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Global Tax Alert

Japan enacts 2019 tax reform bill

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Executive summary

On 27 March 2019, Japan's 2019 tax reform bill (the Bill) was enacted following passage of the Bill by the Japanese Diet. The Bill generally follows the tax reform outline announced by Japan's coalition leading parties in December 2018.[1] The amendments generally apply to taxable years beginning on or after 1 April 2019 unless otherwise specified.

This Alert summarizes the key provisions relevant to multinational corporate taxpayers, including:

- Earnings stripping rules
- Transfer pricing
- Controlled foreign corporation (CFC) rules
- Research and development (R&D) tax credit

Detailed discussion

Earnings stripping rules

Pursuant to the BEPS[2] initiatives and the recommendations by the BEPS Action 4 final report, the earnings stripping rules will be amended by reducing the current 50% of adjusted taxable income (ATI) to 20% in computing interest expense disallowance.

In addition, the Bill includes in an ATI computation a domestic and foreign dividend received deduction and an add-back tax adjustment of non-deductible income taxes. ATI for an operator under a silent partnership arrangement will also be amended.

The Bill revises the scope of interest subject to the earnings stripping rules and the de minimis exceptions.

The revision will apply to taxable years beginning on or after 1 April 2020.

Transfer pricing

The scope of intangibles subject to the transfer pricing rules is clarified and defined as property other than tangible property or financial assets and investments, for which consideration would be paid for a transfer or lease of the property if the transfer or the lease were carried out between unrelated parties.

The discounted cash flow recognized under the OECD[3] Transfer Pricing Guideline is added as a new transfer pricing methodology.

The Japanese tax authorities will be authorized to make an assessment if there is a discrepancy between an outcome and the projected value if the discrepancy is 20% or more without proper documentation.

The current six-year statute of limitations for transfer pricing will be extended to seven years.

This revision will apply to taxable years beginning on or after 1 April 2020 and calendar years beginning 2021 for corporations and individuals, respectively.

CFC rules

The Bill contains new exceptions to the paper company test for holding company, real estate and resource development CFCs.

Holding company CFCs:

1. A CFC holds shares in companies as its core business located in the CFC's jurisdiction, the CFC owns at least 25% of the companies, more than 95% of the CFC's assets are shares in the companies or cash and more than 95% of the CFC's gross revenue are dividends from these companies or interest on bank deposits. Details vary but similar asset and revenue criteria also apply to each of the following tests.
2. A CFC's core business is to hold shares in companies in the CFC's jurisdiction, which are either CFCs themselves meeting the economic activity test or companies managed by a qualified management company CFC. The CFC must be managed by a management company CFC that performs required business functions in the CFC's jurisdiction.

Real estate CFCs:

1. A CFC's core business is to hold real property or shares in companies that are managed by a qualified management company CFC. The CFC must be managed by a management company CFC, performing the real estate businesses in the CFC's jurisdiction.
2. A CFC holds real property used by a qualified management company CFC as its core business. The CFC must be managed by a management company CFC that provides necessary business functions in the CFC's jurisdiction.

Resource development CFCs:

1. A CFC holds shares in companies which are located in the same jurisdiction as the CFC, owned at least 10% by the CFC and perform resource development functions; the CFC provides funds from third parties to these companies or holds real property located in the same jurisdiction as the CFC. The CFC must be managed by a management company CFC in the CFC's jurisdiction, and the management company CFC performs necessary functions for development of oil, natural gas or other social capital.

The Bill clarifies that local tax laws of the CFCs, such as tax consolidation and distributive share of partnership income, will be disregarded in determining the effective tax rate test, income inclusion or indirect foreign tax credit from CFCs.[4]

R&D tax credit

The Bill proposes a number of amendments to general, additional and open innovation type R&D tax credits.

The general R&D tax credit limitation for qualified venture enterprises[5] will increase from the current 25% of corporate income tax liability to 40% and the credit ratio will be higher if an increase in the current R&D expenditure is at least 8% of the three preceding years as compared to 5% under the current law.

The additional R&D credit[6] will be combined with the general R&D tax credit.

The scope of the open innovation type R&D tax credit will be extended to contract R&D provided by large-sized enterprises if specific requirements are met. The current 5% credit limit on corporate income tax liability will be increased to 10%.

Consumption tax

The Bill proposes various tax cuts and more tax credits, such as taxes on vehicles and mortgage tax credits, to mitigate the impact on Japan's economy due to an expected rate increase from 8% to 10% on 1 October 2019.

Endnotes

1. See EY Global Tax Alert, *Japan releases 2019 tax reform outline*, dated 19 December 2018.
2. Base Erosion and Profit Shifting.
3. Organisation for Economic Co-operation and Development.
4. CFC rules applicable to insurance companies are also amended.
5. This includes companies, not owned by a large company, incorporated in the last 10 years with net operating losses.
6. This refers to high standard type and applies if current year R&D exceeds 10% of average sales during the preceding four-year period.

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