Executive summary
On 8 December 2016, Japan’s coalition leading parties released the 2017 tax reform outline (the Outline). A tax reform bill (the Bill) will be prepared based on the Outline. The Bill will be submitted to the Diet (Japanese legislature) and is expected to be enacted by the end of March 2017. This Alert summarizes the key provisions relevant to multinational corporate taxpayers:

- Introduction of spin-off taxation
- Amendment to Japanese anti-tax haven rules¹
- Revision to research and development (R&D) tax credit computation
- Modification to deductibility of director compensation

Separately, on 18 November 2016, the consumption tax revision was enacted, delaying the consumption tax rate increase to 10% from the current 8% for 30 months until 1 October 2019 from 1 April 2017.

Detailed discussion
Introduction of spin-off taxation
Under the current Japanese corporate tax law, a demerger between group companies or the joint business demerger results in no gain or loss if certain requirements are met, for example, no change in ownership relationship for demerging/demerged companies and continuity of merged businesses.
Under the new spin-off taxation, the following two types of spin-off transactions for unrelated parties are treated as non-recognition transfers if certain requirements are met, such as a continuity of business operation by 80% of current employees after the transaction.

- A transferor transfers some businesses to a newly incorporated unrelated company.
- The transferor distributes the shares of a wholly owned subsidiary to its shareholders.

**Amendment to Japanese anti-tax haven rules**

A Japanese company is subject to current taxation on its pro rata share of income of certain foreign subsidiaries referred to as CFC income. Under the current rule, if a foreign subsidiary’s tax burden ratio is less than 20% (the 20% tax rate test), it is treated as a tax haven subsidiary and the Japanese shareholder must include the CFC income currently, unless the active business exception is met. However, certain passive income is still treated as CFC income even though the active business exception is met.

Under the Outline, the 20% tax rate test is repealed and the exception criteria and the scope of the passive income are revised to subject income from the following foreign companies to new CFC income rules:

- A foreign subsidiary which does not meet one of the economic activity criteria, i.e., business criteria, substance criteria, control criteria and location criteria or unrelated party criteria, and its tax burden ratio is less than 20%.
- A foreign subsidiary which meets all the above criteria but its tax burden is less than 20%. Only certain passive income is included as the CFC Income, unless the total passive income is JPY20 million (US$0.2 million) or less.
- “Paper” companies, “cash box” entities and foreign subsidiaries located in the designated “black list” countries, whose tax burden ratios are less than 30%.

Passive income includes interest other than interest on certain group financing, dividend, capital gain on disposition of less than 25% investments, derivative trading income and royalties.

This revision will apply to fiscal years beginning on or after 1 April 2018.

**Revision to R&D tax credit computation**

The applicable percentage of R&D credit will be 6% to 14%, based on the ratio of the R&D cost increase to the R&D cost. Under the current rule, the R&D credit ranges from 8% to 10%, depending on an R&D cost ratio determined by the R&D cost over the average of a given year and its prior three-year sales to the R&D cost.

The R&D cost for the “Industries 4.0” will qualify for the credit.

**Modification to deductibility of director compensation**

Under the current law, regular fixed compensation, pre-determined compensation and profit-linked compensation based on certain indicators paid to executive directors are deductable.

Under the Outline, the scope of the indicators for profit-linked compensation is expanded by adding an indicator for the stock market and sales. Compensations paid by the subsidiary of a publicly traded company to its directors will also be subject to this rule. Stock options are included in a deductible pre-determined compensation if certain requirements, such as an issuance of the fixed number of stock option at the predefined time, are met.

**Consumption tax**

The second phase of the consumption tax rate increase (from 8% to 10%) is postponed to 1 October 2019 (originally scheduled on 1 April 2017).

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**Endnotes**

1. The provision is also known as the Japanese controlled foreign company (CFC) rule.
2. The 14% rate is temporary and only applies to two years.
3. The term means the current trend of automation and data exchange in manufacturing technologies. It includes cyber-physical systems, the Internet of things and cloud computing.
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