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Japan Tax Newsletter

Tax Reform Proposal Issued on December 16, 2010 by the Japanese Cabinet (1)

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On December 16, 2010, the Japanese cabinet issued the tax reform proposal (*Zeisei Kaisei Taiko*) (the "***Proposal***"). The Proposal includes several important changes with respect to corporate tax and the taxation of foreign investments. While the details of the changes that will be made in the process of codification have not been publicized in full, in this memorandum, we shall outline the proposed changes in the area of corporate tax.

1. Reduction of Corporate Tax Rate

Currently, the corporate tax rate under the Corporate Tax Law in Japan is 30%. Under the Proposal, however, this rate will be reduced to 25.5%. Pursuant to this reduction of corporate tax, the current effective tax rate[1] imposed on corporate income (which is approximately 40% at present) will be reduced by approximately 5%.

In conjunction with such reduction of the corporate tax rate, the corporate tax rate applicable to the income of small and medium-sized corporations ("***SMC***" or "***SMCs***") will likewise be reduced. The current 18% tax rate, which is imposed on an SMC's annual income of JPY 8 million or less, will be reduced to 15% under the Proposal.

The term "SMC" referred to above is defined in the Corporate Tax Law as a corporation whose paid-in capital amount is JPY 100 million or less at the end of its fiscal year. However, even if the paid-in capital of a corporation amounts to JPY 100 million or less, (i) if all of the shares of such corporation is held by a Large Corporation (i.e., a corporation whose paid-in capital is JPY 500 million or more, or a mutual corporation), or (ii) if all of the shares of such corporation is held by several Large Corporations that belong to the same 100% group (i.e., a group of corporations whose shares are held, directly or indirectly, by just one corporation), such corporation will not be considered a SMC.

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[1] The effective tax rate on corporate income is an aggregate of the corporate tax rate and the applicable local tax. In calculating the effective tax rate, one must take into account that the amount of enterprise tax (local tax) may be deducted from the corporate income. The formula for calculating the effective tax rate is as follows;

$$\text{Effective Tax Rate} = \frac{\text{Corporate Tax Rate} + (\text{Corporate Tax Rate} \times \text{Resident Tax Rate}) + \text{Enterprise Tax Rate}}{1 + \text{Enterprise Tax Rate}}$$

Although the corporate tax rate will only be reduced by 4.5%, the effective tax rate will be reduced by more than 5% since the resident tax rate will not change.

2. Limitation on the Use of Loss Carried Forward

In order to recover the revenue losses arising from the reduction of the corporate tax rate described above, several measures need to be taken in order to broaden the corporate tax base.

One such measure pertains to limiting the use of losses carried forward. At present, a corporation may offset all the income it generated in the current fiscal year by net losses incurred in prior fiscal years up to a period of seven (7) years before the commencement of the current fiscal year.

Pursuant to the Proposal, the net loss that can be made use of by corporate taxpayers may be broadened. A corporation may offset its corporate income by net losses incurred in previous fiscal years up to a period of nine (9) years before the commencement of the current fiscal year. However, the corporate income that may be offset is limited to 80% of such corporation's corporate income in that fiscal year.

This 80% limitation will not apply to SMCs, which may offset all of their corporate income by making use of net losses incurred in prior fiscal years up to a period of nine (9) years before the commencement of the current fiscal year.

3. Removal of Bad Debt Allowance

Another measure aimed at recovering revenue losses is the rule that bad debt allowance can only be used by banks, life insurance companies, etc. Presently, a certain portion of a corporation's receivables may be deductible as bad debt allowance, with no regard to the actual amount of bad debt write-off. Such deducted allowance is renewed every year with reference to actual bad debt written off. However, under the Proposal, use of this allowance can only be availed of by banks, life insurance companies, and other corporations engaging in similar business.
However, as a transitional measure, a limited portion of the amount currently deductible by corporations may be deductible for a few years starting from 2011, even if the corporations are not banks, life insurance companies, and other corporations engaging in similar business. More precisely, in the fiscal year commencing on or after April 1, 2011 (but before April 1, 2012), 3/4 of the amount currently deductible can be deducted. In the fiscal year commencing on or after April 1, 2012 (but before April 1, 2013) 2/4, and in the fiscal year commencing on or after April 1, 2013 (but before April 1, 2014) 1/4, of the amount currently deductible can still be deducted.

The removal of bad debt allowance will not apply to SMCs, which are allowed to deduct the entirety of the amounts that are currently deductible.

4. Conditions for Tax Qualified Contributions in Kind

Under the Proposal, conditions for tax qualified contributions in kind by foreign companies

will be liberalized.

When a corporation makes a contribution in kind, such corporation is deemed to have made an asset transfer in consideration for the shares of the recipient corporation. As a general rule, the corporation that provided the in-kind contribution has to recognize its gain or loss for tax purposes. If the in-kind contribution meets the applicable conditions for a tax qualified contribution in kind, the corporation will be deemed as having transferred the relevant asset at its book value, and therefore, no gain or loss will be recognized.

The conditions for determining a tax qualified contribution in kind varies depending on the shareholding ratio existing between the parties. If a domestic corporation wishes to incorporate a wholly-owned subsidiary in Japan by contributing assets (other than money), such contribution will be considered a tax qualified contribution in kind provided that the said domestic corporation only receives shares of the newly-incorporated subsidiary and will continue to hold such shares.

However, in addition to the conditions applicable to a domestic corporation, the following conditions must likewise be satisfied in the case of a foreign corporation:

(i) the foreign corporation must have a branch, factory or other fixed place of business in Japan;
(ii) such foreign corporation must maintain the fixed place of business indicated in (i) above; and
(iii) such foreign corporation will continue to book the shares received in consideration for the asset contributed at the fixed place of business indicated in (i) above.[2]

Under the current rule, should a foreign corporation abolish its branch or other fixed place of business in Japan, or cease to book the shares at such fixed place of business in Japan, then it will have to recognize its capital gain from the transfer of the asset it contributed at the time of contribution. On the other hand, even if it incurs capital losses from the asset transfer, such losses will not be recognized.

Pursuant to the Proposal, conditions (ii) and (iii) above will no longer apply with respect to contributions in kind made on or after April 1, 2011. In view of this proposed amendment, it will be much easier for a foreign corporation to convert its branch in Japan into a subsidiary.

[2] Conditions (ii) and (iii) are required only to the extent that there is a capital gain from the transfer of the asset at the time of contribution.

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This newsletter is published as a general service to clients and friends and does not constitute legal advice. This newsletter is co-authored by Kotaro Okamoto, and Ava Tabila of Anderson Mori and Tomotsune.

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