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Global Employer Services (GES)

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GES NewsFlash

Japan – Increase in marginal tax rate and audit activity

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Overview

In January 2015, the highest marginal national tax rate for Japan will increase to 45% for resident taxpayers bringing the marginal combined tax rate for resident tax payers to almost **56%**. In the following, we look at planning opportunities for employers making payments to highly remunerated, tax-equalized employees before the higher tax rate becomes effective.

In addition, we review the increase in audit activity in Japan focusing in particular on individual taxpayers' personal income and equity income reporting. As the employer equity report is now in its second year, we look at how the tax office is using the data and what action employers should be taking as a result.

The 45% tax rate

With effect from January 1, 2015, the highest marginal national tax for a Japan tax resident will increase from 40% to 45%. This rate will apply on ordinary taxable income over JPY40 million (approximately USD400,000).

Resident taxpayers are currently subject to national tax on progressive rates and the tax bands through to December 31, 2014, and from January 1, 2015, are shown below:

To December 31, 2014 Taxable income (JPY)	Tax Rate
0 - 1,950,000	5%
1,950,001 - 3,300,000	10%
3,300,001- 6,950,000	20%
6,950,001 - 9,000,000	23%
9,000,001 - 18,000,000	33%
18,000,001 and over	40%

From January 1, 2015 Taxable income (JPY)	Tax Rate
0 - 1,950,000	5%
1,950,001 - 3,300,000	10%
3,300,001- 6,950,000	20%
6,950,001 - 9,000,000	23%
9,000,001 - 18,000,000	33%
18,000,001 - 40,000,000	40%
40,000,001 and over	45%

The increase in the highest national tax rate, takes the highest marginal rate in Japan to 55.945% when national tax, national surtax, and local inhabitants tax are combined. For those employers with tax-equalized employees in Japan, this potentially brings the resident gross up to 130% (i.e., to deliver a net allowance of USD100 at the highest marginal tax rate, the gross amount would be USD230) compared to the current rate of 100% (to deliver the same USD100 net now the gross amount would be USD200).

Accelerating payments

Employers with high earning assignees in Japan who are tax equalized or have net benefits on which the Company settles the tax, may wish to consider estimating tax reimbursements for any taxes that would normally be paid in 2015 and bring the payment into 2014 and therefore be subject to national tax at a marginal rate of 40% rather than 45%.

Where possible, reviewing the payment timing of other discretionary compensation and keeping payments within 2014, such as a bonus payment, may also result in significant tax savings to the employer, especially once the gross up is factored in. It should be noted that for bonus plans, a review should be made to see that the income is recognized in 2014. Merely advancing the cash would not necessarily meet the income tax requirements.

Employees with equity income, such as stock options may also wish to consider exercising options before the year-end.

Individual tax audits

Audits into individual income tax returns are being opened at unprecedented levels. In particular, we see a focus upon high net-worth foreign individuals by auditors who are skilled in understanding the income sources of such individuals and reviewing foreign financial statements. In some cases, the auditors are using sharing of information clauses in tax treaties to obtain tax reporting information from foreign countries.

Significant fluctuations in income between tax years (which might occur if there is equity/variable compensation one year and not the following), rental loss deductions against ordinary income, and discrepancies between information reported on returns and other sources of information available to the tax office are factors which now appear to trigger audits into an individual's tax affairs.

Currently, audits generally cover a three-year period. During the initial meeting with the auditors, the areas they wish to focus on will be explained along with the information the auditors wish to receive so that the amounts reported on the return can be substantiated. Due to a tax law change in 2011, tax audits for individuals' income tax returns can be extended to cover five tax years from the 2011 tax year. Therefore, from March 15, 2015, individual audits should be expected to cover four tax years (2011-2014) and from March 15, 2016, up to five years (2011-2015) may be included.

With the latest audits to be opened now covering the 2013 tax year, we also see auditors reviewing the new foreign asset reports. The first reports were due March 17, 2014, to report aggregated foreign asset holdings in excess of JPY50 million (approximately USD500,000) held by permanent resident taxpayers at December 31, 2013, and already these are being validated by auditors as a way of checking the income streams that would be expected to be seen on a return.

Do not go it alone

It is recommended that individual taxpayers undergoing an audit in Japan obtain professional advice and audit support. A professional advisor with experience in handling such auditors can be invaluable to an individual taxpayer through:

- Understanding the information requests from the auditor

- Preparing the information for presentation to the auditor
- Contributing to a smooth and concise audit period
- Facilitating an environment of cooperation and engagement with the auditor.

As audits become more common, it is clear that being selected for audit should not be considered a sign that the tax office thinks a tax return is wrong. However, as many amounts reported on a return are aggregated amounts, the tax office is seeking to have the amounts validated and protect its tax base. For taxpayers, it can be stressful to undergo audit, but the process can be made less so with the assistance of a tax advisor's support.

Employer Equity Reports – how is the data used?

We have now had the employer equity reporting requirement for two years, and qualifying employers in Japan are required to file a report of transactions relating to taxable equity compensation received by resident employees (local hires and foreign employees) in the tax year.

The most recent reports for the 2013 Japan tax year were due March 31, 2014. There are currently no penalties being assessed for late submission of the report, therefore, employers who have not yet filed for 2012 or 2013 should take immediate action to review this reporting requirement and ensure that they are fully compliant and up to date with any required submissions.

The contents of the reports are being reviewed on a regular basis in the course of a withholding tax audit (even though it may be the case that there was no withholding tax obligation on the equity compensation paid by an overseas' parent company). In addition, the tax office is using data received in the equity report to check against individual income tax returns submitted to confirm the income has been correctly reported. It is important to note that any discrepancy in data could lead to the individual being audited for tax returns filed over the maximum statutory period (currently three years, increasing to five years as noted above), not just the two years for which the employer equity report was filed.

Educating employees

Many Japanese are unfamiliar with filing tax returns especially when the filing requirement relates to additional sources of employment income. There is an expectation that all employment income is reported through the Japan payroll and subject to payroll withholding. Whilst the responsibility for filing an individual tax return lies with the individual, the tax office is asking employers who file the equity report to confirm what steps the employer takes to educate employees about reporting equity income, which is not subject to payroll withholding. We are assisting clients by holding seminars and tax briefings for their employees, as well as drafting employee guidance and communications, which the employer can distribute to its affected employees. Given the reputational risk to the employer if the tax office finds that no support is given to employees in understanding their filing requirements, we recommend that employers review their policy in this area.

Contacts

If you have any questions concerning the issues in this GES NewsFlash, please contact one of the GES professionals at our Deloitte offices as follows:

Russell Bird, Partner
Tel: +81 3 6213 3979
russell.bird@tohmatsu.co.jp

Shingo Iizuka, Director

Tel: +81 3 6213 3983
shingo.iizuka@tohmatsu.co.jp

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