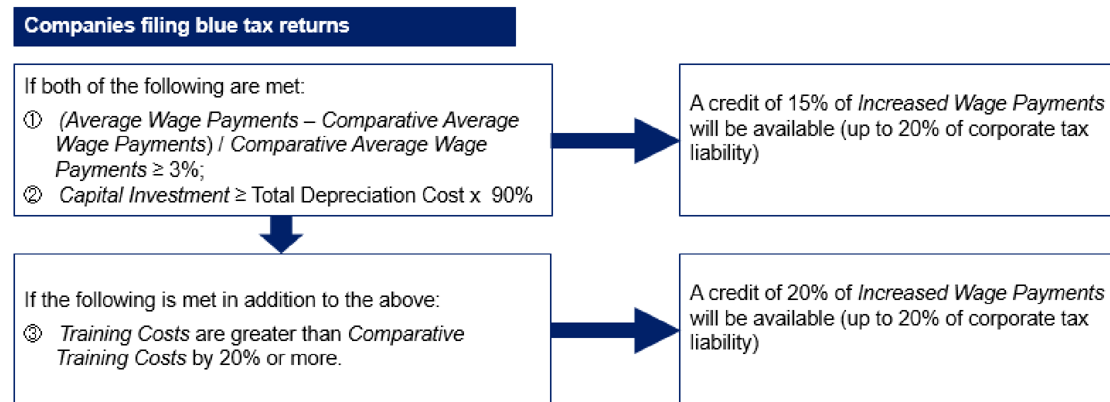
1. Corporate Tax

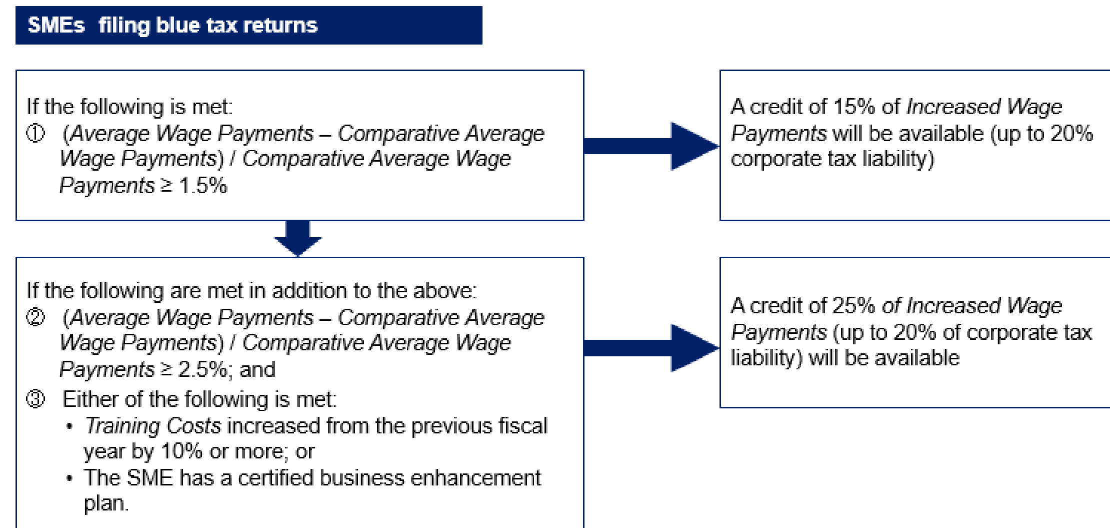
(1) Revision of wage increase tax incentives

The tax credits for wage increases applicable to fiscal years beginning on or before 31 March 2018 which were set to expire will be revised as follows, and the applicable period will be extended by three years. Under the revised rules, a tax credit will be available to companies which raise wages and capital investment and an additional tax credit will be available to companies which increase training costs.



If a tax credit for companies with an increased number of employees under the revised tax incentives for the relocation and expansion of headquarters functions from major cities to local areas is applicable, the same adjustments as those currently made under the incentives will be made.

The tax credits for wage increases are more favorable for Small and Medium-sized Enterprises ("SMEs")[1], and those applicable to fiscal years beginning on or before 31 March 2018 which were set to expire will be revised as follows, and the applicable period will be extended by three years. Under the revised rules, a tax credit will be available to companies which raise wages and capital investment and an additional tax credit will be available to companies which increase training costs.



Note 1:

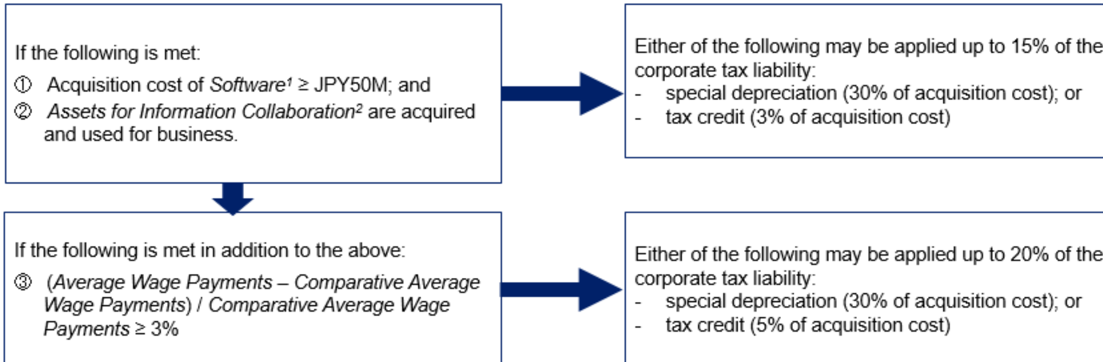
- A company is generally an SME for this purpose if its stated capital is JPY100 million or less except if:
- 50% or more of its shares are owned by a company with stated capital of over JPY100 million
- two thirds or more of its shares are owned by 2 or more companies with stated capital of over JPY100 million; or
- its average profit for the last three fiscal years is over JPY1.5 billion (for fiscal years beginning on or after 1 April 2019).

Increased Wage Payments will be deductible from the tax basis for the value added portion of local enterprise tax provided certain conditions are met. Also, a tax credit is available against local inhabitants tax for SMEs provided certain conditions are met.

These revisions will be applicable to fiscal years beginning from 1 April 2018 to 31 March 2021.

(2) Introduction of information collaboration tax incentives

If a company obtains certification under a to be established Productivity Improvement Act for its innovative data utilization plan and develops or enhances software according to that plan, assets acquired and used for information collaboration will be eligible for either special depreciation or a tax credit.



Notes:

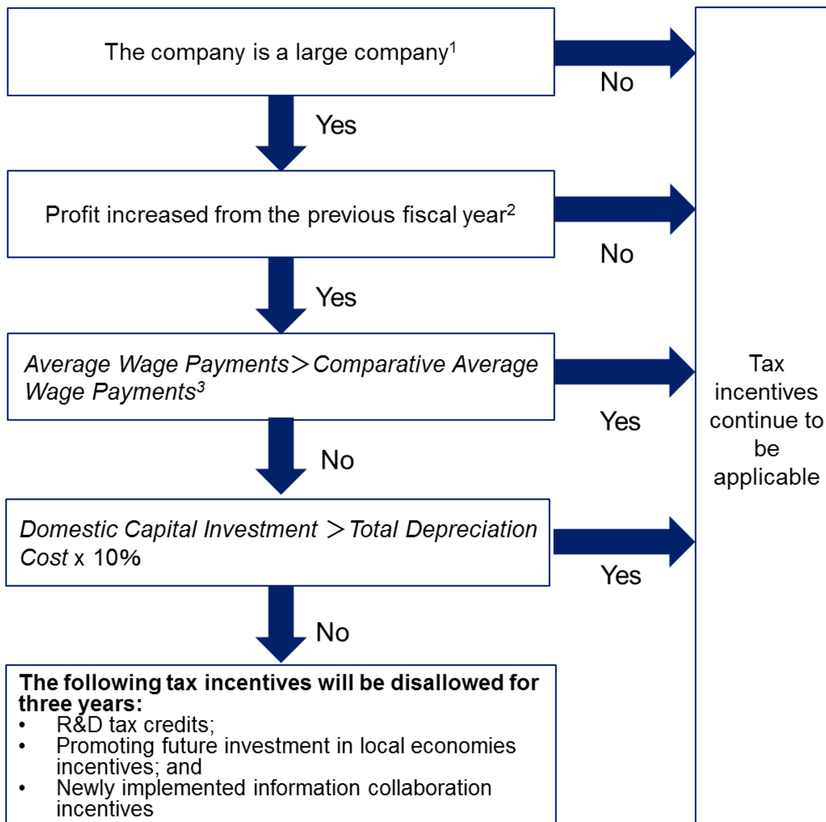
1. Software includes machines, equipment, furniture and fixtures acquired or manufactured with the software.
2. Assets for information collaboration include the above described software, machines and equipment[3], furniture and fixtures, excluding assets for R&D.
3. Machines and equipment are limited to those which continuously and automatically gather data, etc.

This incentive is also available for local tax purposes.

This incentive will be applicable from the effective date of the Act to 31 March 2021.

(3) Disallowance of R&D and other tax incentives

If a large company does not satisfy certain conditions, the application of the R&D credit and certain other tax incentives that are otherwise available to the company will be disallowed. An outline of the revised rule is described in the flow chart below.



Notes:

1 A company is generally a large company for this purpose if any of the following is met:
  - its stated capital is over JPY100 million;
  - 50% or more of its shares are owned by a company with stated capital of over JPY100 million;
  - two thirds or more of its shares are owned by 2 or more companies with stated capital of over JPY100 million; or
  - its average profit for the last three fiscal years is over JPY1.5 billion (for fiscal years beginning on or after 1 April 2019).

2 This is profit before the utilization of net operating losses carried forward and after certain adjustments.

3 If continuously employed employees, which is the basis for calculating Average Wage Payments and *Comparative Average Wage Payment*, do not exist, this condition is deemed to be met.

This provision is applicable to fiscal years beginning from 1 April 2018 to 31 March 2021.

(4) Revisions related to corporate reorganizations

1) Deferred taxation of capital gains on acquisitions of shares using treasury stock

Capital gains tax on certain share transactions, such as takeover bids using treasury shares, will now be deferred.

2) Partial revision of qualification requirements

- Controlling continuity test for corporate reorganizations followed by qualified share distribution

  If a corporate reorganization between companies with a 100% control relationship is expected to be followed by a qualified distribution of shares, the controlling continuity test for the corporate reorganization will be determined based on the relationship between the two entities immediately before the distribution of shares.

- Continuity tests for corporate reorganizations consisting of multiple transactions

  Currently, if a corporate reorganization is subsequently followed by the transfer of a business or employees to a company with a 100% control relationship, the employment continuity test and the business continuity test for the corporate reorganization may not be met. However, the rules have been revised to allow the subsequent transaction with the fully controlled company without affecting the qualification status of the original reorganization.

3) Corporate reorganizations with no consideration

The types of tax qualified corporate reorganizations with no consideration will be revised and the treatment of non-qualified reorganizations with no consideration will be clarified.

(5) Clarification of revenue recognition rules

- It will be clarified under laws and regulations that revenue from the sale of assets or the provision of services for tax purposes:
  - is in principle the value of these assets at the time of their delivery or consideration for these services which should generally be paid.
  - will be included in taxable income for the fiscal year which includes the date of their delivery or the date of the service provision.
- The reserve for sales returns will be abolished for tax purposes, but certain transition rules will apply.
- The special revenue recognition method for the long-term installment sales of assets/provision of services will no longer be available, but certain transition rules will apply.

Deloitte's view

As in prior years, with the goal of increasing economic growth, the government continues encouraging companies to increase wages and capital investment by offering corporate tax incentives. However, different from prior years, the 2018 tax reform also encourages large companies by taking away incentives for companies that do not raise wages or capital investment. Large companies that have benefitted from the R&D credit or certain other tax incentives, and would like to continue to benefit, will need to take steps early on in the year to ensure that they do not trigger the provision that disallows such benefits.

Also, in its continued effort to increase the development of new information technologies in Japan, the government is introducing a new incentive for information collaboration. However, for this incentive to apply, large companies will be required to not only make investments in information technology assets, but also increase wages to avoid the above mentioned provision that could disallow this new incentive.

2. International Tax

(1) Revision to PE related provisions

The definition of a PE under Japanese tax law will be revised as follows to more closely align with the definition under the BEPS project and revised OECD model tax treaty.

Item	Revisions
Agent PE	A person who habitually concludes contracts, or habitually plays the principal role leading to the conclusion of certain contracts in Japan on behalf of a non-resident and those contracts are for the transfer of the non-resident's goods will create an Agent PE.
	The Fills Order-type and Secures Order-type agent PE definitions will be removed from Japanese tax law.
Independent agent exception	A person who acts exclusively or almost exclusively on behalf of its one or more closely related parties[1] will be excluded from the definition of an independent agent.
Fixed place of business PE exception	A fixed place of business solely for the purpose of specific activities such as storage, display or delivery will be excluded from the definition of a PE provided that such activity is of a preparatory or auxiliary character.[2]
Construction PE	If one of the principal purposes of splitting up a contract into several contracts of 12 months or less is to avoid construction PE status, PE recognition will be made based on the aggregate contractual term.

Notes:

1 One party is closely related to another party if more than a 50% direct or indirect shareholding or controlling relationship exists between these two parties.

2 If a closely related party to the non-resident who has the fixed place of business carries on a business activity in that place and certain conditions are met, this exception will not apply.

If there is any difference between the definition of a PE under a tax treaty (including the Japan-Taiwan Tax Agreement) than that under Japanese tax law, the definition under the tax treaty will be applied to determine whether or not a non-resident subject to the treaty has a PE under Japanese tax law.

These revisions will be applicable to fiscal years beginning on or after 1 January 2019 for corporations and from calendar year 2019 for individuals.

(2) Amendments to the anti-tax haven rules (i.e. CFC rules)

- Provided certain conditions are met, certain newly acquired CFCs may transfer shares of other CFCs to a member within its controlled group without causing Japanese shareholders to include any capital gain in their taxable income.
- A foreign financial subsidiary whose main business is the holding of shares will satisfy the main business condition within the economic activity test provided other conditions are met.
- If a Japanese company is subject to the CFC rules, the type of Japanese taxes incurred by a CFC which are creditable against the tax liability of the Japanese shareholder will be expanded.
- These revisions will be applicable to fiscal years beginning on or after 1 April 2018.

(3) Revisions related to real estate rich companies

Capital gains on the transfer of shares in a real estate rich company by a non-resident are taxed in Japan and under the current rules, a company is a real estate rich company if the total market value of its land, buildings, fixtures, structures, etc., and shares in certain subsidiaries at the time of the transfer is 50% or more of its total assets. The timing of determining whether or not a company is a real estate rich company will be revised from the "time of the transfer" to "any time within 365 days prior to the transfer."

These revisions will be applicable to fiscal years beginning on or after 1 April 2018 for corporations and from calendar year 2019 for individuals.

Deloitte's view

Under the new expanded definition of a PE, more non-residents with activities in Japan will be determined to have a PE in Japan, including non-residents that do business through a commissionaire arrangement. However, the impact of this new definition should be mitigated for non-residents in most treaty countries, as most (but not all) tax treaties with Japan currently contain a narrower definition of a PE. Having said that, even non-residents in treaty countries may be subject to the domestic law definition of a PE where they are not eligible for the treaty because, for example, they fail the principal purpose test, which will be commonly found in many of Japan's tax treaties as a result of Japan signing the Multilateral Convention. In addition, the new definition and any associated guidance that is released may influence the tax authority's approach to assessing PE even in a treaty context. Therefore, it is important for non-residents to understand whether their activities in Japan would be a PE under domestic law.

Also, given the above discussed refinements to the PE rules, companies should be reminded that, as prescribed as part of the 2016 tax reform, two types of documentation are required. This includes documentation explaining (a) how the scope of income for a PE is determined and, (b) documentation explaining why pricing for intra-group transactions is consistent with the arm's length standard.

As an anti-abuse measure, the 365 day look back for determining whether a company is a real estate rich company is aimed at preventing non-residents from diluting the percent of real estate in a company by contributing cash or other non-real estate assets shortly before disposition of the company's shares. Non-residents with investments in a Japanese company, especially where that company owns any real estate in Japan, will need to undertake additional calculations to determine whether such company was a real estate rich company at the time of disposition, 365 days prior to disposition and anytime in between.

3. Individual Tax

(1) Revision of employment income deductions

For the purpose of promoting "work style reform" and to widely offer deductions for people with different work styles and different earning methods, the following revisions to the current employment income deductions have been proposed. These will give the basic exemption more importance, as it may be applied to all people regardless of their income, instead of the employment income deduction which applies only to certain incomes such as salaries. Furthermore, following the 2014 tax reform, measures were taken to reduce the upper limit of employment income deductions for high earners.

- The amount of employment income deduction calculated based on employment income will be uniformly reduced by JPY 100,000 from the current deduction amount.
- The amount of employment income to which the upper limit of the employment income deduction applied will be lowered to JPY 8.5 million from the current JPY 10 million. As such, the upper limit of the employment income deduction will be reduced to JPY 1.95 million from the current JPY 2.2 million. However, taking into consideration people with children or parents who require nursing care, a deduction for income adjustment will be introduced as described in (5) as a measure to prevent an increase of tax burden.
- These will be applicable from 2020 onward for individual income tax, and 2021 onward for inhabitants tax.
- The amount of employment income deduction after the revision is as follows.

Employment income	Employment income deduction
Less than JPY 1.625 million	JPY 550,000
Over JPY 1.625 million to JPY 1.8 million	Amount of income x 40% - JPY 100,000
Over JPY 1.8 million to JPY 3.6 million	Amount of income x 30% + JPY 80,000
Over JPY 3.6 million to JPY 6.6 million	Amount of income x 20% + JPY 440,000
Over JPY 6.6 million to JPY 8.5 million	Amount of income x 10% + JPY 1.1 million
Over JPY 8.5 million	JPY 1.95 million

(2) Revision of the public pension income deductions

As with employment income deductions, in order to give the basic exemption more importance in determining the tax burden, and to ensure fairness across generations a revision will be made to public pension income deductions. Furthermore, a public pension income deduction cap will be newly established for high pension earners.

- The amount of public pension income deduction calculated based on the amount of public pension income will be uniformly reduced by JPY 100,000 from the current deduction amount.
- The amount of public pension income deduction for pension income amount of over JPY 10 million will be JPY 1.955 million (upper limit).
- If the total income related to the income other than miscellaneous income on public pension is over JPY 10 million to JPY 20 million, JPY 100,000 will be uniformly reduced from the above deductions. If the total income is more than JPY 20 million, JPY 200,000 will be uniformly reduced from the above deductions.

These will be applicable from 2020 onward for individual income tax, and 2021 onward for inhabitants tax.

(3) Revision of the basic exemption structure

The basic exemption is revised as follows. For high earners, measures are taken to phase out the amount of basic exemption based on the amount of income.

- Amount of basic exemption will uniformly increase by JPY 100,000 from the current JPY 380,000 to JPY 480,000. Furthermore, the basic exemption will be phased out for income over JPY 24 million, and will not be applicable for income over JPY 25 million.
- Similarly, for the basic exemption for inhabitant’s tax, the exemption amount will be increased and phased out for total income of over JPY 24 million, and will not be applicable for total income of over JPY 25 million.
- For total income of over JPY 25 million, as there is no difference between the personal deduction amounts for income tax, no adjustment deduction will be made for the income based levy.
- These will be applicable from 2020 onward for individual income tax, and 2021 onward for inhabitants tax.
- The amount of the basic exemption after revision is as follows.

Total income	Basic exemption (individual income tax)	Basic exemption (inhabitants tax)
Less than JPY 24 million	JPY 480,000	JPY 430,000
Over JPY 24 million to JPY 24.5 million	JPY 320,000	JPY 290,000
Over JPY 24.5 million to JPY 25 million	JPY 160,000	JPY 150,000
Over JPY 25 million	Zero	Zero

(4) Revisions related to spousal, special spousal, and dependent deductions

As a result of the uniform increase of basic deductions by JPY 100,000, the eligible total income for the following personal deductions will be increased.

- The eligible total income for spouse in the same household with salary earner (spouse applicable for spousal deductions) and dependent will be increased to JPY 480,000 (current tax law: to JPY 380,000).
- The classification of total income amount of spouse which is the basis of calculating special spousal deductions will be increased by JPY 100,000, respectively. Accordingly, the eligible total income range for spouse applicable for special spousal deduction will be increased to the range of over JPY 480,000 to JPY 1.33 million (current: over JPY 380,000 to JPY 1.23 million).

These will be applicable from 2020 onward for individual income tax, and 2021 onward for inhabitants tax.

(5) Deductions for income adjustment

While the amount of employment income applicable for upper limit of employment income deductions is reduced, the following measures are taken as a consideration for people with children or parents who require nursing care.

- If a resident with employment income of over JPY 8.5 million falls under as a special handicapped person, or if a person has dependents under 23 in the same household or has a special handicapped dependents or special handicapped spouse in the same household, 10% of the remaining amount calculated by deducting JPY 8.5 million from the total employment income (if the amount is more than JPY 10 million, then JPY 10 million) will be deducted from amount of the employment income. This measure will be applicable in year-end tax adjustment.

This will be applicable from 2020 onward to individual income tax, and 2021 onward to inhabitants tax.

(6) Revision of blue form tax return deductions

- Blue form tax return deductions will be reduced to JPY 550,000 (current: JPY 650,000) when transactions are recorded in accordance with the principle of proper bookkeeping.
- Notwithstanding the above, for the purpose of promoting electronic recordkeeping, if an individual who maintains accounting books in accordance with the principle of proper bookkeeping keeps and stores their journal and general ledger electronically, or if such individual submits his/her income tax return, balance sheet and profit and loss statement through e-Tax by the due date, the blue form tax return deductions will remain unchanged from the current JPY 650,000.

Deloitte's view

Japanese work styles are diversifying recently, and in response to such changes there has been momentum to reconsider taxation on individual income and therefore revision of the employment income deduction has been suggested. The 2018 tax reform proposal suggests that part of the employment income reduction, which is currently applied to only salaried employees, should be replaced by a basic deduction so that every individual will benefit. Accordingly, reduction of employment income deductions and increase of basic deductions have been considered.

With regards to high-income earners, following the 2014 tax reform, a reduction of the maximum amount for the income deduction was discussed in order to prevent a decrease in tax burden. When an employer bears tax for expatriates from foreign countries, tax for high-salaried expatriates will be increased and accordingly an increased tax burden is expected for the employer.

4. Inheritance/Gift Tax

(1) Revision of inheritance/gift tax obligations for foreign nationals after leaving Japan

Under the 2017 tax reform, if a foreign national having domicile outside Japan acquires assets located outside Japan in the form of inheritance or gift from a foreign national temporarily living in Japan,[1] the assets located outside Japan have become out of scope for inheritance/gift tax. However, assets located outside Japan have also become subject to inheritance/gift tax, even if they constitute inheritance/gift made between foreign

nationals having domicile outside Japan, if the decedent or donor is not defined as a foreign national temporarily living in Japan.[2]

As part of continuous efforts to encourage the inflow and longer stay of skilled foreign talent, the 2018 tax reform proposal provides that, in principle, assets located outside Japan received in the form of inheritance/gift from foreign nationals previously having domicile in Japan for a significant duration of time before they left Japan should also be out of scope for inheritance/gift tax, excluding certain types of gifts.

- Assets located outside Japan acquired in the form of inheritance/gift by a foreign national having domicile outside Japan from a decedent or donor having domicile outside Japan at the time of inheritance/gift[3] will not be subject to inheritance or gift tax.
- However, in order to prevent tax avoidance, if a donor gives assets located outside Japan within two years after the date on which they ceased to have domicile in Japan and returns to have domicile in Japan again within that period, the above treatment will not be applicable to the gifted assets and gift tax will be imposed.

Notes:

1. Those who are granted with status of residence under Schedule 1 of the Immigration Control and Refugee Recognition Act and their total period of having domicile in Japan is ten or less years within the past 15 years.
2. Those who do not have Japanese nationality and their total period of having domicile in Japan is ten or less years within the past 15 years.
3. Their total period of having domicile in Japan is more than ten years within the past 15 years before ceasing to have domicile in Japan (limited to those who continue to be foreign nationals for the relevant period).

Applicable to inheritance or gift tax on assets to be acquired in the form of inheritance/gift on and after 1 April 2018.

Deloitte's view

This amendment will be warmly received by the foreign business community, especially to foreign nationals that have worked in Japan for many years, but were planning to leave or retire overseas as assets located outside Japan will no longer be subject to inheritance/gift tax upon losing their domicile in Japan.

5. Consumption Tax

(1) Revised place of supply rules for the transfer of securities, etc.

Currently, the place of supply for Japanese Consumption Tax purposes with respect to the transfer of securities, etc., is in principle where the certificate is physically located. If no certificates have been issued, the transfer is treated as taking place at the office of the supplier. With effect from taxable periods including 1 October 2019, the place of supply rules applicable to the transfer of securities, etc. will be changed as follows:

- Transfer of securities, etc. managed by book-entry transfer institutions: Where the institution is located
- Transfer of non-certificated securities, etc. other than those falling under (a) above: Where the head office of the issuer is located

(2) Introduction of international tourist passenger tax

International tourist passenger tax of JPY 1,000 will be collected from tourists departing from Japan on or after 7 January 2019.

Deloitte's view

International airline companies, etc. operating in Japan will be required to collect and remit international tourist passenger tax, and submit the underlying calculation statement to the tax authorities (for Japanese airlines) or customs authorities (for foreign airlines). This should impose additional compliance burden for these companies, including the adjustment of accounting systems.

6. Other

(1) Mandatory e-filing

Large companies (generally companies with stated capital of over JPY100 million) will be required to e-file certain tax returns (along with attachments) for corporate tax, local corporate tax, inhabitants tax and enterprise tax.

Failure to e-file the tax returns will be considered as a failure to file except in limited cases where it was not possible to e-file due to electronic transmission problems, natural disaster, etc. However, if a substantial part of the tax returns are e-filed, no penalty would be imposed for failure to file.

E-filing is mandatory for fiscal years beginning on or after 1 April 2020.

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Contacts

Inbound Group, Deloitte Tohmatsu Tax Co.
Not all articles or facts and circumstances are covered in this alert. If you have any questions regarding your specific situation, please contact one of the tax professionals at our Deloitte office in Tokyo as follows:

Yang Ho Kim, Inbound Group Leader	yangho.kim@tohmatsu.co.jp	+81 3 6213 3841
Business Tax Services		
Sunie Oue, Partner	sunie.oue@tohmatsu.co.jp	+81 3 6213 3753
Jun Takahara, Partner	jun.takahara@tohmatsu.co.jp	+81 3 6213 3946
Indirect Tax Services		
Chikara Okada, Partner	chikara.okada@tohmatsu.co.jp	+81 3 6213 3900
Global Employer Services		
Russell Bird, Partner	russell.bird@tohmatsu.co.jp	+81 3 6213 3979
Transfer Pricing		
Timothy O'Brien, Partner	timothy.obrien@tohmatsu.co.jp	+81 3 6213 3923
Jun Sawada, Partner	jun.sawada@tohmatsu.co.jp	+81 3 6213 3927

Issued by

Deloitte Tohmatsu Tax Co.
Tokyo Office
Shin-Tokyo Building 5F, 3-3-1 Marunouchi, Chiyoda-ku, Tokyo 100-8305, Japan
Tel: +81 3 6213 3800
email: tax.cs@tohmatsu.co.jp
Corporate Info: www.deloitte.com/jp/en/tax
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