Executive summary

On 28 March 2018, Japan’s 2018 tax reform bill (the Bill) was enacted following passage of the Bill by the Japanese Diet. The tax law enforcement orders, which are regulations provided by the Government to supplement tax law, were also published in the Official Gazette on 31 March 2018. The Bill generally follows the tax reform outline announced by Japan’s coalition leading parties in December 2017. The amendments generally apply to taxable years beginning on or after 1 April 2018 unless otherwise specified.

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

- Modification of the permanent establishment (PE) definition
- Tax credit for wage increases and productivity improvement
- Restrictions on research and development (R&D) tax credit and other tax credits

Detailed discussion

Modification of the PE definition

The PE definition under the Japanese domestic tax law is amended. The amendments basically follow the recommendations by the Organisation for Economic Co-operation and Development in the Base Erosion and Profit Shifting Action 7 final report.
An agency PE includes a person who habitually concludes contracts on behalf of a nonresident individual or a non-Japanese company, or habitually plays a principal role leading to the conclusion of contracts that transfer the ownership of a nonresident individual or non-Japanese company to another person. A person who acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related is regarded as a dependent agent.

Exceptions to a PE, such as a fixed place used for storage, display or delivery, apply only if the activities are of a preparatory or auxiliary character. Furthermore, the anti-fragmentation rules are added, which deny the PE exceptions where the activities of two persons constitute complementary functions and the combined activities exceed the PE threshold.

The splitting up of contracts rules are added by aggregating separate periods of construction contracts for purposes of determining a construction PE if the main purpose of the separation of the construction contracts is to avoid the one-year threshold period.

A fills-order-agent and a secures-order-agent is excluded from the scope of the agency PE under the Japanese domestic tax law.

This revision will apply to fiscal years beginning on or after 1 January 2019.

**Tax credit for wage increases and productivity improvement**

The current tax credit system for wage increases is amended.

Under the new credit system, a company can enjoy a 15% tax credit on wage increases if both of the following conditions are met:

- The average salary paid by the company to the employees increases by at least 3% from the previous fiscal year.
- Domestic investment in depreciable assets is equal to or more than 90% of depreciation.

A company meeting these conditions can also claim a deduction for the business scale enterprise tax.\(^2\)

A company receives a 20%, in lieu of 15%, tax credit on the wage increases, if the costs incurred on training increase by at least 20% of the average training costs during the previous two years.

The requirements for the tax credit are relaxed for a small or medium sized company.

The tax credit applies to fiscal years beginning on or after 1 April 2018 and ending on or before 31 March 2021.

**Limitations on R&D tax credit**

The R&D credit does not apply to large corporations if all the following conditions exist:

- Current taxable income exceeds the prior year’s taxable income.
- The average salary paid by the company to the employees is equal to or less than the average salary paid during the previous fiscal year.
- Domestic investment in depreciable assets is equal to or less than 10% of depreciation.

This revision applies to fiscal years starting on or after 1 April 2018 and ending on or before 31 March 2021.

**Other proposals**

The Bill includes but is not limited to the following:

- Bonus depreciation or tax credit on acquisition of software used to connect information and data
- Tax deferral on exchange of stock for shareholders who have accepted take-over bids
- Amendments to tax-qualified reorganization requirements
- Updates on the Japanese controlled foreign company (CFC) rules, including exclusion of capital gains arising from post-merger integration, the effective tax rate computation for a CFC in a tax haven jurisdiction and a qualified financial services company provision

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**Endnotes**

2. The term refers to capital and value added tax components.
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