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Japan Inbound Tax＆Legal Newsletter

2020 Tax Reform Proposals - Announced

December 2019, No.49

In Brief

On 12 December 2019, proposals for the 2020 tax reform were announced by the Liberal Democratic Party (LDP) and the New Komeito Party and posted on the LDP's website. (Japanese / PDF).

The 2020 proposals include changes to the tax consolidation system, which is expected to be replaced with a group aggregation system, new incentives to encourage investment in start-ups, and the ability to the extend the Japanese consumption tax filing deadline. Also, the proposals introduce an anti-avoidance provision preventing companies from inappropriately creating capital losses, as well as a number of provisions impacting individuals.

To date, Japan has been a first mover in the region in locally implementing the Organisation for Economic Co-operation and Development's ("OECD") Base Erosion and Profit Shifting ("BEPS") related measures. While the 2020 proposals do not include any measures related to the OECD's BEPS project, in the introductory statements of the tax reform, the Government specifically highlighted the importance of the ongoing OECD work relating to taxation of the digital economy. This may signal that the Japanese government once again intends to be at the forefront of change resulting from the work currently being undertaken by the OECD.

This newsletter highlights some of the key items that may affect foreign headquartered 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.

TABLE OF CONTENTS

1. Corporate Tax

(1) Change from tax consolidation system to group aggregation system

Japan’s 2020 tax reform proposes to replace the tax consolidation rules, introduced in 2002, with group aggregation rules. The group aggregation rules will be applicable for fiscal years beginning on or after 1 April 2022.

The purpose of moving to a group aggregation system is to reduce the administrative burden imposed on taxpayers and the tax authority, such as the complicated tax calculation procedures and post-audit amendment and correction procedures, while maintaining and encouraging flexible reorganization.

The group aggregation rules vary significantly from the tax consolidation rules. For example, tax filings and payments will no longer be performed on a consolidated basis, but by each separate entity. Also, the scope in which the mark-to-market (“MTM”) valuation and net operating loss (“NOLs”) forfeiture rules applied at the commencement of, or at the time of joining, a consolidation will be reduced and aligned with the corporate reorganization rules. However, the offsetting of profit and loss within a consolidated group will continue to be allowed under the group aggregation system.

1) Outline of group aggregation rules

The table below outlines some of the key differences between the tax consolidation system and the group aggregation system.

	Current **Tax consolidation rules**	**Proposed** **Group aggregation rules**
Applicable entities	A Japanese parented group of 100% owned Japanese companies	No significant difference
Application procedures	Apply for approval three months before the beginning of the first consolidated fiscal year	No significant difference
Taxable entity	The tax consolidated group	The parent company and each group subsidiary
Relationship with blue form taxpayer status[1]	Blue form taxpayer status not required	Blue form taxpayer status required
E-filing	Required if the parent company’s stated capital is more than JPY100 million for fiscal years beginning on or after 1 April 2020	All aggregated entities required to e-file national and local corporate tax returns
Fiscal year	Fiscal year of the parent company	No significant difference
Voluntary discontinuation	Generally prohibited	No significant difference
Offsetting of profit and loss between entities	Allowed	Allowed, but NOLs are allocated to profit generating companies on a pro rata basis according to their income. For details, see 2)(i)
Calculation of income and tax credits	Some items calculated on a group basis while others on a separate entity basis	In principle, on a separate entity basis, but certain items on a group basis. For details, see 5)

1 Blue form taxpayer status is a specified status in Japanese tax law that provides a wide range of tax privileges, subject to certain conditions, to taxpayers filing blue form tax returns.

Amendment and correction	Calculated on a group basis	In principle, calculated on a separate entity basis with any corrections not impacting the original group profit-loss allocation. However, the tax ofice may recalculate profit-loss allocation if they find that the company is inappropriately reducing its tax. For details, see 2)(iii).
Joint liability to pay tax	Jointly liable	No significant difference
Applicability of general anti-avoidance rules	Applicable	No significant difference

2) **Calculation of taxable income and tax liability under the group aggregation system**

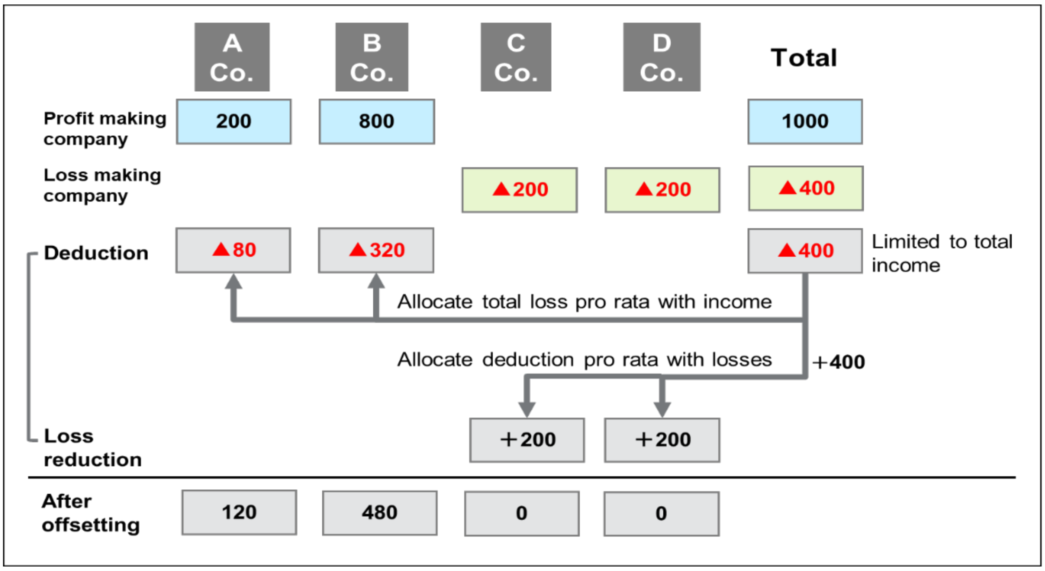
(i) **Offsetting of profits and losses within a group**

Losses of loss-making group companies will be allocated within the group on a pro rata basis as follows:

(A) Allocate total losses of loss-making companies (to the extent of total income of profit-making companies) among profit-making companies on a pro rata basis according to their income. Then, these profit-making companies deduct the allocated loss against their income.

(B) Allocate the total losses deducted above among loss-making companies on a pro rata basis according to their losses. Then, these loss-making companies reduce their losses by the allocated loss.

Calculation example



(A) Allocate total loss (400 ≦ income of 1,000) pro rata with income and deduct the loss.

A Co. 400 x 200 / 1,000 = 80

B Co. 400 x 800 / 1,000 = 320

(B) Allocate the total loss deduction pro rata.

C Co. 400 x 200 / 400 = 200

D Co. 400 x 200 / 400 = 200

(ii) **Utilization of NOL carryforwards**

The utilization of NOL carryforwards by a group will be limited to the total of 50% (certain exceptions apply) of the income of companies before NOL utilization (but after profit and loss offsetting). The details of how to allocate utilized NOLs are not provided in the tax reform proposals.

(iii) Amendment and correction

(A) Offsetting of profits and losses
If an aggregated group company's profit or loss for a fiscal year is amended in a subsequent fiscal year, the amendment should not impact the originally calculated allocation of profits or losses among the other aggregated group companies for purposes of offsetting profits and losses.

(B) Utilization of NOL carryforwards
If an aggregated group company's profit or NOL carryforwards for a fiscal year are amended in a subsequent fiscal year, the amendments to the profits or NOL carryforwards should not impact the originally calculated NOLs utilized by other group companies.

(C) Treatment of inappropriate tax reduction
The tax office, however, may override the rules in (A) and (B) and recalculate the group tax amount if they find that the company is inappropriately reducing its tax liability, for example, by utilizing NOLs which would otherwise expire, or is transferring NOLs to a company leaving the aggregated group.

(iv) Book value adjustments for group companies

Rules for the adjustment of book value of group companies will also be revised as follows:

(A) Valuation gain or loss on shares in group subsidiaries and gain or loss on share transfers within an aggregated group will no longer be recognized.

(B) The book value of the shares of a group company immediately before leaving the group will be the book value of its net assets.

(C) The shares of a subsidiary which will join a group aggregation, but which is no longer expected to be 100% owned by the parent company will be marked-to-market, and valuation gain or loss on those shares will be recognized by the shareholders of the subsidiary.

(v) Tax rate

The applicable tax rate of a group company will be the rate which would be applied if the company were not aggregated. However, the lower rate for SMEs[2] will not be applicable to companies of a group if the group has one or more than one large company.

(vi) Tax filing and payment

(A) E-filing
Companies of an aggregated group will be required to file final, interim and amended corporate tax returns (both national and local) electronically.

(B) Extension of filing due date
The filing due date of aggregated companies may generally be extended by two months as is the case under the current tax consolidation rules.

3) Starting a group aggregation and joining an aggregated group

The tax consolidation rules require that the assets of subsidiaries be subject to MTM valuation at the start of, or at the time of joining, a tax consolidation and that their NOLs incurred before such time be forfeited

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2 A small and medium sized enterprise is an entity whose stated capital is JPY 100 million or less, except for either of the following cases:

- Where 100% of the shares of the company are directly or indirectly owned by a company with stated capital of JPY 500 million or more (large sized company).
- Where 100% of the shares of the company are directly or indirectly owned by two or more large sized companies in a 100% control group.

unless certain conditions are met. The parent company, on the other hand, is exempt from such MTM valuation and NOL forfeiture rules and its NOL carryforwards brought into a group at the start of tax consolidation may be utilized to offset the consolidated income of the consolidated group.

The group aggregation rules, however, are expected to have a narrower scope for MTM valuation and NOL forfeiture at the start of, or at the time of joining, a group aggregation and align more closely with the corporate reorganization rules. In addition, losses realized in an aggregate group from certain built-in-loss assets ("BILs") may be limited. Furthermore, a parent company will no longer be exempt from MTM valuation or forfeiture of NOL carryforwards unless certain conditions are met.

(i) At the start of group aggregation - MTM valuation and limitation of NOL carryforwards and BILs

Treatment of parent company

The MTM valuation and the treatment of NOLs and BILs of a parent company at the time of start of group aggregation are outlined in the table below.

<table>
<tr><th colspan="5">Group aggregation rules</th><th rowspan="2">Tax consolidation rules</th></tr>
<tr><th colspan="2">MTM valuation of assets</th><th colspan="3">BILs and pre-aggregation NOLs</th></tr>
<tr><td rowspan="3">Expected to maintain 100% ownership of any group subsidiary</td><td rowspan="3">Not applicable</td><td colspan="2">Control Relationship[3] with any group subsidiary for more than 5 years</td><td rowspan="2">No limitation, but NOLs subject to SRLY[4] rule</td><td rowspan="4">・Out of scope of MTM
・No limitation on utilization of NOLs or BILs</td></tr>
<tr><td rowspan="2">Control Relationship with every group subsidiary for 5 years or less</td><td>Joint Business Test[A] met</td></tr>
<tr><td>Joint Business Test[A] NOT met</td><td>Partial limitation[B]</td></tr>
<tr><td>Not expected to maintain 100% ownership of any group subsidiary</td><td>Applicable</td><td colspan="3">NOLs generated before the start of aggregation forfeited</td></tr>
</table>

Table notes

A The joint business test is met if similar conditions to the "deemed joint business test" under the corporate reorganization rules are met.

B The specific limitation will depend on the particular facts and circumstances.

Treatment of subsidiaries

The MTM valuation and the treatment of NOLs and BILs of group subsidiaries at the start of group aggregation are summarized in the table below.

<table>
<tr><th colspan="4">Group aggregation rules</th><th rowspan="2">Tax consolidation rules</th></tr>
<tr><th colspan="2">MTM valuation of assets</th><th colspan="2">BILs and pre-aggregation NOLs</th></tr>
<tr><td>Expected to maintain 100% ownership by</td><td>Not applicable</td><td>Control Relationship with parent for more than 5 years</td><td>No limitation, but NOLs subject to SRLY rule</td><td>Specified consolidated subsidiaries:</td></tr>
</table>

3 Control relationship is a relationship in which:

- a company owns directly or indirectly more than 50% of the outstanding shares in another company; or
- more than 50% of shares in a company and more than 50% of shares in another company are directly or indirectly owned by the same company.

4 Separate return limitation year (SRLY) rules limit the utilization of NOL carryforwards to the income amount of the company which originally generated the NOL.

<table>
<tr><td rowspan="2">parent company</td><td rowspan="2"></td><td rowspan="2">Control Relationship with parent for 5 years or less</td><td>Joint Business Test[A] met</td><td></td><td rowspan="3">・Out of scope of MTM
・No limitation on utilization of NOLs or BILs

Other subsidiaries:
・Subject to MTM valuation
・Utilization of NOLs limited</td></tr>
<tr><td>Joint Business Test[A] NOT met</td><td>Partial limitation[B]</td></tr>
<tr><td>Not expected to maintain 100% ownership by parent company</td><td>Applicable</td><td colspan="3">NOLs generated before the start of group aggregation forfeited.</td></tr>
</table>

Table notes

A The joint business test is met if similar conditions to the “deemed joint business test” under the corporate reorganization rules are met.

B The specific limitation will depend on the particular facts and circumstances.

(ii) Subsidiaries joining an aggregated group - MTM valuation and limitation of NOL carryforwards and BILs

The MTM valuation and the treatment of NOLs and BILs of group subsidiaries upon joining an existing aggregated group are summarized in the table below.

<table>
<tr><th rowspan="2">Types of entity</th><th colspan="4">Group aggregation rules</th></tr>
<tr><th>MTM valuation of assets</th><th colspan="3">Built-in losses and pre-aggregation NOLs</th></tr>
<tr><td>A newly established subsidiary of an aggregated group</td><td rowspan="5">Not applicable</td><td colspan="2" rowspan="2">Control Relationship with parent for more than 5 years</td><td rowspan="4">No limitation, but NOLs subject to SRLY rule</td></tr>
<tr><td rowspan="2">A subsidiary joining through qualified share-for-share exchange</td></tr>
<tr><td rowspan="3">Control Relationship with parent for 5 years or less</td><td rowspan="2">Joint Business Test[B] met</td></tr>
<tr><td rowspan="2">A subsidiary fulfilling certain conditions[A]</td></tr>
<tr><td>Joint Business Test[B] met</td><td>Partial limitation[C]</td></tr>
<tr><td>Other than the above</td><td>Applicable</td><td colspan="3">NOLs generated before joining the group forfeited.</td></tr>
</table>

Table notes

A The conditions are similar to those for a qualified corporate reorganization.

B The joint business test is met if any of the following are met:

- For subsidiaries that do not have a more than 50% shareholding relationship with the parent company immediately before joining the aggregated group, if certain conditions under A above are met.

- For subsidiaries that have a more than 50% shareholding relationship with parent company immediately before joining the aggregated group, if similar conditions to the “deemed joint business test” under the corporate reorganization rules are met.

- For subsidiaries that join the aggregated group through a non-qualified share-for-share exchange, if at least certain conditions to be treated as a qualified share-for-share exchange are met.

C The specific limitation will depend on the particular facts and circumstances.

(iii) Deemed fiscal year of subsidiaries joining an aggregated group

If a company becomes fully controlled by the parent company and, as a result, joins a group aggregation in the middle of a fiscal year, the company may treat the date following the end of the fiscal year in which the 100% shareholding relationship is established as its effective date of joining and the beginning of its fiscal year.

4) Withdrawal from an aggregated group

The tax consolidation rules do not require the assets of exiting companies to be marked to market, but the group aggregation rules will require the following assets to be marked to market for the fiscal year immediately before the exit:

- If the main business of the exiting company is expected to cease (except for the case where the amount of built-in gains is equal to or greater than the amount of built-in losses immediately before the exit): Fixed assets, land, securities (excluding trading securities), monetary receivables, and deferred assets, excluding those whose book value is less than JPY10 million or whose built in gains or losses are less than the smaller of the following amounts:
  - Half of capital (i.e., stated capital and capital reserve) for tax purposes; or
  - JPY10 million
- If the company is expected to recognize a loss on the transfer of assets whose book value is more than JPY1 billion and a shareholder of the company is expected to make a loss on the transfer of the company shares: The assets which are expected to make a loss and whose book value is more than JPY1 billion

5) Group calculations

Calculations of income and tax credits under the group aggregation rules will generally be made on a separate entity basis except for certain items. The following are list of how they will be calculated under the group aggregation system.

(i) Calculations to be made on an aggregated group basis

- Foreign dividend exclusion
- Determination of SMEs (applying certain tax benefits for SMEs is disallowed if the group has one, or more than one, large company).
- Foreign tax credits
- R&D tax credits
- Determination of SMEs for which R&D and other tax credits are disallowed
- Special deduction of NOLs in case of discharge of debt, etc. due to corporate rehabilitation, etc.
- Refunds from NOL carryback

(ii) Calculations to be made on a separate entity basis, but based on the concept of a group

- Domestic dividend exclusion
- Bad debt provision
- Special deduction for asset transfer

(iii) Calculations to be made on a separate entity basis

- Deduction of donations
- Determination of loss making company which may be subject to NOLs restrictions and built-in-loss restrictions
- Income tax credits
- Credit/refund of overpaid corporation tax due to correction of disguised accounting
- Special tax rate for specified family corporations
- Other corporate tax credits
- Calculation of non-deductible interest amount under earnings stripping rules

6) Effective date

The group aggregation rules will be applicable for fiscal years beginning on or after 1 April 2022. Transitional measures are as follows:

- The group aggregation system will automatically replace the tax consolidation system, and will apply to existing groups for fiscal years beginning on or after 1 April 2022.

- Existing consolidated groups may elect not to join the group aggregation system by filing notifications before the start of the first fiscal year beginning on or after 1 April 2022.

Deloitte's view

While many details of the group aggregation system are not included in the proposals and while these proposals could change prior to enactment, we can make a couple of observations that multinationals with multiple corporations in Japan may want to start considering.

First, for corporate groups currently in tax consolidation, a decision will need to be made whether to opt out of the group aggregation system. While we would expect that most groups would not opt out as they can continue to enjoy the benefits of offsetting group profits and losses, the tax treatment of certain transactions (e.g. selling shares of a subsidiary out of the group) may differ depending on whether it is performed under the tax consolidation system, under the group aggregation system, or on a standalone basis. Some analysis should be undertaken to understand the tax treatment prior to executing the transaction.

Second, corporate groups not currently in tax consolidation may want to consider applying for group aggregation, especially if the group has some loss-making entities. It's expected that the hurdles (e.g. forfeiture of NOLs, etc.) faced when entering into a tax consolidation will be reduced under the group aggregation system, while maintaining some of the key benefits of the tax consolidation system, such as the offsetting of profits and losses within a group. However, as the conditions for beneficial tax treatment are closely linked with the complicated conditions found under corporate reorganization rules, companies should perform a detailed analysis to understand the specific implications for each member of a group prior to entering into a group aggregation.

Also, corporations not currently in tax consolidation, but interested in applying the group aggregation system, should consider whether there is any benefit to entering into tax consolidation and automatically rolling over into the group aggregation system versus waiting to elect into the group aggregation system. For example, one of the key differences between the tax consolidation rules and group aggregation rules is the treatment of NOLs of a parent company. The tax consolidation rules allow the transfer of a parent company's NOLs without any limitation while the group aggregation rules limit their utilization to its income amount under the SRLY rules. As such, a group of companies considering the effective utilization of the parent company's NOLs may want to start analyzing these options.

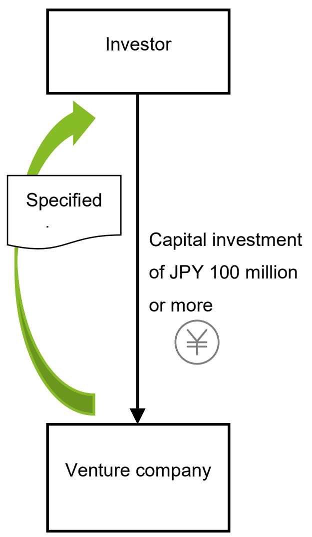
Lastly, it should be noted that corporate groups of Japanese entities that are not wholly owned by a Japanese holding/parent company (for example, corporate groups with multiple Japanese entities, but each wholly owned by different foreign corporate shareholders) would need to undertake some internal corporate restructuring to have all Japanese entities held within the same group wholly owned by a Japanese holding/parent company before it is eligible to apply for group aggregation. Due to Japanese tax and legal requirements, internal reorganizations may take time to fully implement so any Japanese tax analysis should be undertaken well in advance of any target start for group aggregation.

(2) Establishment of the Tax System for Promoting Open Innovation

Under this the new tax system, a deduction will be available for operating companies ("Investors") making investments in certain venture companies. To make use of the system, an Investor must obtain approval from the Ministry of Economy, Trade and, Industry ("METI"), and if the Investor disposes of the shares of the venture company within a specified time period, all or a portion of the deduction amount may be reversed and added back to the Investor's taxable income.

Details on the system's specific application requirements, amounts includable in deductible expenses, and amounts includable in taxable income are provided below.

1) **For large companies (i.e. other than small and medium-sized enterprises - “SMEs”)**

<table>
<tr><th>Applicable investment</th><th>Basic requirements</th></tr>
<tr><td rowspan="3">
</td><td>Investor requirements:
■ A company that satisfies the following requirements:
➢ Corporation filing “blue form” tax returns
➢ A company aiming to engage in business that is expected to have high productivity, or develop a new business, by utilizing management resources other than its own (e.g. “specified business activities”)

■ Specified shares are those acquired by an investor, or those which become partnership property of an investment limited partnership in which the Investor is the only limited liability partner, and their investment ratio exceeds 50% (*)</td></tr>
<tr><td>Open innovation requirements (*)
■ Investor engages in specified business activities (i.e., the acquisition of shares of a venture company)

■ Management resources of the venture company will contribute to business activities that are expected to have high productivity, or has ability to develop new business

■ Certain other requirements</td></tr>
<tr><td>Venture company requirements
■ A domestic corporation (or similar foreign corporation) that has already started business and is less than 10 years old and has ability to develop new business under the Act on Strengthening Industrial Competitiveness, and is conducting business under the Act that contributes to specified business activities</td></tr>
<tr><td colspan="2">Other requirements
■ Venture company must issue stock (specified shares) to the Investor in return for the increase in stated capital resulting from the capital investment. (*)

■ The capital investment should be JPY 100 million or more (JPY 500 million or more in the case of payment to a foreign corporation) (Note: Maximum payment limits may apply). (*)

■ The Investor acquires the specified shares during the period from 1 April 2020 to 31 March 2022, and holds the shares until the end of the business year in which the date of the acquisition occurs.</td></tr>
</table>

(*) Marked items require certification from METI

Where an investment meets the above requirements under the Tax System for Promoting Open Innovation, a deduction will be available, subject to reversal should a certain triggering event occur. Details are as follows:

Category	Requirements / Triggering events	Amount
Deductible expense	25% or less of the total acquisition cost of the specified shares must be accounted for using a special account	The amount accounted for in the special account is includable as a deduction, but only to the extent of taxable income for the fiscal year
Inclusion in taxable income	The following events may trigger reversal of the deduction (excluding where five years have passed since the acquisition of the specified shares): ■ METI revokes certification of the specified shares ■ All or part of the specified shares are no longer held ■ A dividend is received with regard to the specified shares ■ The book value of specified shares is reduced ■ A change occurs in the investment ratio of an investment limited partnership, etc. where specified shares are held as partnership property ■ Venture company is dissolved ■ Investor is dissolved ■ The special account is arbitrarily written down	Includable amount depends on which event has triggered the inclusion

2) **For SMEs**

The Tax System for Promoting Open Innovation also applies to SMEs. The requirements for SMEs to take advantage of the System's tax incentives are generally the same as for non-SMEs, with certain exceptions as noted below:

- Investor must be an SME
- The minimum amount of capital investment (for both domestic and foreign corporations) is JPY 10 million (Note: Maximum payment limits may still apply)

(3) Revisions of existing tax incentive systems

1) **Revision of requirements for large companies to utilize productivity improvement incentives**

The requirements for large companies to utilize the following incentive systems will be revised as follows:

Item	Current	Proposed
Capital Investment requirements	Domestic capital investment > Total depreciation × **10%**	Domestic capital investment > Total depreciation × **30%**
Applicable system	■ R&D Tax Credit System ■ Regional Future Investment Promotion Tax System ■ Connected Industries Tax System (IoT Tax System)	■ R&D Tax Credit System ■ Regional Future Investment Promotion Tax System ■ Special Depreciation or Tax Credit for 5G Mobile Communication Systems

2) **Revision of the tax incentives for wage and productivity improvement**

The requirements for utilization of the system have been revised as follows:

Item	Current	Proposed
Capital Investment requirements	Domestic capital investment ≧ Total depreciation × **90%**	Domestic capital investment ≧ Total depreciation × **95%**

3) **Incentive for the relocation/expansion of headquarter functions from major cities to local areas**

These tax incentives will be revised, and their end date will be extended by two years.

4) **Other revisions to tax incentives under the Special Taxation and Measures Law (“STML”)**

The following incentive systems under the STML have been revised and/or extended (extension period indicated in parenthesis):

- Special measures for the acquisition of advanced energy conservation promotion equipment (2 year extension)
- Special measures for certain warehouses (2 year extension)
- Reserves for loss on overseas investment (2 year extension)
- Additional taxes for short-term gains on sales of land (3 year extension of suspension period)
- Special Provisions for Taxation on Investment Corporations
- Measures to Suspend Corporation Tax on Retirement Pension Funds (3 year extension)
- Special measures for acquisition of machines, etc. in National Strategic Special Zones (2 year extension)
- Special measures for acquisition of machinery, etc. in the International Strategic Special Zone (2 year extension)
- Connected Industries Tax System (abolished as of 31 March 2020)
- Special measures for renewable energy power facilities (1 year extension)
- Special measures for equipment facilitating the distribution of information (abolished)
- Special Provisions for Taxation on Designated Corporations in National Strategic Special Zones (2 year extension)
- Additional tax measures for capital gains on land sold by corporations
- Special tax measures for the repurchase of certain specified assets (3 year extension)
- Special measures for the deduction of certain low-value depreciable assets of SMEs (2 year extension)

Deloitte’s view

It is clear that the Japanese government is intent on promoting innovation and growth in the domestic economy by offering various tax incentives to companies willing to make the investment. With the addition of the Tax System for Promoting Open Innovation, there is now an immediate benefit in the form of a tax deduction for corporate investors in the venture capital market. Similarly, the extension of a significant number of the existing incentives keeps the window open for future opportunities.

As is common with these types of incentive programs in Japan, there is generally an application and certification process which is required, and therefore utilization will require proper planning and foresight for potential investors. However, for companies already planning to invest further in Japan, the availability of benefits are wide ranging and if properly applied can add to the return on investment.

2. International Tax

(1) Anti-tax avoidance measures on transfers of certain subsidiaries’ shares

1) **Overview**

If a taxpayer corporation receives dividends, etc. from certain subsidiaries (“Specified Related Subsidiaries”)[5] and the dividend amount (“Subject Dividend Amount”)[6] exceeds 10% of the tax basis in

5 “Specified Related Subsidiary” refers to a corporation with which the taxpayer (together with its specially related parties) has a direct/indirect ownership of more than 50% of the shares or certain voting interests in another corporation on the date on which the payment of the dividends is resolved by the Specified Related Subsidiary.

6 “Subject Dividend Amount” refers to aggregate amount of dividends previously received from the Specified Related Subsidiary during the same fiscal year of the taxpayer.

the shares of the Specified Related Subsidiary ("Outside Tax Basis"), the Outside Tax Basis shall be reduced by the portion of the Subject Dividend Amount to the extent excluded from taxable income of the taxpayer corporation under the Japanese dividend exclusion regime, etc.

2) **Exemptions**

No adjustment shall be made to the Outside Tax Basis with respect to the dividends amount outlined in the following:.

- Subject Dividend Amount where the Specified Related Subsidiary is a Japanese ordinary corporation with more than 90% of its total outstanding shares being continuously owned by Japanese ordinary corporations, Japanese cooperatives and/or Japanese tax resident individuals from the date of incorporation through the date on which the Specified Controlling Relationship[7] was generated ("Specified Controlling Relationship Date").

- Subject Dividend Amount from the Specified Related Subsidiary where i) less ii) is equal to or greater than iii):
  - i. Retained earnings of the Specified Related Subsidiary as on the commencement date of the fiscal year of the Specified Related Subsidiary in which dividend payment was resolved ("Commencement Date");
  - ii. Aggregate amount of dividends received by the shareholders of the Specified Related Subsidiary from the Commencement Date through the date on which dividend payment was resolved;
  - iii. Adjusted retained earnings of the Specified Related Subsidiary as on the commencement date of the fiscal year of the Specified Related Subsidiary in which the Specified Controlling Relationship was generated.

- Dividends paid on and after the date on which 10 years have passed following the Specified Controlling Relationship Date; and

- Subject Dividend Amount which is not greater than JPY 20 million.

3) **Exception**

If the Subject Dividend Amount is paid out of the retained earnings generated on and after the Specified Controlling Relationship Date (i.e., i. less iii. above), such portion shall not be reduced from the Outside Tax Basis at the discretion of the taxpayer.

(2) Revision to the earning stripping rules

Payments of interest by a Japanese company to a Japanese permanent establishment of a foreign company, where the receivable giving rise to the interest is transferred to the head office of the foreign company, will no longer be out of scope for purposes of the earnings stripping rules.

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[7] "Specified Controlling Relationship" refers to a relationship with which the one party (together with its specially related parties) has a direct/indirect ownership of more than 50% of the shares or certain voting interest in another corporation.

Deloitte's view

In some countries, capital gains are fully taxable at the corporate shareholder level unlike dividends. In order to mitigate double taxation between the corporate income tax at the company level and capital gain tax at the shareholder level, corporate shareholders may prefer to strip retained earnings of the subsidiaries as dividends tax-free to reduce the value of the shares in the subsidiaries prior to a share transfer.

Based on this reform, such dividend stripping planning may no longer be feasible from a Japanese tax perspective as the tax exempt portion of the dividends may reduce the outside tax basis in the hands of the corporate shareholders which would nullify the recharactarization of fully taxable capital gains to tax-exempt dividends.

In an inbound M&A context, similar planning may be used if the withholding tax on dividends is more preferable than corporate income tax on capital gains from Japanese tax perspective, with consideration given to relevant tax treaties. However, it is not clear as of the writing of this letter if this provision is applicable to foreign shareholders without a permanent establishment in Japan.

Corporate shareholders investing in Japanese companies should keep an eye on future developments.

3. Consumption Tax

(1) Introduction of extension to file Japanese Consumption Tax ("JCT") returns for corporations

- If a corporation which extends the filing due date for its annual corporate tax returns files a notification for the extension of the filing due date for JCT returns, the filing due date of the JCT return for the applicable taxable period will be extended by one month.
- The JCT return due-date extension will be applicable to the taxable period for which the last day of the fiscal year belongs.
- Interest will be levied on the JCT payment due for the extended period.
- The revision will apply beginning from the taxable period which includes the last day of the fiscal year ending on or after 31 March 2021.

(2) Revision of the JCT credit system for purchases of residential rental buildings

- JCT paid on a taxable purchase of certain buildings used for residential leasing ("Residential Buildings") will not be creditable. However, a portion of the JCT paid will be creditable if it is clear that a portion of such buildings will not be used for residential leasing.
- If the use of the Residential Buildings is changed to something other than residential leasing, or the Residential Buildings are transferred during a certain period (basically three years from the beginning of the taxable period which includes the purchase date), a certain amount of JCT paid may be creditable.
- This revision applies to the purchases of Residential Buildings on or after 1 October 2020. However, the revision does not apply to the Residential Buildings that are purchased on or after 1 October 2020 under contracts concluded before 1 April 2020.

Deloitte's view

The one month extension of the JCT return filing, while short, is aligned with the typical extension available for corporate tax return filings. In the past, if certain amendments were made to a corporate tax return prior to the corporate tax return filing deadline, but after a JCT return was filed, taxpayers were required to amend their JCT returns to reflect the amendment causing additional administrative burden. With the extension, amendments to the corporate tax return can also be amended on the JCT return prior to filing.

Also, the purpose of the above measure related to Residential Buildings is to discourage the use of certain transactions that enable taxpayers to inappropriately claim a JCT credit on purchase of Residential Buildings. Even for taxpayers that do not inappropriately claim a JCT credit, these revisions may still impact the amount and timing of creditable JCT incurred on a purchase of Residential Buildings.

4. Individual Tax

(1) Taxation of financial securities

The following revisions will be made to tax exemptions on dividend/capital gain income generated from listed stocks, etc. within a NISA (Nippon Individual Savings Accounts).

- The tax exemption period for savings NISAs will be extended for another five years until 31 December 2042.
- The tax exemption period for ordinary NISAs will end on 31 December 2023. However, an election is available to apply for continued tax exemption in a savings NISA.
- The tax exemption period for junior NISAs will end without extension.

(2) Revisions to the angel tax regime

- The conditions that corporations must meet for the angel tax regime will be reviewed and administrative procedures for corporations to newly register themselves with the authorities will be simplified.
- The maximum allowable angel tax deduction will be decreased from JPY10,000,000 to JPY8,000,000 from 2021 onwards.

(3) Revisions to derivative transactions using cryptocurrency

Taxpayers can no longer apply separate taxation (20%) on miscellaneous income gain from derivative transactions using cryptocurrency. Similarly, losses can no longer be carried forward to offset against future gains.

(4) Revisions to the housing loan deduction on local inhabitant's (resident) tax

For properties sold after 1 April 2020 by an individual eligible to apply a special JPY30,000,000 deduction on any capital gains derived from selling the property acquired for personal residence purposes during the first three years of living in a such property, the housing loan deduction on local inhabitant's taxes cannot be applied if the previously mentioned deduction has already been taken on an annual Japanese tax return (a similar stipulation is already in effect for national tax purposes).

(5) Treatment of offsetting profit and loss on income from second-hand buildings outside of Japan

Under aggregate taxation, the following types of overseas buildings cannot include depreciation as part of their overall expenses to offset against income generated from other categories :

- Buildings whose current useful life is calculated using one of the following methods:
  - Buildings that have already exceeded the statutory useful life at the time of acquisition, and thus, applied a useful life of 20% of the normal statutory useful life.

- Buildings for which a portion of the statutory useful life has already been used at the time of acquisition, and thus, applied a useful life of: (statutory useful life) – (portion of useful life already passed) + (20% of portion of the useful life that already passed).

- Buildings which have applied an estimated useful life and official documentation cannot be provided to back up the estimation.

- If there are second-hand overseas buildings that generate real estate income, a real estate loss from other overseas buildings can be used to offset the income. However, any outstanding losses still available after offsetting with real estate income cannot be used to offset against income generated from other categories under aggregate taxation.

- For tax calculations purposes, outstanding real estate losses as described above are assumed to no longer exist.

(6) Revisions to charitable organizations applicable for the charitable contributions deduction

Individuals will now be able to apply the credit for charitable contributions made to charitable organizations that meet either of the following conditions:

- Public or private academic organizations that have met both the “Public Support Test” and information disclosure requirement.

- Charitable contributions made to assist the research of students and researchers under difficult employment conditions. Note that official confirmation from the Japanese authorities is required for such contributions.

(7) Revisions to the Overseas Dependents Deduction

From 2023, overseas dependents between 30 and 69 years old will not be eligible for the dependents deduction, unless one of the following conditions are met:

- Dependent has become a Japan non-resident due to studying abroad;
- Dependent has a disability; or
- Dependent receives a living or educational allowance of at least JPY380,000 from the taxpayer during the tax year.

If the dependent meets either condition one or three, supporting documentation must be submitted as proof.

(8) Revisions to the calculation of taxable miscellaneous income

- If gross miscellaneous income from two tax years prior was JPY3,000,000 or less, the current tax year’s taxable miscellaneous income can be calculated using cash basis accounting.

- If gross miscellaneous income from two tax years prior was more than JPY3,000,000, any related documents regarding cash and deposit transactions must be kept for five years starting 15 March of the year following the year in which the current year’s taxable miscellaneous income was reported.

- If gross miscellaneous income from two tax years prior was more than JPY10,000,000, the profit and loss statement of the current year’s miscellaneous income must be submitted along with the annual tax return (assuming an annual tax return needs to be filed).

(9) Revisions to foreign asset reporting

- If any foreign assets become subject to inheritance tax upon failure to submit a foreign asset report beforehand, additional penalty taxes will be now be imposed if an individual is required to amend or file an inheritance tax return after the due date.

- If any additional foreign assets become subject to income tax upon failure to submit any supporting documents within 60 days of a request, additional subsequently imposed penalty taxes will increase from 5 to 10%, if an individual is required to file an amended national income/inheritance tax return.

- If supporting documents related to any foreign assets are not submitted by the individual and the tax authorities must request these through exchanging information with foreign authorities per agreement under a tax treaty, the statute of limitations for submitting an amended return will extend by three years from the date of request to the foreign authorities.

Deloitte's view

Taxpayers should be aware that starting in 2021, losses from overseas rental property for which depreciation is calculated using simplified methods (e.g., four years on wood-structured properties that exceeded their legal useful lives) cannot be included as rental loss expenses used to offset against other categories of income under aggregate taxation.

Further, starting in 2023, overseas dependents cannot be claimed for the dependents deduction without supporting evidence that at least JPY380,000 has been transferred as living allowance or proof of studying abroad.

If a taxpayer has generated more than JPY3,000,000 in miscellaneous income, they should ensure that documents regarding cash and deposit transactions are safely kept for submission at the tax authorities' request.

Finally, we anticipate that the tax authorities will take stricter measures to enforce compliance with foreign asset reporting.

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