13 February 2020

Japan tax newsletter

Ernst & Young Tax Co.

2020 Japan tax reform outline

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Contents

The ruling parties (a coalition comprised of the Liberal Democratic Party and Komeito) released an outline of the 2020 tax reforms (hereinafter, "Outline") on 12 December 2019. This newsletter provides an overview of the major amendments and revisions contained in the outline.

The Abe Cabinet continues to implement initiatives to overcome deflation based on the policy that economic revitalization is essential to ensuring the nation's fiscal health. Tax regulations are deeply connected to the state of the economy and society. A major challenge for the 2020 tax reforms is the establishment of tax regulations that are adapted to the structural changes underway, such as the digitalization of the economy, and which simultaneously contribute to the sustainable growth of the Japanese economy.

As part of the corporate tax measures aimed at encouraging business innovation and increasing the international competitiveness of Japanese companies, new tax rules will be introduced to support companies' open innovation initiatives and to encourage investment in 5G infrastructure. Furthermore, the consolidated taxation regime has been fundamentally revised for the first time since its introduction, and will be replaced by a new group profit and loss sharing regime in April 2022.

Another challenge is preparing tax regulations which meet the needs of an aging population of 100-year lifespans and low birth rates and the diversification of work-styles. However, these reforms will contain no major revisions to individual and asset-related tax regulations, in part due to the increase of the consumption tax rate in October 2019.

Furthermore, the reviews of international tax rules underway at the OECD are mentioned in the preamble to the Outline (Fundamental Concepts of the 2020 Tax Reform). The Outline provides clarification concerning the five perspectives Japan is to utilize when participating in such discussions, and exhorts the government to ensure the influence of those concepts by leading the international debate.

Please note that the contents of this newsletter may be partially revised, deleted or added to in response to future Diet deliberations on the reform bill.

Building a better working world

Corporate taxation

1. Revision of the consolidated taxation regime

The consolidated taxation regime is a regime under which taxes are levied by treating an entire corporate group as though it were a single taxable entity, e.g. by offsetting the profits and losses of individual companies that belong to the corporate group. Due to the poor application results of the regime and to strengthen and make efficient group management, the consolidated taxation regime will be transformed into a more simplified regime (hereinafter, "the group profit and loss sharing regime") to reduce the administrative burden of companies, while maintaining the basic profit and loss sharing framework.

(1) Basic structure of the group profit and loss sharing regime

a. Eligible entities

A domestic parent entity and its wholly-owned subsidiaries wherein the domestic parent entity directly or indirectly owns 100% of its outstanding shares (excluding foreign entities) will be covered (i.e. a condition equivalent to that of the consolidated taxation regime).

b. Application method

To receive application of the group profit and loss sharing regime, all entities in a corporate group eligible for coverage must file an application and thereby obtain approval from the Commissioner of the National Tax Agency (i.e. a condition equivalent to that of the consolidated taxation regime). Under the consolidated taxation regime there is no distinction between blue tax returns and white tax returns; once approval is obtained for the group profit and loss sharing regime, however, the entities will be deemed to have obtained approval for the filing of blue tax returns. To maintain consistency with the grounds set forth for the rejection of the application for filing blue tax returns, grounds sufficient to deem the existence of false statements or records in bookkeeping documents will be added to the grounds for the rejection of such applications. Furthermore, in the event that an approval for blue tax return filing is canceled, the approval for the group profit and loss sharing regime will also be canceled. Reasons for withdrawal from the regime will be limited to unavoidable circumstances, a condition equivalent to that under the consolidated taxation regime, and the withdrawing entities will not be permitted to re-elect application of the regime for 5 years after withdrawal.

c. Taxpaying entities

Replacing the consolidated taxation regime, under which the entire corporate group is treated as a single taxpaying unit and the parent entity files returns for national corporation taxes calculated as if the group were a single entity, will be a new regime, under which the parent entity and its subsidiaries will individually calculate and file their own corporation taxes.

In addition, the parent entity and its subsidiaries will have joint and several liability for the payment of the corporation taxes of other entities within the same profit and loss sharing group (i.e. a condition equivalent to that of the consolidated taxation regime).

d. Fiscal year

The fiscal years of eligible entities will be the deemed fiscal years realigned with the parent entity's fiscal year (i.e. a condition equivalent to that of the consolidated taxation regime).

The basic structure of the new regime is equivalent to that of the current regime, except for the requirement that the parent entity and each of its subsidiaries file corporate tax returns separately (individual tax return filing method) and the presumption of approval for the blue tax return filing.

(2) Income and corporate tax calculations

a. Offsetting of profits and losses

Tax losses posted by loss-generating entities in a profit and loss sharing group will be offset against the income of profit-generating entities within the same group. Offsetting will be conducted on a pro rata basis, whereby the total tax losses of the loss-generating entities (limited to the total sum of the income of profit-generating entities) will be distributed to each profit-generating entity in proportion to its income and deducted from its income. The total sum of said deductions will then be distributed to each loss-generating entity in proportion to its tax losses and added to its taxable income.

Moreover, even in the event of an error in an initial tax return, because the tax loss amount that can be offset within the profit and loss sharing group is set at the amount reported in the initial tax return, the error will not affect the tax calculations of other entities in the group.

Under the current regime, if any entity in a consolidated group makes a calculation error, then the entire group has to recalculate taxes; the administrative burden caused by corrections is expected to be reduced because, under the new regime, only the entity that made the calculation error will make corrections (i.e. no other entities will be required to make corrections).

b. Offsetting of tax losses (NOLs)

With regard to the calculation of deductions of carryforward tax losses (hereinafter, "NOLs") of entities covered by the group profit and loss sharing regime, the deductible limit will be the total sum of the equivalent of 50% (or 100% of the income for small and medium sized enterprises (SMEs), companies undergoing reorganizations and newly-established corporations) of the income of each entity of the group prior to the deduction of NOLs, and the deduction method will therefore be the same as that under the consolidated taxation regime.

In the event of an error in an initial tax return, because the amount of NOLs offset with other entities of the group is generally set at the amount reported in the initial tax return, the error will not affect the tax calculations of other entities in the group.

However, in the event an entity can be deemed to have improperly reduced its corporate tax burden, e.g. by intentionally filing an incorrect tax return to evade restrictions on NOL carryforward periods or to transfer NOLs to an entity withdrawing from the group, the tax authorities will be allowed to exercise their authority to issue corrections to conduct recalculations.

Under the current regime, the NOL deduction limit for large enterprises is the equivalent of 50% of consolidated income after deductible expenses are subtracted from the taxable income of each entity within a consolidated group. Under the new regime, since the deductible limit is also the total sum of the equivalent of 50% of the income of each entity of the group (after offsetting profits and losses) prior to the deduction of NOLs, it is thought that there will be no changes to the deductible limit on a group-wide basis. Moreover, in contrast to the current regime where NOLs deducted from consolidated income are distributed to all entities that have posted NOLs, in the new regime, the use of NOLs will be limited to entities that have posted income; therefore, the entities that use the NOLs may differ from the entities that have posted the NOLs.

c. Prevention of the double entry of profits and losses

Under the consolidated taxation regime, there are rules (the investment tax book value adjustment rules) which allow a group to adjust the tax book value of shares upon the transfer, etc. of shares of a consolidated entity it owns.

Under the group profit and loss sharing regime, the investment tax book value adjustment rules will be redesigned as follows. Note the following, however, will not apply to entities that withdraw from the profit and loss sharing group within two months of the initial application or entry into a profit and loss sharing group without offsetting profits and losses.

- Shareholders cannot recognize valuation gains or losses on the shares of subsidiaries belonging to the profit and loss sharing group, and capital gains or losses on the shares of subsidiaries transferred to other entities of the profit and loss sharing group.

- The tax book value of the shares of an entity withdrawing from the profit and loss sharing group immediately prior to withdrawal will be considered an amount equivalent to the tax book value of the net assets of the withdrawing entity.
- Shareholders record valuation gains or losses on the shares of a subsidiary using market value if said subsidiary's status as a wholly-owned subsidiary of the parent entity is not expected to continue upon initial application of the new regime or entry of said subsidiary into an existing profit and loss sharing group.

Measures will be introduced to prevent tax evasion carried out through the double entry of profits and/or losses within a single group as exemplified by the following acts: (i) the double entry of losses within the same group conducted by recognizing both the valuation losses or transfer losses of the shares of a subsidiary possessing unrealized-loss assets and the realization of said unrealized losses by said subsidiary; or (ii) offsetting the capital losses generated via the transfer of shares of a subsidiary that has recognized its unrealized gains against said subsidiary's unrealized gains within the same group.

d. Tax rates

The tax rates applied to profit and loss sharing groups will be the respective tax rates applied to each individual entity in accordance with its corporate classification. Moreover, the annual amount of up to JPY8 million in income eligible for the reduced tax rates applicable to SMEs will be distributed to profit-generating entities in proportion to the income of each entity.

Under the current regime, classification as an SME is conducted via examination of the consolidated parent entity. Under the new regime, determination of whether a group is an SME will be conducted by examining the parent entity and all its subsidiaries; if any entity in the profit and loss sharing group does not qualify as an SME, then no other entity in the group will qualify as an SME.

e. Settlement of tax amount reduced

In the event that amounts equivalent to a reduction of corporate taxes and local corporate taxes (hereinafter, "profit and loss sharing tax reductions") are granted and received by entities of the same profit and loss sharing group through application of the group profit and loss sharing regime, any settled reductions will not be included in taxable income or treated as deductible expenses.

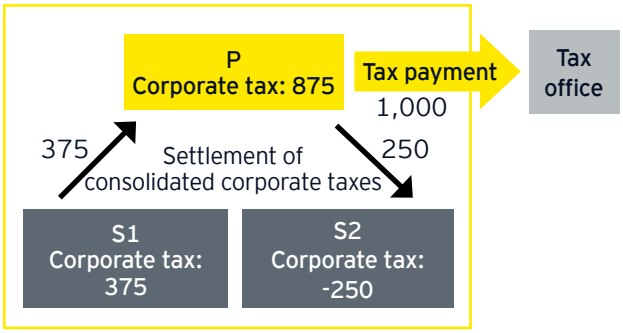
Under the current regime, the consolidated parent entity pays corporate taxes and local corporate taxes in a lump sum and the amounts settled within a consolidated group are not included in taxable income nor treated as deductible expenses; the same will be true under the new regime in the event that profit and loss sharing tax reductions are settled within a profit and loss sharing group.

Moreover, under the current regime, income taxes payable pertaining to corporate taxes and local corporate taxes are recorded only in the accounting books of the consolidated parent entity, while the amounts of consolidated corporate tax and local corporate tax that are to be received or paid between the parent entity and subsidiaries for portions attributable to individual entities are recorded as receivables or payables by the respective entities. It is thought that under the new regime each entity will record their own income taxes payable pertaining to corporate taxes and local corporate taxes in their accounting books due to implementation of the individual tax return filing method. In the future, the Accounting Standards Board of Japan (ASBJ) may deliberate the accounting treatment of profit and loss sharing tax reductions. Future developments concerning the treatment of accounting for income taxes under the new regime will also garner attention.

Settlement of tax amount reduced (Illustration)

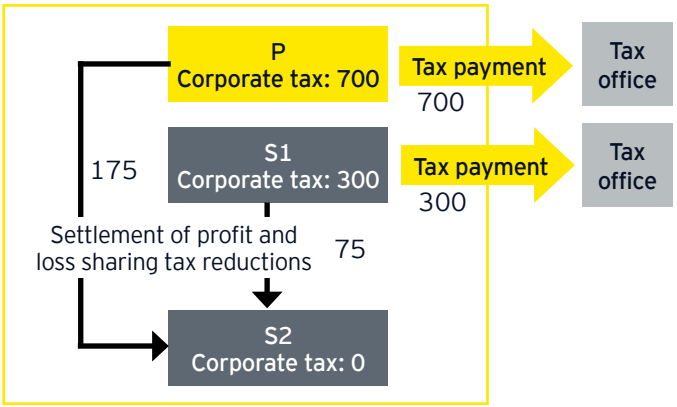
(Example) Parent entity (P): Income of 3,500; Subsidiary 1 (S1): Income of 1,500; Subsidiary 2 (S2): Loss of 1,000 (Total group income of 4,000)

Consolidated tax regime



Consolidated income of 4,000 x 25% tax rate = 1,000
(Breakdown)
P: Income of 3,500 x 25% tax rate = 875
S1: Income of 1,500 x 25% tax rate = 375
S2: Loss of -1,000 x 25% tax rate = -250

Group profit and loss sharing regime



P: (Income of 3,500 - 1,000 x 3,500/5,000) x 25% tax rate = 700
S1: (Income of 1,500 - 1,000 x 1,500/5,000) x 25% tax rate = 300
S2: (Loss of -1,000 + 1,000) x 25% tax rate = 0

(3) Application date of the group profit and loss sharing regime, and joining or withdrawing from a profit and loss sharing group

a. Deemed fiscal year

Under the consolidated taxation regime, there is a special tax measure concerning the timing of entry to a group in the event that an entity becomes a wholly-owned subsidiary of the parent entity during a given fiscal year, which deems the first day of the following month as the entry date; a measure permitting the deeming of the first date of the following fiscal period as the entry date will be added under the group profit and loss sharing regime.

Furthermore, under the consolidated taxation regime, the first fiscal year of a subsidiary following its withdrawal from a group during a given fiscal year is considered to be the period from the withdrawal date to the final day of the parent entity's fiscal year; this measure will be abolished under the group profit and loss sharing regime and said first fiscal year will continue until the final day of the withdrawing subsidiary's fiscal year.

b. Built-in gains taxation (mark to market taxation) upon the initial application of the group profit and loss sharing regime or upon entry of an entity into an existing profit and loss sharing group

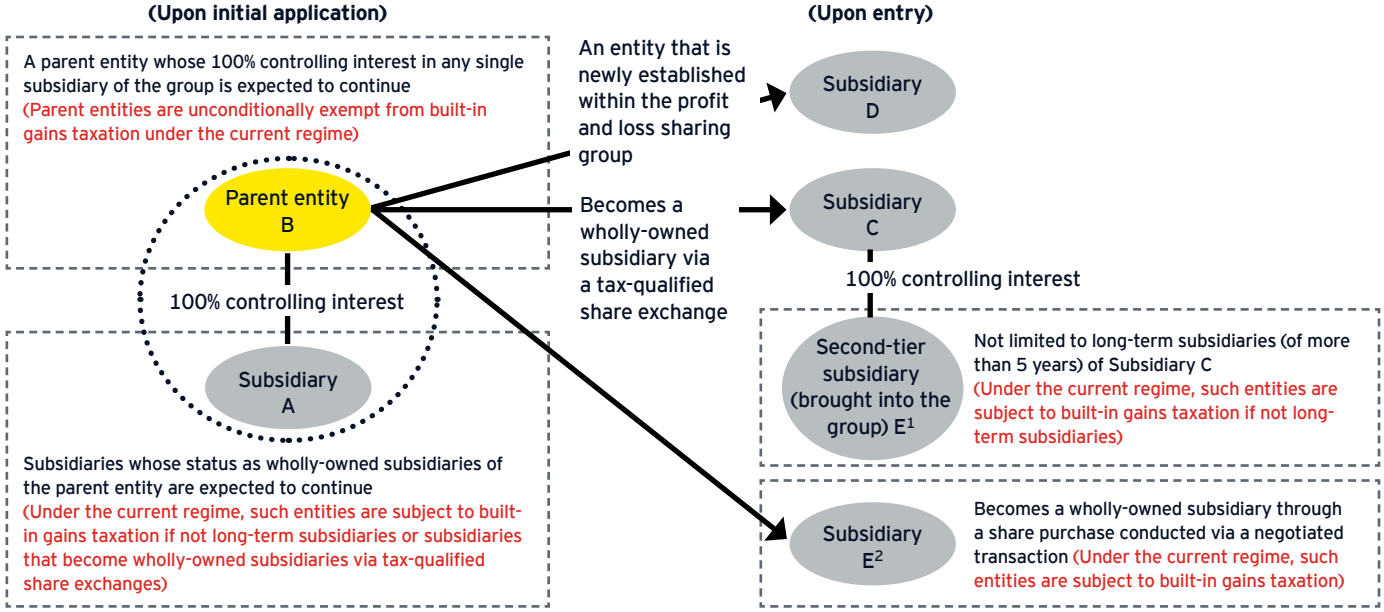
Under the consolidated taxation regime, built-in gains taxation is generally levied on assets subject to built-in gains taxation owned by a subsidiary upon the initial application of the regime or upon its entry into an existing consolidated group. However, a subsidiary that has been a wholly-owned subsidiary for more than 5 years or which became a wholly-owned subsidiary via a tax-qualified share exchange is exempt from built-in gains taxation.

Under the group profit and loss sharing regime, the entities exempt from built-in gains taxation upon an initial application of the regime or upon entry to an existing profit and loss sharing group are listed under i. to v. in the table on the following page.

Under the new regime, parent entities will also be included in the scope of entities subject to built-in gains taxation. In addition, subsidiaries that have not been wholly-owned subsidiaries of the parent entity for more than 5 years prior to the initial application of the regime or which enter an existing group for reasons other than tax-qualified share exchanges will become exempt from built-in gains taxation if they meet certain requirements, and the scope of entities subject to built-in gains taxation will be reduced.

Entities exempt from built-in gains taxation upon the initial application of the new regime	Entities exempt from built-in gains taxation upon entry to an existing profit and loss sharing group
i. Subsidiaries whose status as a wholly-owned subsidiary of the parent entity is expected to continue ii. Parent entities whose 100% controlling interest in any single subsidiary of the group is expected to continue	iii. Wholly-owned subsidiaries that entered a group via a tax-qualified share exchange iv. Entities newly established within the profit and loss sharing group v. Entities that fulfill requirements equivalent to those for qualified reorganizations

Entities exempt from built-in gains taxation upon initial application or entry into a profit and loss sharing group (Illustration)



Source: Partial modification of documents prepared by the (Third) Experts Meeting on Consolidated Taxation on 18 April 2019

c. The forfeiture of NOLs and restrictions on the use of unrealized losses

Under the consolidated taxation regime, any NOLs held by a subsidiary subject to built-in gains taxation are forfeited upon the initial application of the regime or upon its entry to an existing group, while the NOLs held by a subsidiary exempt from built-in gains taxation are carried over into the consolidated taxation group as specified consolidated NOLs that are deductible only from that subsidiary's income.

Under the group profit and loss sharing regime, any NOLs held by an entity **(including a parent entity)** subject to built-in gains taxation existing upon the initial application of the regime or upon its entry to an existing group will be forfeited, while the NOLs held by an entity **(including a parent entity)** exempt from built-in gains taxation will be carried over into the profit and loss sharing group as specified NOLs that are deductible only from that entity's income. Furthermore, measures will be added concerning the partial forfeiture of NOLs and restrictions to the deduction of built-in losses within profit and loss sharing groups.

Under the current regime, the NOLs of a parent entity prior to the initial application of the regime are carried over and deducted from the consolidated income of the entire group; however, under the new regime, the parent entity will be treated in the same manner as its subsidiaries in that its NOLs owned prior to application of the regime will be treated as NOLs (specified NOLs) that are deductible to a limit of the amount of the parent entity's income.

Moreover, the NOLs of a parent entity that has applied the current regime will continue to enjoy the same treatment after the transition to the new regime (i.e. they may be offset with the income of other entities within the profit and loss sharing group).

Comparison between the consolidated taxation regime and the group profit and loss sharing regime

Treatment upon initial application of the regime

Treatment		Consolidated tax regime (Subsidiaries)	Group profit and loss sharing regime	
			(Subsidiaries)	(Parent entities)
Not subject to built-in gains taxation	NOLs may be brought into the group (deductible only from the entity's own income)	▸ Subsidiaries pertaining to **qualified share exchanges** or to **share transfers** that resulted in the incorporation of a consolidated parent entity ▸ Long-term subsidiaries that have been **wholly-owned for more than 5 years** (including **newly established entities within the group** and **long-term subsidiaries** that enter the group via qualified mergers)	▸ **Subsidiaries whose status as wholly-owned subsidiaries of the parent entity are expected to continue,** provided that either (i) said parent-subsidiary relationships have lasted for more than 5 years or (ii) said subsidiaries satisfy the joint venture criteria (*3)	▸ **Parent entities whose 100% controlling interest in any single subsidiary of the group is expected to continue,** provided that said controlling relationship has been in place for more than 5 years
	Partial forfeiture of NOLs (*1) Restrictions on the use of built-in losses (*2)		▸ **Subsidiaries whose status as wholly-owned subsidiaries of the parent entity are expected to continue,** provided that (i) said parent-subsidiary relationships have been in place for 5 years or less and (ii) said subsidiaries do not satisfy the joint venture criteria	▸ **Parent entities whose 100% controlling interest in any single subsidiary of the group is expected to continue,** provided that said controlling relationship has been in place for 5 years or less
Subject to built-in gains taxation	Forfeiture of NOLs	▸ Upon application of the consolidated taxation, wholly-owned subsidiaries **that have been wholly-owned subsidiaries for 5 years or less**	▸ **Subsidiaries whose status as wholly-owned subsidiaries of the parent entity are not expected to continue**	▸ **Parent entities whose 100% controlling interest in none of its subsidiaries are expected to continue**

Treatment upon entry to an existing group

Treatment		Consolidated tax regime (Subsidiaries)	Group profit and loss sharing regime	
			(Subsidiaries)	(Parent entities)
Not subject to built-in gains taxation	NOLs may be brought into the group (deductible only from the entity's own income)	▸ Subsidiaries pertaining to **qualified share exchanges** ▸ **Newly established entities within the group** and **long-term subsidiaries** that enter the group via qualified mergers	▸ Subsidiaries that have entered the group via **qualified share exchanges** or **by fulfilling requirements equivalent to those for qualified reorganizations,** provided that either (i) said controlling relationships have been in place for more than 5 years or (ii) the subsidiaries meet the joint venture criteria (*3) ▸ Newly established entities within the profit and loss sharing group	
	Partial forfeiture of NOLs (*1) Restrictions on the use of built-in losses (*2)		▸ Subsidiaries that have entered the group via **qualified share exchanges** or **by fulfilling requirements equivalent to those for qualified reorganizations,** provided that (i) said controlling relationships have been in place for 5 years or less and (ii) the subsidiaries do not satisfy the joint venture criteria (*3)	
Subject to built-in gains taxation	Forfeiture of NOLs	▸ Entities that become wholly-owned subsidiaries via **unqualified reorganizations** or transactions **other than reorganizations**	▸ Entities that become wholly-owned subsidiaries not via **qualified share exchanges** and not via transactions that fulfill **requirements equivalent to those for qualified reorganizations**	

*1: NOLs that can be carried over into the group will be treated as specified NOLs deductible only from the respective entity's income.

*2: Use of NOLs and the deduction of realized losses of assets with built-in losses that exist prior to the initial application of the group profit and loss sharing regime or entry into an existing profit and loss sharing group will be partly restricted until the earlier of (i) the date 5 years after a relationship of control began or (ii) the date 3 years after said application date or entry date.

*3: The condition will be satisfied when the joint venture criteria are fulfilled between the entity and any single entity in the profit and loss sharing group. (The joint venture criteria will be the same as the deemed joint venture criteria set forth in the NOLs usage restrictions for tax-qualified reorganizations.)

d. Withdrawal from a profit and loss sharing group

An entity that withdraws from a profit and loss sharing group will not be permitted to reenter the same group for 5 years (i.e. a condition equivalent to that of the consolidated taxation regime). Furthermore, in the event an entity that has withdrawn from a profit and loss sharing group is not expected to continue its major business, valuation gains or losses on the assets it owns will be recognized in the fiscal year immediately prior to the withdrawal at their market value.

To prevent the double deduction of capital losses for the transfer of shares at the time of withdrawal and capital losses for the transfer of assets after withdrawal, measures which levy built-in gains taxation on specified withdrawing entities at the time of their withdrawal will be introduced.

(4) Individual tax regulations

Appropriate frameworks will be created in concern to individual tax regulations, such as the dividend received deduction (DRD) rules, while retaining as a general principle the separate calculation of taxes in view of the fact that a parent entity and each of its subsidiaries will file standalone tax returns.

a. The DRD rules will be revised as follows:

- Each entity will assess which of their shares are recognized as short-term shares.
- The amount of debt interest deductions pertaining to related-party shares will be equal to four one-hundredths of the amount of dividends, etc. pertaining to related-party shares (up to a limit of the equivalent of one-tenth of the debt interest paid during that same fiscal year).
- The determination of whether shares qualify as related-party shares or shares held for non-controlling purposes will be conducted based on the entire number of shares owned by the 100% group, which may include entities that are not members of the profit and loss sharing group (ex. foreign entities).

b. Under the new regime, the current foreign tax credit rules, which allow group calculations, will remain in place.

- The calculation of creditable limits for each entity within a profit and loss sharing group will generally be the same as those of the consolidated taxation regime.

Treatment after the reform	Details
Transition from group-based calculations to individual calculations	▸ Determination of shares owned for a short period pursuant to DRD rules ▸ Calculation of the deductible limit for donations ▸ Rules restricting the use of NOLs generated by entities posting losses that are controlled by specified shareholders ▸ Income tax credits ▸ Corporate tax credit and refund rules in conjunction with corrections made in the event excessive taxable income based on falsified accounting are reported in tax returns ▸ Taxes for retained earnings on specified family companies ▸ Non-deductible expenses under the earnings stripping rules ▸ Other special taxation measures (e.g. the employment promotion tax incentive)
Continuation of group calculations in a manner equivalent to that under the consolidated taxation regime	▸ Determination of share ownership ratios in accordance with the FDE rules ▸ Deduction rules applicable to blue tax return losses in the event debts are forgiven due to corporate reorganizations ▸ Determination of SME status ▸ Foreign tax credits ▸ Tax credits (R&D credit rules) applicable when R&D activities are carried out ▸ Calculation method and criteria for the application of NOLs subject to refund rules as a result of the carry back of NOLs ▸ Determination of status as a business ineligible for the application of special measures for SMEs pursuant to the Act on Special Measures Concerning Taxation ▸ Condition for exemption from the earnings stripping rules (JPY20 million)
Incorporation of adjustments made within a 100% group in regard to the standalone tax system	▸ Determination of share categories pursuant to DRD rules (i.e. related-entity shares or shares held for non-controlling purposes) ▸ Estimated calculation of debt interest deductions pertaining to related-entity shares pursuant to DRD rules ▸ Exclusion of debts inside a 100% group during the calculations of limits on the provision of allowances for doubtful accounts ▸ Special measure for specified deductions pertaining to asset transfers (JPY50 million per annum)

- If the amount of foreign tax credits of an entity belonging to a profit and loss sharing group during a given fiscal year deviates from the amount of foreign tax credits stated in its final tax return, then the amount of foreign tax credits stated in said final tax return will be deemed the amount of foreign tax credits for that same fiscal year.
- Adjustments for excess or insufficient amounts in relation to the foreign tax credits in a given year and the amount of foreign tax credits stated in a final tax return will be made through the foreign tax credit amount or corporate tax amount of the fiscal year in progress.
- In the event any entity in a profit and loss sharing group attempts to reduce its corporate tax burden by increasing its foreign tax credit amount through the concealment or falsification of facts used as the basis for the calculation of the foreign tax credit, the tax authorities will be allowed to exercise their authority to issue corrections to conduct recalculations.

c. Under the new regime, the current R&D credit rules (i.e. the tax credit rules which apply when an entity has conducted R&D), which allow group calculations, will remain in place

- The permitted tax credit amount, which is the lower of either the credit limit or the maximum credit amount as calculated for the entire profit and loss sharing group, will be distributed to each entity in proportion to each entity's pre-adjustment corporate tax amount. The distributed amount will determine the tax credit limit for each entity.
- In the event the amount of R&D expenses for any fiscal year or the pre-adjustment corporate tax amount of a given fiscal year of another entity in the same profit and loss sharing group differ from the amounts stated in its final tax return, the amount of R&D expenses for said fiscal year(s) or the pre-adjustment corporate tax amount for the given fiscal year stated in its final tax return will be deemed the amount of R&D expenses for said fiscal year(s) or the pre-adjustment corporate tax amount of that same fiscal year. Under such circumstances, if the permitted tax credit amount is less than the permitted tax credit amount stated in the final tax return, then the entity will be required to make adjustments to the corporate tax amount.

Regarding the R&D credit rules, under the current regime, tax credits deducted from pre-adjustment consolidated corporate taxes are distributed to entities that have recorded R&D expenses; however, since under the new regime the permitted tax credit amount will be distributed in proportion to each entity's pre-adjustment corporate tax amount, the entities which have recorded R&D expenses will differ from the entities which receive the R&D credits.

(5) Other reforms

a. Entities covered by the group profit and loss sharing regime will be required to submit final tax returns, interim tax returns and corrected tax returns for corporate taxes and local corporate taxes via an electronic data processing system (e-Tax).

b. In addition to measures permitting a parent entity to, upon the provision of its electronic signature, simultaneously file tax returns and/or submit applications and notices on behalf of its subsidiaries, measures required to allow the direct payment of taxes will be introduced.

c. In the event an entity files an interim tax return using the provisional settlement of accounts, all entities that belong to the same profit and loss sharing group will be required to do the same.

d. The submission of the relevant application by the parent entity will permit the application of the special measure for the extension of the corporate tax return deadline (generally a two-month extension) to all entities of the group (i.e. a condition equivalent to that of the consolidated taxation regime). Furthermore, necessary rules will be introduced to extend the tax return filing deadline in the event the final accounts of an entity cannot be settled due to the occurrence of natural disasters, etc. and in concern to the tax treatment upon entry to or withdrawal from a profit and loss sharing group.

e. Comprehensive provisions to prevent acts of tax avoidance will be introduced (i.e. provisions equivalent to that of the consolidated taxation regime).

f. Measures equivalent to those of the consolidated taxation regime will be introduced with regard to the following aspects of tax audits: penalties, the authority to make inquiries and inspections, and the competent authorities presiding over the collection of taxes.

g. While the basic framework currently in place for local taxes will be maintained, the measures necessary to align the regime with the national tax revisions will be introduced.

Under the current regime, a consolidated parent entity will be obligated to submit tax returns electronically in the event that it qualifies as a large enterprise in a fiscal year that starts on or after 1 April 2020; under the new regime, the obligation to submit tax returns electronically will apply to each individual entity. Furthermore, under the current regime, a parent entity which files tax returns electronically is permitted to submit the set of notifications concerning the amounts attributable to individual group entities simultaneously, and under the new regime, the simultaneous submission of the tax returns of group subsidiaries will be permitted through use of the electronic signature of the parent entity.

(6) Applicability

a. Application of the group profit and loss sharing regime will begin with fiscal years starting on or after 1 April 2022.

b. Consolidated entities currently using the consolidated taxation regime will automatically transition to the group profit and loss sharing regime in their first fiscal year beginning on or after 1 April 2022. However, consolidated parent entities will be permitted, by filing a notification with the Tax Office District Director by the day preceding the first day of the first fiscal year beginning on or after 1 April 2022, to become standalone taxable entities to which the group profit and loss sharing regime does not apply.

c. Specified consolidated NOLs attributable to individual entities under the consolidated taxation regime will be deemed specified NOLs under the group profit and loss sharing regime. In addition to the aforementioned reforms, temporary measures necessary to transition from the consolidated taxation regime to the group profit and loss sharing regime will also be implemented in concern to individual tax regimes.

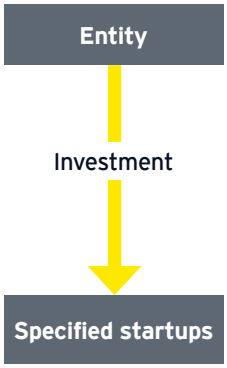
Corporate groups to which consolidated taxation currently applies must consider whether to transition to the new regime or return to standalone taxpayer status during the period of transition allotted for the new regime.

Corporate groups that are considering consolidation have several options: transition to the new regime after applying the current regime; applying the current regime and then returning to standalone taxpayer status; or applying the new regime directly, without applying the current regime.

2. Establishment of measures pertaining to open innovation

A tax incentive to promote open innovation in relation to investments in startups will be established from the perspective of collaborating with startups which possess new technology and know-how and which act as pioneers of innovation and placing heavy emphasis on the promotion of open innovation.

[Reform overview] Applicable until the end of FY2021 (31 March 2022)



Requirements for investing companies

i. A domestic business company or
ii. A CVC* operated by a domestic business company

** A fund operated by an entity or its subsidiary, and in which the entity or subsidiary owns more than 50% interest.*

Required actions

i. Large investments of **at least JPY100 million per capital contribution** (investments of **at least JPY10 million** by SMEs; investments of **at least JPY500 million** to foreign startups)
ii. Investments whereby new capital is supplied to startups (acquisition of outstanding shares are ineligible), rather than the execution of share purchase and sale transactions between shareholders
iii. A certain deduction limit
iv. Share ownership of 5 years

Requirements for startups receiving investments

i. **Innovative, growing, unlisted startups whose age is less than 10 years** (Newly-established companies are excluded)
ii. Startups **that do not belong to the companies making the investments** nor to **other large corporate groups**

+

The entity provides a summary report to the Ministry of Economy, Trade and Industry at fiscal year-end (certifications are not granted in advance) concerning all the capital contributions for that same fiscal year, stating that each capital contribution was successful in bringing about business innovation for both the entity and the startup and not an abuse of the measure

Source: Prepared based on materials published by the Ministry of Economy, Trade and Industry.

(1) In the event an eligible entity (Note 1) acquires, through the payment of capital contributions, shares in a specified startup (hereinafter, "specified shares"; Note 2) between the period from 1 April 2020 to 31 March 2022 and continuously owns those shares through the end of the fiscal year in which falls the acquisition date of said shares, and if 25% or less of the acquisition cost of the specified shares is recorded in a special account, the entity will be allowed to deduct the total amount recorded in said special account up to a maximum equaling the amount of taxable income posted by said entity during the same fiscal year.

In the event an eligible entity that has taken advantage of the above tax incentive transfers said specified shares or receives dividends therefrom, it will be required to reverse a certain portion of the special account depending on the corresponding reason and include that amount in taxable income. However, specified shares owned for a period of 5 years or more will not be subject to this treatment.

Note 1: "Eligible entities" refers to entities that file blue tax returns and carry out specified business activities (i.e. joint-stock corporations that utilize managerial resources other than their own managerial resources and which intend to carry out businesses that are projected to be highly productive or to develop new businesses). Such entities are referred to as "entity" in the above figure.

Note 2: "Specified shares" refers to shares of domestic entities (limited to entities that have already begun conducting business and whose age is less than 10 years) that are businesses developing new businesses as defined under the Act on Strengthening Industrial Competitiveness which engage in specified business activities pursuant to the same Act, or foreign entities similar in nature to the foregoing (hereinafter collectively referred to as "specified business(es) developing new businesses"), which have been certified by the Minister of Economy, Trade and Industry as fulfilling the following requirements. Specified businesses developing new businesses are referred to as "certain startups" in the figure above.

a. *Shares acquired by an eligible entity or shares that are partnership assets owned by an investment limited partnership whose sole limited partner with an investment ratio exceeding 50% is said eligible entity.*

b. *Shares transferred as a result of capital contributions which increase stated capital.*

c. *Said capital contributions amount to a minimum of JPY100 million (or a minimum of JPY10 million for capital contributions made by SMEs; or a minimum of JPY500 million for capital contributions to foreign entities). However, a maximum will be established with regard to the amount of eligible capital contributions.*

d. *The eligible entity engages in certain business activities such as the acquisition of shares of a specified business developing new businesses, and the managerial resources of said specified business developing new businesses contribute to businesses that are projected to be highly productive or in the development of new businesses and fulfill other requirements (concerning open innovation and other factors).*

(2) In the event of any of the grounds described below, an appropriate amount will be reversed from the special account and included in taxable income.

a. Cancellation of the certification of the specified shares issued by the Minister of Economy, Trade and Industry
b. Loss of possession of all or a portion of the specified shares
c. Receipt of dividends in relation to the specified shares
d. Reduction of the tax book value of the specified shares
e. A change in the entity's investment ratio in the investment limited partnership that treats the specified shares as partnership assets
f. Dissolution of the specified business developing new businesses relating to the specified shares
g. Dissolution of the eligible entity
h. Voluntary reversal of amounts placed in the special account

In order to encourage the use of the increasing amount of available cash and deposits, one of the successes of Abenomics, as new supplies of capital for the promotion of startups, which act as pioneers of innovation, and to nurture their growth, a new measure will be introduced to provide a 25% income deduction for investments of JPY100 million or more made by domestic entities and corporate venture capitals (CVCs) (refer to the figure on the previous page for the criteria which apply to investments made by SMEs and investments in foreign entities) to unlisted startups whose age is less than 10 years.

The introduction of corporate tax measures permitting income deductions for investments of a certain amount is extremely rare; to ensure that this tax incentive is used in line with the purposes outlined above, rules whereby the Minister of Economy, Trade and Industry conducts confirmations (i.e. documents submitted by the entity after an investment is made will be confirmed at the Ministry of Economy, Trade and Industry and the Minister of Economy, Trade and Industry will provide certification covering the year of investment and a specified period (5 years)), and rules whereby reversals will be conducted in the event that the shares received through investment are transferred or dividends are received therefrom within five years of acquisition, will be established.

Moreover, future developments concerning the following points will garner attention since the Outline provides no clarification regarding their treatment.

- Whether the acquisition of certain ratios of startup shares will give rise to ineligibility for this tax incentive.
- The minimum investment amount of JPY100 million or more (refer to the figure on the previous page for criteria concerning investments made by SMEs and investments in foreign entities) is stated, but the maximum eligible amount is not clearly stated.
- The calculation for the amount of the special account to be added to taxable income in the event dividends are received is not clearly stated. For example, there is no indication as to whether, given an investment of JPY100 million and a deduction from taxable income of JPY25 million (= JPY100 million x 25%), JPY2.5 million (= JPY10 million x JPY25 million / JPY100 million) would be added to taxable income in the event of a subsequent receipt of dividends amounting to JPY10 million.
- Whether an entity that has existing investments in a startup would be also eligible for the incentive if it made additional investments on or after 1 April 2020. If so, and in the event dividends were received under such circumstances, how would the portion of the special account that must be added to taxable income be calculated?
- Whether the certification issued by the Minister of Economy, Trade and Industry will be canceled in the event a startup that an entity invests in becomes listed on a stock exchange during the specified period (5 years).
- Whether the dissolution of the entity or startup due to a merger would be considered grounds for the reversal of the special account.

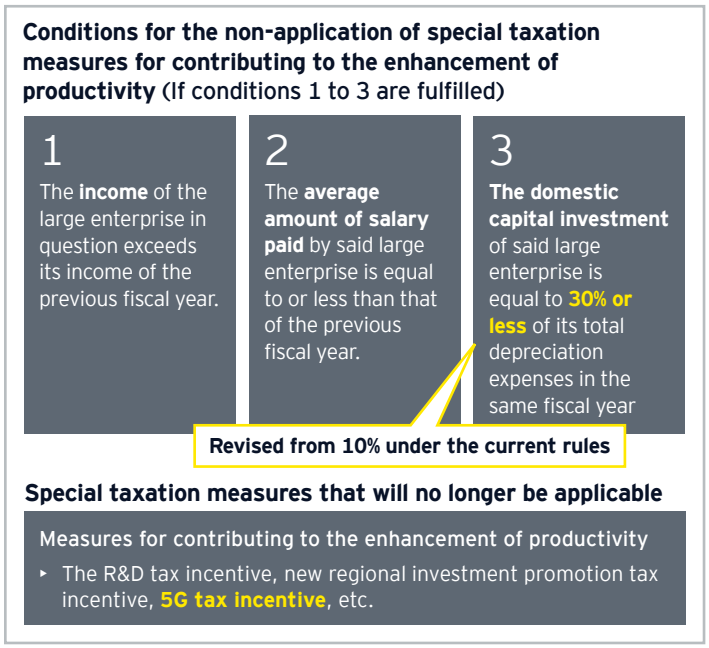
3. Tax measures to encourage investment and salary increases

(1) Revision of conditions that will give rise to the termination of the application of the R&D credit and other incentives by large enterprises

a. In order to encourage large enterprises that are not proactively increasing salaries or making capital investments despite increasing revenues to produce outflows of cash, the capital investment criteria will be made more stringent. Specifically, when the domestic capital investment amount of a large enterprise is equal to 30% or less (10% or less under the current rules) of its depreciation expenses in a given fiscal year, the entity will be deemed to have met one of the conditions for the termination of application of special taxation measures for contributing to the enhancement of productivity, such as the R&D tax incentive.

b. The special depreciation or tax credit regime applicable upon the acquisition of facilities certified as specified advanced information and telecommunications facilities (name tentative; refer to the section below titled "5G infrastructure (5th generation mobile communication systems)" for details) will be added to the scope of this measure.

Therefore, (i) the conditions for non-application of special taxation measures for contributing to the enhancement of productivity and (ii) special taxation measures that will no longer be applicable after the reform are as depicted in the figure below.



Source: Prepared based on "The Ministry of Economy, Trade and Industry's (METI) FY2018 Tax Reform Plans (December 2017)" published by METI.

The condition under the current rules (introduced through the FY2018 tax reforms and applicable to fiscal years starting between 1 April 2018 and 31 March 2021) stating that domestic capital investments must be equivalent to 10% or less of an entity's total depreciation expenses will, after the reform, state that domestic capital investments must be equivalent to 30% or less of an entity's total depreciation expenses. Although the termination condition will not be triggered so long as an entity does not meet other conditions, after this year's reform, some industries such as the service industry are likely to become ineligible for the special taxation measures for contributing to the enhancement of productivity. This requires careful consideration, as triggering ineligibility for the special taxation measures for contributing to the enhancement of productivity impacts not only taxes, e.g. via the inability to take advantage of the R&D tax incentive and 5G tax incentive, but also financial accounting.

For details of the current rules, please refer to the tax alert "Matters Requiring Consideration upon Application of the R&D Tax Incentive" issued by EY on 14 February 2019 (available in Japanese only).

(2) Under the tax credit rules applicable when salaries are raised and capital investments are made, the condition that domestic capital investments must equal 90% or more of an entity's total depreciation expenses of a given fiscal year will be revised to a requirement that such amounts must equal 95% or more of an entity's total depreciation expenses of a given fiscal year.

(3) Revisions to the treatment of entertainment expenses

a. Application of the entertainment expense non-deductibility rules will be extended by two years (Article 61-4, paragraph (1) of the Act on Special Measures Concerning Taxation (ASMT)).

b. Since the implementation of the special tax measure for hospitality-based food and drink expenses (i.e. entertainment expenses that are classified as expenditures required for eating, drinking and other similar acts (excluding expenditures used exclusively by the entity to pay for hospitality shown to its directors, its employees or their relatives)) has not led to great changes in the entertainment expense amount of some large enterprises and has not contributed to a significant reduction of cash and deposits of such enterprises, large enterprises with stated capital exceeding JPY10 billion will be excluded from the scope of entities eligible for this special tax measure. The figure below depicts the applicability of the measure in concern to hospitality-based food and drink expenses incurred by large enterprises with stated capital exceeding JPY10 billion.

Entertainment expenses that are classified as hospitality-based food and drink expenses	Current rules	Reform proposals
Over JPY5,000 per person	50% deductible	None of the amount is deductible

** Hospitality-based food and drink expenses equal to or less than JPY5,000 per person will remain expenses that do not qualify as entertainment expenses.*

c. From the perspective of supporting the economic activities of SMEs, which fulfill a central role in revitalizing regional areas, the special tax measure regarding entertainment expenses for SMEs (providing for the deduction of the full amount of entertainment expenses up to a standard deduction (of JPY8 million)) will be extended by 2 years without any revisions.

4. 5G infrastructure (5th generation mobile communication systems)

In light of a desire for the widespread and early installation of 5G infrastructure, which will form the backbone of Japan's economic society and the lives of its citizens, a tax incentive will be introduced for the construction of safe and reliable 5G systems; said incentive will allow an entity to receive a tax credit or special depreciation in concern to investments relating to certain 5G facilities introduced in accordance with a Certified Introduction Plan (name tentative) prepared in accordance with the provisions of the Specified Advanced Information and Telecommunications Systems Promotion Act (name tentative).

The reform presumes the enactment of the Specified Advanced Information and Telecommunications Systems Promotion Act (name tentative); under such circumstances, if a blue-return entity certified as a business introducing advanced information and telecommunications systems (name tentative) under the same Act and which introduces certain systems (Note 1) acquires facilities certified as specified advanced information and telecommunications facilities (Note 2) and places said facilities into service in a domestic business between the enforcement date of the same Act and 31 March 2022, then said entity may elect between a 30% special depreciation or 15% tax credit in relation to said acquisition cost. However, the tax credit will be capped at 20% of the corporate tax for a given fiscal year.

Note 1: "Introduction of certain systems" refers to the act of introducing advanced information and telecommunications systems (name tentative) recognized under the Specified Advanced Information and Telecommunications Systems Promotion Act in accordance with a Certified Introduction Plan (name tentative) of the same Act that have received the confirmation from the relevant minister in concern to meeting standards set forth for systems which contribute to the stable supply of such systems and encourage its early adoption.

Note 2: "Facilities certified as specified advanced information and telecommunications facilities" refers to certain equipment and other depreciable assets listed in the Certified Introduction Plan of an eligible entity that are placed into service for the introduction of certain systems.

Eligible business companies	Eligible facilities*	Selection of one of the following:	
		Tax credit**	Special depreciation
Mobile carrier businesses located in Japan	Machinery, equipment, etc.	15%	30%
Licensed local 5G*** operators			

** Examples of eligible facilities to be installed in advance in base stations constructed by nationwide 5G businesses are transmitters, receivers, and antennas. Furthermore, examples of 5G facilities to be installed by local 5G operators are transmitters, receivers, communication modules, core facilities and optical fibers.*

*** The tax credit will be capped at 20% of corporate tax for a given fiscal year.*

**** Local 5G refers to a new system in which local companies, local municipalities and various other organizations are permitted to flexibly construct and operate localized private networks, separate from the nationwide 5G services provided by mobile carriers, within their own buildings or premises; the system is expected to fulfill various needs, including the resolution of local issues. Although this system is generally expected to be used only for a company or organization's own operations, in order to provide for the diverse needs unique to specific localities, companies and individuals will be permitted to issue requests to local companies, etc. for the construction of networks and to receive telecommunications services therefrom. (Source: "Local 5G Implementation Guidelines" published by the Ministry of Internal Affairs and Communications.)*

In regard to local taxes, measures for special depreciation, etc. pertaining to corporate inhabitant taxes and corporate enterprise taxes will also be introduced. Furthermore, with regard to fixed asset taxes, a measure which reduces the taxable base of fixed assets purchased by licensed local 5G operators to 50% for 3 years after purchase will be introduced.

5. Revisions of the regional revitalization tax rules

To remediate the excessive concentration of the population in Tokyo, a number of revisions, such as the enhancement of incentives to increase employment by relocating business offices to regional areas, will be implemented, and subsequently the certification of plans approved under these tax rules will be extended to 31 March 2022.

(1) The special depreciation and tax credit rules pertaining to the acquisition of specified property (office buildings, etc.) in regions specified as revitalization regions (i.e. office tax reduction measure) will be extended by 2 years.

(2) The requirements and tax credit amounts provided under the tax credit rules applicable when the number of an entity's employees in regions specified as revitalization regions is increased (employment promotion tax incentive) will be revised and extended by 2 years.

6. Other

(1) Expansion and extension of the hometown tax for businesses

Under the current rules, if an entity makes donations to businesses included in the Regional Revitalization Plans approved by the Prime Minister of Japan, a tax credit measure effective from FY2016 to FY2019 has been established for corporation-related taxes (corporate inhabitant tax, corporate enterprise tax and corporate tax) in addition to a measure for the deduction of such donation amounts.

Measures will be introduced to extend the special tax credit rules by 5 years (to FY2024) and raise the tax credit ratio to 60% (from 30% under the current rules).

(2) The following measures will be implemented based on the presumption of the revision of company-related rules.

a. In regard to the special tax measure for the fiscal years to which expenses for compensation paid in the form of restricted stocks belong, restricted stocks issued as compensation for services provided to an entity and concerning which payments or benefits are not required in exchange for said restricted stocks will be added to the scope of the measure.

b. In regard to the formal basis used to assess directors' compensation paid by an entity for excessive directors' compensation, if an entity has set forth the maximum number of shares or share acquisition rights it may grant to directors as compensation in its articles of incorporation, etc., then the maximum compensation payable via the provision of shares or share acquisition rights by that entity shall be the amount calculated by multiplying said maximum number by the share price at the time the compensation is paid.

c. In regard to the requirements for procedures pertaining to directors' performance-linked compensation paid by companies, the scope of persons deemed persons who execute operations of parent entities that were excluded from the scope of independent persons who execute duties will be revised.

d. Other necessary measures will also be introduced.

(3) Necessary measures will be introduced to align tax rules with the revisions of the definition of the market value of trading securities under the accounting standards concerning calculations of market value.

(4) Application of the measure for reserves for loss on foreign investments (a measure which allows the accumulation of reserves in preparation for the risk of project failure, etc. when undertaking foreign resources exploration and development, as well as the deduction of said reserves as expenses) will be extended by 2 years.

(5) The special tax measure for the replacement of specified assets through purchase will undergo partial revision and will be extended by 3 years.

(6) The special depreciation or tax credit rules for the acquisition of facilities utilized in connective industries (IoT tax incentive) will be abolished as of 31 March 2020 and the necessary transitional measures will be implemented prior to the date of abolishment.

(7) Revision of the imposition of corporate enterprise tax pertaining to electricity suppliers (corporate enterprise tax)

Currently, the taxable base of electricity suppliers for the purposes of corporate enterprise tax is the amount of revenue, and such suppliers therefore enjoy treatment that differs from that of general corporations (income-based taxation and business scale taxation); business scale taxation will, however, be incorporated in relation to the taxation of power generation companies and electricity retailers.

International taxation

1. Addressing schemes which incorporate dividends received from subsidiaries and subsidiary share transfers

Under the current rules, it is possible for an entity to employ a scheme by which it both receives tax-exempt dividends from a subsidiary after acquiring shares of that subsidiary (Note 1) and generates capital losses by transferring the shares of said subsidiary, whose market value decreases greatly as a result of the foregoing dividend distribution. The following revisions will be implemented to prevent the use of such schemes:

Note 1: A certain ratio of the dividends received from a subsidiary, determined according to the ratio of shares owned in said subsidiary, is excluded from taxable income.

(1) In the event an entity receives dividends (including deemed dividends) from a subsidiary of specified relationship (Note 2) in a single fiscal year whose total exceeds the equivalent of 10% of the tax book value of shares, etc., then the tax book value of those shares, etc. will be reduced by an amount equal to the portion of said dividend that is excluded from taxable income (Note 3).

Note 2: "Subsidiary of specified relationship" refers to a subsidiary of whose outstanding shares an entity and its related parties directly or indirectly own more than 50% as of the date of the resolution concerning dividends (hereinafter, "dividend resolution date").

Note 3: "An amount equal to the portion [of said dividend] that is excluded from taxable income" refers to the amount equivalent to the portion of dividends that is excluded from taxable income pursuant to the dividends received deduction (DRD) rules.

(2) Dividends that meet any of the following conditions will be exempt from this tax measure.

a. Dividends from a subsidiary that is an ordinary domestic entity and of whose total outstanding shares 90% or more were owned by ordinary domestic entities from the incorporation date of the subsidiary of specified relationship to the establishment date of a specified control relationship (Note 4).

Note 4: "Establishment date of a specified control relationship" refers to the date an entity and its related parties begin to directly or indirectly own over 50% of shares, etc. of another entity.

b. Dividends received from a subsidiary of specified relationship in the event that the amount remaining after subtracting the amount in ii. from the amount in i. is equal to or greater than the amount in iii.

i. The amount of retained earnings held by a subsidiary of specified relationship as of the start date of the fiscal year of said subsidiary of specified relationship in which falls the dividend resolution date.

ii. The total amount of dividends received by shareholders of the subsidiary of specified relationship during the period from the aforementioned start date to the date the dividends were received.

iii. The amount resulting after certain adjustments are made to the amount of retained earnings held by a subsidiary of specified relationship as of the start date of the fiscal year of the subsidiary of specified relationship in which falls the establishment date of a specified control relationship.

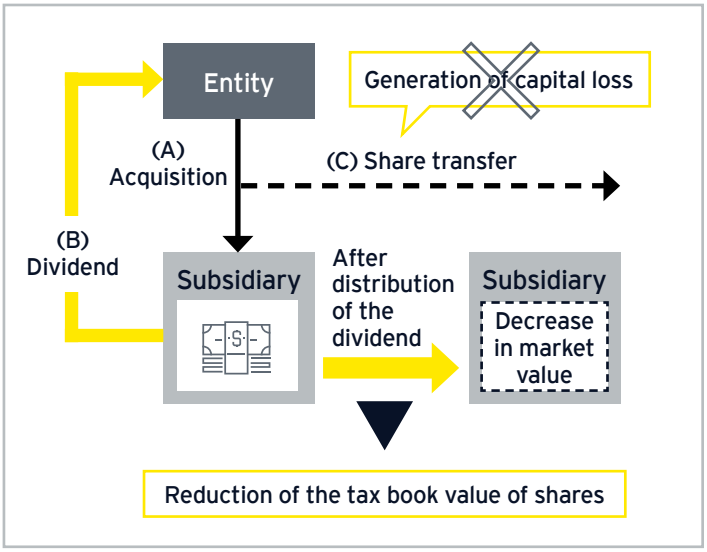
The amount remaining after subtracting the amount in ii. from the amount in i. can be considered the amount of retained earnings after the distribution of dividends, while the amount in iii. can be considered the amount of retained earnings as of the acquisition date. In other words, circumstances in which the amount of retained earnings after the distribution of dividends exceeds the amount of retained earnings as of the acquisition date have been exempted under the premise that such dividends are not distributed from retained earnings generated prior to the acquisition.

c. Dividends received on or after the date when 10 years has elapsed from the establishment date of a specified control relationship.

d. Dividends whose amount does not exceed JPY20 million

(3) In the event that a portion of the dividends is deemed to have been paid from retained earnings generated after the establishment date of a specified control relationship, then the amount of dividends in excess of that portion may be considered dividends excluded from taxable income.

(4) Necessary measures regarding local tax (corporate inhabitant tax and enterprise tax), consistent with the treatment in concern to national taxation, will also be established.



Source: Prepared based on materials published by the Ministry of Finance.

As shown in the figure above, to counter the use of schemes which incorporate dividends (primarily tax-exempt) that are received after acquisition of an entity, and share transfers (recognition of capital loss) (i.e. the generation of capital losses via transfers after reducing the subsidiary's value through distributions of dividends), the reform proposal is one which reduces the tax book value of subsidiary shares in the event an entity receives certain dividends from certain subsidiaries.

Since the reform targets only cases when (a) total dividends received in a single fiscal year exceed 10% of the tax book value of shares (excluding dividends of less than JPY20 million) from (b) subsidiaries acquired within the preceding 10 years (with which control relationships have been established), a certain amount of consideration has been given to reducing the administrative burden of companies. However, caution is required since it is not only dividends from foreign subsidiaries, but also dividends received from domestic subsidiaries that may be subject to the scope of the reform when they meet the foregoing criteria and furthermore, since deemed dividends are also included in the scope of dividends.

Explanations have been provided in concern to the dividends subject to this tax measure in (1) above, the dividends not subject to this tax measure in (2) above and the tax book value reduction in (3) above. Future developments will garner attention since the method of calculating the tax book value reduction in (3) is not made clear in the Outline.

2. Revision of the controlled foreign company (CFC) regime

(1) In the event the directors and employees of a foreign related company carry out all businesses ordinarily considered necessary to appropriately carry out the business of selling inventory assets and other ancillary businesses (limited to that pertaining to interest derived from the sales of inventory assets (i.e. usance interest)) in the country where its head office is located, the amount of interest derived from the sales of inventory assets sold by said foreign related company to unrelated parties will be excluded from the scope of interest income subject to partial income inclusion rules.

Note 1: The above revision will be applied to the fiscal years of foreign related companies beginning on or after 1 April 2020.

Note 2: Revisions similar to the foregoing will be implemented with regard to the special measure concerning the taxation of income relating to foreign related companies pertaining to domestic companies which are shareholders of specified relationship.

(2) A measure will be introduced to treat, in the event an investment corporation is subject to the CFC regime, dividends of the investment corporation as amounts eligible for double taxation adjustments by deeming an amount which corresponds to the portion of foreign corporation taxes levied on the income of a foreign related company that was also subject to income inclusion under the CFC regime as the amount of foreign corporation taxes paid by said investment corporation.

Note 1: The above revision will be applied to the fiscal years of foreign related companies ending on or after 1 April 2020.

It is thought that these reforms were proposed to rectify the scope of partial income inclusion taxation in view of the tax reform requests submitted by the Japan Business Federation (Keidanren), the Japan Foreign Trade Council (JFTC) and the Japan Machinery Center for Trade and Investment (JMC). (The "Proposal for Fiscal 2020 Tax Reform" submitted by the Keidanren states that interest received in the event of the provision of usance (the act of granting a grace period for payment prior to collection) to clients for selling products should be excluded from the scope of passive income since this is income directly relevant to business activities.)

The following amounts will be excluded from the scope of interest income subject to the partial income inclusion rules.

- Interest on saving deposits arising during the normal course of business
- Interest pertaining to cash loans provided by certain moneylenders
- Interest pertaining to certain installment sales
- Interest pertaining to certain group financing

Although there are various types of passive income other than interest, such as dividends and capital losses from the transfer of securities, it is hoped that future reforms will bring the tax rules more in alignment with actual business conditions, as the greatest number of consultations are made in relation to interest income.

3. Revision of the scope of foreign taxes eligible as foreign tax credits

Added to the list of foreign corporation taxes ineligible for foreign tax credits, due to the fact that they are foreign corporation taxes levied on amounts not considered income in Japan are the following:

(1) Foreign corporation taxes levied on a domestic entity on the portion of the income of a foreign entity, etc. that is deemed to be the income of said domestic entity

> Envisaged under (1) are, for example, withholding taxes levied on license fees when the granting of a license by a domestic entity to a subsidiary in country A via a subsidiary in country B is deemed by the tax authorities of country A as a direct transaction between the domestic entity and the subsidiary in country A, and the license fees paid by the subsidiary in country A to the subsidiary in country B are deemed as license fees paid by the subsidiary in country A to the domestic entity.

(2) Foreign corporation taxes levied on income that would be obtained by the foreign business facility, etc. of a domestic entity if the foreign business facility, etc. is deemed not to have made payments to its Japanese headquarters or other parties (i.e. taxes levied on substantial payments)

Note 1: Foreign tax credit rules pertaining to residents will also be revised in line with the above.

Note 2: The above revisions will apply to corporate taxes for fiscal years beginning on or after 1 April 2021 and individual income taxes for 2022 and thereafter.

> Envisaged under (2) are foreign corporation taxes levied on income that would be obtained by the branch office of a domestic entity located in country C if the branch office is deemed not to have made payments such as interest to related parties, etc.

Revisions were proposed based on the following perspectives:

- Foreign tax credit rules, for the purpose of eliminating international double taxation, permit entities to deduct foreign taxes paid in foreign countries within the scope of corporate taxes required to be paid in Japan in regard to their foreign income.
- Certain types of foreign corporation taxes that are listed as foreign corporation taxes levied on amounts not considered income in Japan are excluded from the scope of eligible foreign tax credits, in view of the regime's objective of eliminating international double taxation.

  Note: "Certain types of foreign corporation taxes" are the following:

  - *Foreign corporation taxes levied on cash or the value of other types of assets received for reasons which give rise to deemed dividends for tax purposes*
  - *Taxation on deemed dividends levied as part of secondary adjustments conducted for transfer pricing taxation purposes*
  - *Foreign withholding taxes, etc. pertaining to dividends subject to the foreign dividends exclusion (FDE) rules*
  - *Foreign corporation taxes levied on internal transactions, etc. conducted between foreign business facilities, etc. and their Japanese headquarters*
  - *Certain types of foreign corporation taxes levied on payments deemed as dividends to a domestic entity. (These were added during the 2019 tax reforms. Specifically, the amount of foreign corporation taxes levied on the amount equivalent to the increase in a foreign entity's income which results from the issuance of an administrative decision that is equivalent to a correction or determination by deeming that increase to be a dividend in the event said administrative decision is pursuant to the laws and regulations of the country or region in which is located the headquarters or principal office of the foreign entity that issued the shares or investments owned by a given domestic entity, and made in relation to the taxable base or tax amount of said foreign entity for the purposes of taxation. The withholding taxes levied by Germany on hidden dividends are thought to qualify as such an amount. However, under the revised Germany-Japan Income Tax Treaty, parent-subsidiary dividends that meet certain requirements are exempt from withholding tax (down from the 10% effective prior to the revision), and this rule will therefore not have any impact in cases when such dividends are exempt from withholding tax.)*

- In recent years, foreign corporation taxes allowed to be levied on items not recognized as income in Japan have been identified and there is a need to conduct revisions.

4. Revision of the scope of non-qualified interest expenses under the earnings stripping rules

When it is determined in advance that the rights of a permanent establishment (Japanese branch) of a foreign entity to receive economic benefits (interest equivalents) pertaining to receivables (loans) will be transferred to its foreign headquarters, the interest paid by a domestic entity to said PE will be excluded from the scope of non-qualified interest expenses (i.e. said amounts will be treated as qualified interest expenses).

5. Revisions to the reporting regulations for the automatic exchange of financial account information concerning non-residents (data exchange pursuant to the Common Reporting Standards (CRS))

Revisions will be implemented such that entities that fulfill certain requirements will be removed from the scope of entities to which these regulations apply and revisions which clearly state that these regulations shall be applied to third parties in cases when an entity conducts a covered transaction on behalf of a third party will also be implemented. Furthermore, measures to exclude from the scope of transactions exempted from these regulations any transactions pertaining to shares which have been acquired and to which have been applied the exemption from taxation of economic benefits relating to the acquisition of shares via the execution of share acquisition rights received by a specified director (i.e., the stock option tax rules) will be implemented.

(For details, please refer to the CRS Tax Reform Update issued by EY on 13 December 2019 (available in Japanese only).)

Individual income taxation, tax administration and other reforms

1. Individual income taxation

(1) Expansion of the NISA program

With regard to installment-type NISAs, both the period in which accounts may be opened and the expiry date of the program itself will be extended by 5 years; installments may thus be made for a maximum of twenty years during the period lasting until the end of 2042. With regard to ordinary NISAs, for which the period in which accounts may be opened is scheduled to conclude in 2023, said period will be extended by 5 years and accompanied by revision of the program into a new two-tiered program. The first tier of the program (JPY200,000 per year) is similar to that of the existing installment-type NISA, and permits investment in investment trusts (publicly-offered, etc.); the second tier of the program (JPY1,020,000 per year) follows the precedent set in the existing ordinary NISA in permitting investment in listed shares, etc.

Revision and expansion of the NISA program will occur for the twin purposes of increasing the supply of the capital necessary for economic growth and assisting the steady growth of household financial assets.

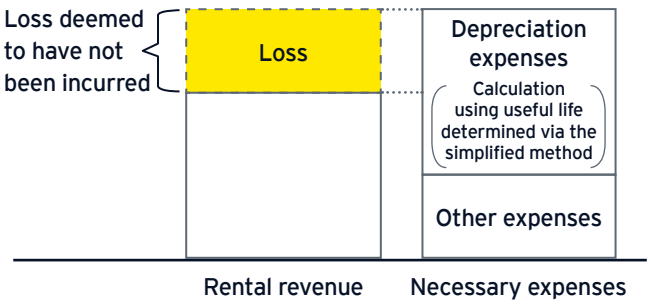
(2) Tax measures for never-married single parents and revisions of the deduction for widows or widowers

The scope of the deduction for widows or widowers will be applied to never-married single parents in a manner indistinguishable from that applied to parents who become single due to bereavement or divorce. An income limitation equivalent to that set forth for widowers (total income of JPY5,000,000) will be established in regard to the deduction for widows, which has never before been subject to an income limitation. The deduction for widowers with children shall be increased to equal the amount provided for widows with children (JPY350,000). These revisions will apply to individual income tax for 2020 and thereafter. (Transitional measures will be established.)

(3) Special measure for the offset of gains and losses, etc. pertaining to real estate income derived from foreign pre-owned buildings

In the calculation of real estate income, in the event that the amount of taxable income in relation to foreign real estate is negative, losses attributable to the depreciation expenses of foreign pre-owned buildings whose useful lives were calculated via the simplified method shall be deemed to have not been incurred, and said amounts will not be permitted to be offset against income from other sources. This reform will apply to individual income tax for 2021 and thereafter.

Real estate income arising due to the lending of foreign pre-owned real estate



Source: Ministry of Finance documents

Attention had been called to the calculation of real estate income pertaining to the lending of foreign pre-owned buildings because the useful lives of pre-owned buildings as calculated via the simplified method at times fall greatly below the actual usable periods of such buildings in the relevant foreign country, particularly in the US and Europe and consequently, losses generated via the recording of depreciation expenses which exceed rental revenue were being used to suppress income tax amounts via the offsetting of such losses with income from other sources. This reform will therefore act to rectify the taxation of foreign real estate income.

(4) Revision of the dependent deduction pertaining to family members residing overseas

Under the current regulations, when an individual taxpayer sustains the livelihood of a relative of 16 years of age or older whose total income is JPY380,000 or less, the dependent deduction from income tax affords the taxpayer a deduction from income amounting to JPY380,000 per person for each such relative. Subsequent to the reform, the deduction will apply in relation to relatives of the ages 16 to 29 or 70 years or older who reside overseas; persons of ages 30 to 69, the age range treated as the working age, will be removed from the scope of eligibility for the deduction, with the exception of specified circumstances. This revision will apply to individual income tax for 2023 and thereafter.

(5) Establishment of a special deduction for long-term capital gains arising from the transfer of low-use or unused land, etc. (temporary measure)

Rules will be established such that, in the event that an individual conducts a transfer (excluding transfers between relatives) of specified low-use or unused land that is located within a city planning area and is not used as a residence or for business and said transfer meets specified conditions, the taxpayer may deduct JPY1,000,000 from the capital gains arising from said transfer. The period of applicability will last from 1 July 2020 (tentative) to 31 December 2022.

The transaction prices of low-use or unused land which has a frequency of use significantly inferior to that of neighboring land tend to be low and sellers therefore incur disproportionately high transaction costs. Thus, transactions to sell such land are seldom concluded and the resulting neglect of said land has become a social issue; these rules are expected to contribute to the amelioration of that issue.

2. Tax administration

(1) Establishment of a special measure for the extension of the consumption tax return filing due date for corporations

When an entity to which approval has been granted for application of the special measure for the extension of the final corporate tax return filing due date submits a notification indicating an extension of the final consumption tax return filing due date, then a one-month extension of the final consumption tax return filing due date will be granted in relation to taxable periods in which fall the final day of the fiscal year in which said notification was submitted or fiscal years thereafter. Application of this reform will begin with taxable periods in which fall the final day of fiscal years ending on or after 31 March 2021. However, the application of this measure will not extend the statutory payment due date for consumption taxes and interest tax for the corresponding extension period will be imposed on any additional principal tax paid after the statutory payment due date.

Prior to this change, corporations unable to complete financial closing by the consumption tax return filing due date suffered from an administrative burden caused by the initial submission of a final consumption tax return and the subsequent request for a correction or submission of an amended tax return. Furthermore, as interest tax is imposed in relation to the extension period, it is projected that estimated tax payments will be made on an as-needed basis in the same manner as is done for corporate taxes.

(2) Rectification of the taxation of consumption taxes pertaining to the lending of dwellings

a. Input tax credits will generally not be applied in concern to taxable purchases pertaining to the acquisition of residential rental buildings (with the exception of those portions which will clearly not be used in the lending of a dwelling). This provision will apply to purchases of residential rental buildings made on or after 1 October 2020. (However, this measure will not be applied to purchases of residential rental buildings made on or after 1 October 2020 in accordance with agreements concluded on or before 31 March 2020.)

b. Even when the purposes for the lending are not clearly stated in the agreement pertaining to the lending of a dwelling, consumption tax will be exempted in relation to leases for which provision for use as a residence is evident through the condition of the building or other factors. This revision will apply to lending conducted on or after 1 April 2020.

Incidents in which taxpayers have received an input tax credit in relation to the acquisition of residential rental buildings which would otherwise be ineligible for the input tax credit, by intentionally increasing the taxable sales ratio through methods such as conducting a series of contrived gold ingot transactions, have been considered controversial; this reform, however, will contribute to the rectification of the input tax credit calculation.

(3) Revision of the electronic books maintenance rules

Two new types of invoices received electronically will be added to the list of invoices that are permitted to be preserved as electronic data: (1) The issuer has affixed a time stamp to the data and (2) The use of a system (cloud-based accounting, expense settlement services, etc.) which does not allow the user (recipient) to freely modify the data. This revision will be applied beginning 1 October 2020.

The revision of the Electronic Books Maintenance Act in keeping with the changes in the digital environment, which include increased back office efficiencies, the utilization of cloud services, and the spread of cashless financial settlement methods, will contribute to the digitalization and automation of accounting and tax processes and improvements in corporate productivity.

(4) Reduction of the interest tax rate and interest rates on tax refunds

Prior to this change, the rate used for interest tax and interest on tax refunds had been stipulated as the "average contract interest rates on short-term loans and discounts (of domestically licensed banks) plus 1%," and in light of recent reductions in lending interest rates, this amount will be revised to the "average contract interest rates on short-term loans and discounts (of domestically licensed banks) plus 0.5%." (Were the post-reform rate applied to the year 2019, for example, this would lead to the reduction of the rate from 1.6% to 1.1%.) Furthermore, in relation to delinquent tax (with the exception of delinquent taxes pertaining to payment grace periods, etc.), in light of collection risk, the nature of the tax as interest on delinquent payments and its function in deterring delinquent payments, the current rates therefor will remain unchanged, and will continue to be defined as the "average contract interest rates on short-term loans and discounts (of domestically licensed banks) plus 1%." This revision will apply to interest tax and interest on refunds pertaining to dates on or after 1 January 2021.

(5) Measure to ensure appropriate taxation in relation to foreign transactions

a. In regard to the foreign asset reporting requirements, the following reforms will be added in relation to penalty measures for imposing additional taxes which apply in the event a taxpayer fails to present or submit required documents by the designated due date. This reform will be applied to individual income tax for 2020 and thereafter and inheritance tax on assets acquired through inheritance or bequests on or after 1 April 2020.

Rates for additional tax on underreported tax returns

	Current rules	Post-reform
Ordinary circumstances	10% (Note 1)	As indicated at left
Adequate indications on the foreign assets report	5% (5% reduction)	As indicated at left
Non-presentation or non-submission of relevant documents	Same as above	10% (Reduction not applied)
Non-submission of or inadequate indications on the foreign assets report	15% (Additional 5%)	As indicated at left
Non-presentation or non-submission of relevant documents	Same as above	20% (Additional 10%)

Note 1: 15% is applied to the amount in excess of the larger of a) the amount reported in the tax return prior to the tax return filing deadline and b) JPY500,000
Source: Partial modification of documents prepared by the Ministry of Finance

b. In the event a tax examiner of the National Tax Agency, etc. requests that a taxpayer present or submit documents concerning foreign transactions or foreign assets and the taxpayer fails to present or submit said documents by the designated due date and a request for the exchange of information is made to a foreign tax authority in accordance with the provisions of a tax treaty or other agreement, corrections, assessments, etc. will be permitted for a period of three years following the date of said request for the exchange of information, regardless of any restrictions on said periods specified under the existing laws and regulations. This reform will be applied in concern to national taxes for which the statutory filing due date arrives on or after 1 April 2020.

As it is difficult for the Japanese tax authorities to physically arrive on-site and obtain materials located overseas due to limitations on executive jurisdiction, in the event that a taxpayer does not present such materials, the tax authorities issue a request for information exchange to the relevant foreign tax authorities; responses to such requests sometimes require a significant amount of time. Prior to this point, there had been cases in which the authorities lost the ability to impose taxes because the deadline pertaining to amendments or determinations was reached before such materials could be obtained.

3. Other reforms

(1) Addressing issues pertaining to the taxation of land of unknown ownership

Municipalities will be permitted, in concern to fixed asset taxes for FY2021 and thereafter, to levy fixed asset taxes through the deeming of the user of a given fixed asset as the owner thereof in the event that none of the owners of said fixed asset can be ascertained even upon the dutiful performance of specified investigative procedures.

In recent years, the amount of land of unknown ownership has increased throughout Japan, presenting a wide variety of problems including those in relation to the promotion of public works and improvement of the residential environment. The problem has also presented itself in relation to fixed asset taxation, as investigating and identifying the current owner of an asset, i.e. the party with the obligation to pay the tax, requires an immense investment of time and manpower.

(2) Presumptive taxation in relation to withholdings at source

The ability of the authorities to collect income taxes via the presumptive assessment of the amounts paid to each payee of wages, based on the period in which each payee of wages engaged in labor, the nature of that labor and other factors, in the event that a withholding agent does not submit payment of income taxes pertaining to the payment of wages, will be clarified in the relevant laws and regulations. This reform will apply to wages paid on or after 1 January 2021.

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