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Sonderhoff & Einsel News Update: Tax Newsletter (September 2016)

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We are pleased to provide you with our Tax Newsletter, September 2016 Issue. Summarized below are important amendments to the domestic tax laws under the 2016 Tax Reform and revision to the tax treaty between Japan and Germany.

I. TAX TREATY

The agreement between Japan and the Federal Republic of Germany for the elimination of double taxation with respect to taxes on income[KT1] and to certain other taxes and the prevention of tax evasion and avoidance ("Tax Treaty") was signed on December 17, 2015, approved by the Japanese Diet in May 2016, and will most likely be effective as of January 1, 2017. Under the new Tax Treaty, withholding tax on income arising from various investments will be substantially reduced or fully exempt as summarized in the table below.

Dividends （Article 10）		Interest (Article 11)	Royalties (Article 12)
Recipient is a company (other than a partnership) directly holding at least 25% shares with voting rights for at least 18 consecutive months	Fully exempt	Fully exempt (Except for interest computed based on revenue, indexed to asset value, etc. of a debtor or related parties thereof, distributions from partnership and the like. Art. 4 (a) (ii) of Protocol)	Fully exempt
Recipient is a company (other than a partnership) directly holding at least 10% shares with voting rights for at least 6 consecutive months	5%		
Other than the above, e.g., individual shareholders	15%		
Dividends paid by TMK, investment SPC and the like are allowed to treat dividends as expenses for tax purposes	Fully taxed (No exemption under Art. 4 (a) (i) of Protocol)		

Under the current Tax Treaty, the maximum reduction of the withholding tax rate is 10%. Moreover, 15% withholding tax is applied to dividends paid by German corporations to their Japanese shareholders. The drastic reduction of withholding tax burdens on dividends will have a substantial impact on the business operations conducted by Japanese corporations in Europe. Together with the impact of Brexit, Germany is expected to become a very attractive location for Japanese companies to establish its European headquarters. The new treaty will also have significant impact on German enterprises with investments in their subsidiaries/affiliates/ business partners in Japan, as interest and royalties will also be exempt from Japanese withholding tax.

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While the new Tax Treaty provides extensive benefits, the following measures will be introduced to prevent international tax evasion and tax avoidance through abusive use of treaty benefits.

- A stricter application of the arm's length principle for the purposes of computing business profits attributable to a permanent establishment (Art.7).
- Taxation on capital gains arising from the alienation of shares or interest in a company, partnership or trust deriving at least 50% of the value of its property directly or indirectly from immovable property (Art.13 (2))
- Limitation of treaty benefits solely on qualified residents satisfying certain conditions (Art. 21)
- Expansion of the scope of cases and taxes subject to information exchange and detailed provisions for mutual assistance in the collection of taxes (Art.25-26).
- Introduction of explicit provisions regarding the filing requirements for the treaty benefits (Art. 27)

The New Treaty provides various other new measures with respect to transfer pricing taxation (Art.24-25), tax treatment of fiscally transparent entities (Art. 1) and taxation of a silent partnership (Art.4 in Protocol). In making business/investment decisions, potential impacts under the New Treaty should be carefully considered.

II. CORPORATE TAX

Under the 2016 Tax Reform, the tax base has expanded, while the tax rate has been reduced. In addition, new transfer pricing reporting obligations for multinational enterprises (MNEs) have been introduced, following the endorsement of the Action Plans of Base Erosion and Profit Shifting (BEPS) Project led by the Organization for Economics, Co-Operation and Development (OECD). As a result, MNEs will be required to prepare and file relevant documents in compliance with the standard set by the OECD and endorsed by G20 nations including Japan.

Key points under 2016 Tax Reform

- Reduction of national corporate tax rate
- Reduction in deductible losses carried forward
- Expansion of factor-based taxation for local enterprise tax purposes
- Repeal of tax incentives for newly-purchased equipment for productivity improvement
- Revision to the depreciation methods
- Introduction of reporting requirements for MNEs
- Introduction of contemporaneous documentation for transfer pricing determination

Reduction of corporate tax rates

The tax rate applicable to corporations and incorporated associations has been reduced from 23.9% to 23.4% (and further to 23.2%). The reductions will be implemented in steps as shown in the chart below.

Fiscal years beginning	On or after 2015・4・1～	On or after 2016・4・1～	On or after 2017・4・1～	On or after 2018・4・1～
Nominal national corporate tax rate	23.9%	23.4%	23.4%	23.2%
Effective combined (national and local) corporate tax rate （*1）	32.11%	29.97%	29.97%	29.74%

（*1） Computed based on the standard rates for corporate inhabitant tax and factor based enterprise tax purposes

Reduction in deductible losses carried forward

Further limitation will be imposed on the amount of the losses carried forward of large corporations filing blue form tax returns, that can be offset against their taxable income in future. On the other hand, the carry-forward period will be extended for one more year.

Fiscal years beginning	between 2015・4・1 and 2016.3.31	between 2016・4・1 and 2017.3.31	between 2017・4・1 and 2018.3.31	On or after 2018・4・1~
Deductible portion of the loss carried forward	65%	60%	55%	50%
Carry-forward period （*2）	9 years	9 years	9 years	10 years

（*2） The extension of the carry-forward period also applies to small and medium sized corporations

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Expansion of factor-based taxation for local enterprise tax purposes

Some amendments have been made to the factor-based taxation for local enterprise tax purposes, which are applicable to large corporations, the stated capital amount of which exceeds 100 million Japanese yen. While the tax rate for the profit factor is reduced, the tax rates for the other factors (value added factor and capital factor) is increased. As a result, enterprise tax burdens of profitable corporations will be reduced, while those of corporations incurring losses will be increased.

Fiscal years beginning	Before 2016・4・1	On or after 2016・4・1～
Profit Factor (at maximum)	6.0%	3.6%
Value Added Factor	0.72%	1.2%
Capital Factor	0.3%	0.5%

Repeal of tax incentives for newly-purchased equipment for productivity improvement

Tax incentives (one time depreciation or tax credit) granted to certain newly-purchased facilities/equipment for productivity improvement will be repealed in steps.

Purchased and put in use during the period	2014・1・20～ 2016・3・31	2016・4・1～ 2017・3・31	On or after 2017・４・1～
Equipment	One time depreciation or 5% tax credit	One time depreciation of 50%acquisition cost or 4% tax credit	No longer available
Building Structure	One time depreciation or 3% tax credit	One time depreciation of 25%acquisition	No longer available

		cost or 2% tax credit	

Applicable tax credit is subject to limitation in the amount of 20% of corporate tax.

Revision to the depreciation methods

Leasehold improvements and structures, the depreciation method of which each taxpayer was able to select at his/her discretion, must be depreciated based on a straight line method. This regulation is applied to such assets purchased and put in use on or after April 1, 2006.

	Purchased before 2016.4.1	Purchased on or after 2016・4・1～
Building	Straight line method only	Straight line method only
Leasehold improvement	Straight line method or declining balance method	Straight line method only
Structure	Straight line method or declining balance method	Straight line method only

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Introduction of reporting requirements for MNEs

The following reporting requirements will be applied to MNEs where the amount of gross revenue on a consolidated basis for the immediately preceding year is 100 billion Japanese yen or more.

1. Reporting regarding ultimate parent corporation

A Japanese corporation or a foreign corporation having a permanent establishment in Japan, which either belongs to an MNE, are required to report information regarding their ultimate parent corporation via electronic tax filing system. The information to be reported includes the name, location, corporate registration number (if any) and the name(s) of (a) representative director(s) of the ultimate parent corporation. The reporting must be made by the end of each fiscal year of the ultimate parent corporation, starting on or after April 1, 2016.

2. Filing of Country by Country (CbC) Report

A Japanese corporation, that is an ultimate parent corporation of an MNE, will be required to file a CbC Report via electronic tax filing system. The same filing requirement may be imposed on a Japanese subsidiary or branch office of a foreign MNE in certain instances. The filing due date is the date on which one year passes after the following day of the end of the fiscal year of the ultimate parent corporation. The information that needs to be contained in the CbC Report are the amount of revenues earned, profits before taxes, tax liabilities in each country where the MNE has business operations, and other relevant information. This new filing requirement will be applicable to the fiscal year of the ultimate parent corporation, starting on or after April 1, 2016. The CbC report must be prepared in English.

3. Submission of Master File

A Japanese corporation or a foreign corporation having a permanent establishment in Japan, either of which belongs to an MNE, are required to submit a Master File via electronic tax filing system. The submission due date is the date on which one year passes after the following day of the end of the fiscal year of the ultimate parent corporation. The information needs to be contained in the Master File, includes but is not limited to corporate structure, summary of business operations and financial conditions of the MNE. This new filing requirement will be applicable to the fiscal year of the ultimate parent corporation, starting on or after April 1, 2016. The Master File shall be prepared either in English or Japanese.

Introduction of contemporaneous documentation for transfer pricing purposes

A Japanese corporation that has conducted related party transactions with its foreign affiliate must prepare (or obtain) a contemporaneous document (Local File), which is deemed necessary to determine the arm's length price of the related party transactions. The Local File must be prepared before the filing due date of the tax return and maintained at the office of such Japanese corporation for seven years. The Local Filing obligation will be waived, where the amount of the transaction with a foreign affiliate is less than 5 billion Japanese yen and the amount of the transaction of the same foreign affiliate involving intangible assets is less than 300 million Japanese yen during the previous year.

Upon introduction of this contemporaneous documentation, some amendments were made to the provisions to allow taxation based on presumption. Under the new rules, the Japanese tax authorities may impose a tax on a presumption basis and based on their audit of other enterprises, that are deemed by the tax authorities as conducting comparable transactions, only if the taxpayer cannot disclose requested information within 60 days after the request is made. If the Local File is to be prepared/obtained, the disclosure of the Local File must be made within 45 days. The new disclosure rules clearly set the reporting/filing due dates, contrary to the old regulations, which merely required "reporting without delay".

The revisions relating to contemporaneous documentation will become effective for the fiscal year starting on or after April 1, 2017. Corporations, whose fiscal year is a calendar year, must prepare or obtain the first Local File by the filing due date of its tax return February 28, 2019. There is no explicit provision as to the language to be used in contemporaneous documentation. A Japanese translation needs to be attached if the original document is in a foreign language.

The National Tax Administration (NTA) made public announcements relating to the reform to the transfer pricing legislations. Please visit the homepage of the NTA as well.
https://www.nta.go.jp/shiraberu/ippanjoho/pamph/pdf/h28iten-kakaku.pdf
http://www.nta.go.jp/shiraberu/ippanjoho/pamph/pdf/takokuseki_00.pdf

III. CONSUMPTION TAX

It was originally planned that the consumption tax rate would be increased from the current 8% to 10% -- to be effective as of April 1, 2017. Prior to the election of the Upper House in July 2016, however, the coalition parties, currently controlling the majority of the Diet,

promised the postponement of the tax hike for two and a half years. Accordingly, it is anticipated that the increase of the tax rate up to 10% will most likely take effect as of October 1, 2019.

Set out below is a summary of the Bill to reform the consumption tax law, which already passed the Diet in March 2016, i.e., before the election. Due to the above mentioned promise, however, the actual date of the enforcement of each of the measures discussed below will be postponed for two and a half years (anticipated timing of the actual enforcement is provided in the parenthesis).

Key points

- Introduction of multiple rates
- Introduction of qualified invoice maintenance system (so-called “Invoicing System”)

Introduction of multiple rates

As of April 1, 2017 (October 1, 2019), consumption tax will be applied at multiple rates. The 8% reduced rate will remain as the applicable rate for taxable goods such as foods and drinks (except for alcoholic beverages). It should be noted that any foods/drinks consumed in dining and/or drinking facilities, e.g., in restaurants/bars/fast food shops, etc., are subject to the 10% rate. When groceries, to which the 8% rate applies, are sold together with other goods subject to the 10% rate as an integral part of one package, the 8% rate will be applied to the entire purchase price, provided that such price, exclusive of consumption tax, is 10,000 Japanese yen or less and that at least two-third[KT2][S&E3] of the entire package price consists of the value of the groceries. Subscription for newspapers issued more than two times per week is also subject to the reduced 8% rate.

Introduction of qualified invoice maintenance system

Due to the introduction of the multiple tax rates, the documentation method to receive the credit of input tax needs to be overhauled. As of April 1, 2021 (October 1, 2023) the new Invoicing System will replace the current method, which requires maintenance of bills and invoices issued in any form. Under the new Invoicing System, to receive credit for input tax, qualified invoices need to be maintained in a designated format which indicates relevant information such as the registration number of the issuer, applicable consumption tax rate, and the amount of the consumption tax imposed.

Prior to the introduction of the new Invoicing System, there will be a four year transition period (from April 1, 2017 (October 1, 2019) through March 31, 2021 (September 30, 2023)). During the transition period, a simplified documentation method may be used, under which the goods subject to the reduced tax rate must be stated in simple qualified invoices. Further, the aggregation of the amounts of the goods sold must be made separately for the 8% sale and the 10% sale.

IV. INCOME TAX

There are only small changes to the income tax law under the 2016 Tax Reform.

Key Points

- Increase of non-taxable amount of commuting expenses
- Introduction of tax incentives for home renovations to promote three generation co-habitation
- Introduction of special tax credits for capital gains arising from alienation of vacant houses

Increase of non-taxable amount of commuting expenses

As many people commute longer distances, the non-taxable amount of commuting expenses has increased from 100,000 yen to 150,000 yen. This amendment takes effect retroactively as of January 1, 2016 and thus, already taxed amounts shall be settled through the year-end-adjustments.

Introduction of tax incentives for home renovations to promote three generation co-habitation

If one renovates his/her own house so that it can be used as a residence for co-habitation of three generations of his/her family and resides in the renovated house during the period from April 1, 2016 through June 30, 2019, either of the following special treatment can be applied.

① 1% of the year-end balance (up to 10,000,000 yen) of the entire loan borrowed for renovation purposes (the term of which shall be five years or more) and 2% of the specific tranche of the loan (up to 2,500,000 yen), corresponding to the three generation co-habitation renovation, may be creditable from the annual income tax liability for five years. The credit is subject to a limitation of 125,000 yen per year (625,000 yen in total for five

years).

② 10% of the expenditures generally incurred to renovate a house for three generation co-habitation may be creditable from annual income tax liability, subject to a limitation of 250,000 yen. This credit is available only for one year of the renovation.

The above special tax treatment are available only to the renovations which satisfy certain conditions, including but not limited to issuance of designated certificates.

Introduction of special tax credit for capital gains arising from the alienation of vacant houses

If an heir sells during the period from April 1, 2016 through December 31, 2019 an inherited house (including its land), which was used as a residence of the decedent alone, he/she may deduct 30,000,000 yen from the capital gain arising from such sale of the house, provided that certain conditions are satisfied, such as the selling price does not exceed 100,000,000 yen, the sale must be conducted by the end of the third year since the inheritance, the house must be renovated to become earthquake resistant prior to the sale, the house has not been used for any purpose since the inheritance until the sale, etc. The 30,000,000 yen deduction is also available if the inherited house is demolished and only the land is sold. This special tax measure has been introduced in order to minimize abandoned vacant houses, which may have an adverse impact on the environment of the neighboring communities.

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