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Japan Tax Update: Tax Reform 2011 Effected After Significant Delay; Corporate Tax Rate Cut and Taxation Basis Increased

BY YOSHIHITO UENO

The Japanese Diet Nov. 30, 2011, finally approved certain pending items of the tax reform proposals for the fiscal year 2011 (the "New Law"), which were put forward by the administration back in December 2010.[1]

The New Law, together with the regulations relating to it, was published and came into effect in part on Dec. 2, 2011.[2]

This memorandum provides a brief summary of parts of the New Law that may be of interest to non-Japanese taxpayers.

Overview

In order to seek to end Japan's long-lasting and serious deflation, and to put the Japanese economy back onto a full-fledged growth track, the New Law includes cutting the national corporate tax rate by 4.5 percentage points, resulting in cutting the overall effective corporate tax rate by approximately 5 percentage points, coupled with several means to enlarge the overall taxation basis.

It also includes changes in rules with respect to net operating losses, bad debt reserves, depreciation, and foreign tax credits, which should mitigate the reduction of tax revenue caused by the cut in the corporate tax rate. These changes will also have a complicated impact on financial statements.

Reduction of Corporate Tax Rate

Corporations are currently taxed on their worldwide income at an effective tax rate of approximately 40.69 percent.[3] The national corporate tax rate will be reduced by 4.5 percentage points for taxable years beginning on or after April 1, 2012, though a surtax of 10 percent of the amount of national corporate tax payable (pre-credit) will be levied for taxable years starting on or after April 1, 2012, and on or before March 31, 2015.[4]

Due to this 10 percent surtax, the effective tax rate will only go down to approximately 38.01 percent for the taxable years beginning on or before March 31, 2015, then will go down to approximately 35.64 percent from the taxable year beginning on or after April 1, 2015, when the 10 percent surtax will no longer be levied.

Eighty Percent Limitation Rule And Extension of NOL Carryforward Period

Currently, NOLs can be utilized to offset taxable income in each of the relevant taxable years to which the NOLs are carried forward, and NOLs can be carried forward for up to seven taxable years so long as the taxpayer maintains so-called blue form tax return status.

Under the New Law, the use of NOLs will be limited to 80 percent of taxable income in each of the relevant taxable years to which the NOLs are carried forward[5]

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[1] Tax reform proposals have customarily been approved by the Diet and passed into law by the end of March of the following year, prior to the fiscal year start of April 1 of the relevant year. The 2011 proposals, however, were not approved by the end of March 2011 due to political turmoil after the earthquake of March 11, 2011, and certain items were separately approved and made into law in June 2011.

[2] Certain parts of the New Law will be applied from future dates.

[3] The rate of the national corporate tax is currently 30 percent and the final effective tax rate varies slightly due to slight differences in applicable municipal taxes.

[4] The surtax is named "Special Corporate Tax for Recovery" and is created for the purposes of raising funds for recovery from the earthquake of March 11, 2011.

[5] The 80 percent limitation rule will not apply to certain small and midsize entities (SMEs) that have a paid-in capital of 100 million yen ($1.3 million) or less unless they are wholly

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and taxpayers who maintain the blue form tax return status will be allowed to carry forward NOLs for up to nine taxable years.

The 80 percent limitation rule will apply to taxable years beginning on or after April 1, 2012, and the extension will apply to NOLs arising during taxable years ending on or after April 1, 2008.

Abolishment of Bad Debt Reserves

The New Law repeals existing rules related to tax deductions for bad debt reserves, except for banks, bank holding companies, insurance companies, insurance holding companies, registered moneylenders, licensed servicers, and similar entities, and certain small and midsize enterprises.

As a transitional measure to mitigate the impact of the change, tax deductions for bad debt reserves will phase out over four taxable years by decreasing allowable deductions by one-quarter each year, resulting in complete abolishment from a company's taxable year beginning on or after April 1, 2015.

The abolishment of bad debt reserves may give taxpayers more incentive to dispose of bad debts rather than holding them and setting aside bad debt reserves, and may consequently lead to a higher volume of bad debt sales in the Japanese market, thereby accelerating recognition of taxable capital losses[6] and avoiding recognition of a deferred tax asset for accounting purposes.

Declining Balance Method Reduced From 250 Percent to 200 Percent

Japan implemented the so-called 250 percent declining balance method in April 2007, under which the applicable depreciation rate is 250 percent of the corresponding rate under the straight-line method. As explained by the Ministry of Finance, the 250 percent declining balance method was introduced to put the Japanese tax regime on an equal footing with those of major foreign jurisdictions.

The new rules will, however, reduce the 250 percent multiplier to 200 percent with respect to depreciable assets acquired on or after April 1, 2012, subject to certain transitional measures.

Foreign Tax Credits—Less Cross-Crediting

Currently, Japan's foreign tax credit system adopts an overall limitation, under which foreign income taxes are not creditable to the extent the tax rate of such foreign income taxes exceeds 50 percent. The credit limitation is computed based on the following formula but may not exceed the larger of 90 percent of the pre-credit taxable income for the relevant year and the pre-credit taxable income multiplied by the ''foreign employee ratio''[7]: Credit Limitation = Pre-Credit Corporate Tax $\times$ Foreign Source Income/Taxable Income.

Under current rules, ''foreign source income'' effectively comprises the aggregate of 100 percent of foreign source income that is subject to foreign income taxes and one-third of foreign source income that is not subject to foreign income taxes (''exempted foreign source income''), thereby increasing the formula numerator and so the limitation, and thus giving taxpayers an increased chance of cross-crediting.

The New Law will tighten foreign tax credits in several respects and will give taxpayers less chance of cross-crediting. First, the maximum creditable foreign tax rate of 50 percent will be reduced to 35 percent for foreign taxes due in the taxable year beginning on or after April 1, 2012, in line with the new effective corporate tax rate.

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Second, the one-third of exempted foreign source income included in the numerator will, as a transitional measure, be reduced to one-sixth for taxable years beginning on or after April 1, 2012, and will further become a complete exclusion for taxable years beginning on or after April 1, 2014.

Third, the maximum limitation alternative computed by reference to the foreign employee ratio will be repealed for taxable years ending on or after April 1, 2012.

Complicated Implications For Financial Statements

Reduction of the effective corporate tax rate will reduce the value of deferred tax assets under Japanese generally accepted accounting principles, which adopt an asset and liability approach with respect to tax effect accounting. Indeed, it has been reported that numerous major Japanese corporations have reduced their deferred tax assets in response to the tax rate reduction, resulting in worse than expected financial results.

Conversely, abolishment of bad debt reserves and the revision of the 250 percent declining balance method may create deductible temporary differences and therefore may result in recognition of a deferred tax asset under Japanese GAAP.

Limitations on NOL utilization and the tightening of foreign tax credits may or may not have impacts on financial statements, depending on the financial situation of the relevant company. Thus, companies should assess the amount of their deferred tax assets, their recoverability, and the need for a valuation allowance when preparing financial statements.

owned by a corporation with a paid-in capital of 500 million yen ($6.5 million) or more. The 80 percent limitation rule will not apply to certain statutory special purpose companies (i.e., a tokutei mokuteki kaisha (TMK)) and investment companies that qualify for deducting dividend payments from their taxable income.

[6] For corporations, capital gains/losses are not distinguished from ordinary income and are taxed in the aggregate.

[7] A foreign employee ratio is the ratio that the number of employees based in the taxpayer's overseas permanent establishments bears to the number of the entire employees of the taxpayer.

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The Accounting Standards Board of Japan Dec. 22, 2011, released a draft circular, Tax Expenses for Quarterly Financial Reporting due to Tax Reform 2011,[8] in which some of these issues are addressed. Companies following Japanese GAAP in preparing financial statements should be alert for any further developments.

[8] See news release from ASBJ at https://www.asb.or.jp/asb/asb_e/technical_topics_reports/practical_business/no37/index.jsp. The full text of the draft circular is only available in Japanese and can be found at https://www.asb.or.jp/asb/asb_j/documents/exposure_draft/practical_business/no37/no37_02.pdf.