



Taxation in Japan 2009

KPMG TAX CORPORATION



Taxation in Japan

Preface

This booklet is intended to provide a general overview of the taxation system in Japan. The contents reflect the information available up to November 20, 2009.

While the information contained in this booklet may assist in gaining a better understanding of the tax system in Japan, it is recommended that specific advice be taken as to the tax implications of any proposed or actual transactions.

Further information on matters in this booklet can be obtained from KPMG Tax Corporation either through your normal contact at the firm or using the contact details shown below.

KPMG Tax Corporation
Izumi Garden Tower, 1-6-1 Roppongi, Minato-ku,
Tokyo 106-6012, Japan
Tel: +81 (3) 6229 8000 Fax: +81 (3) 5575 0766
E-mail: info-tax@jp.kpmg.com

Epson Osaka Building 14F, 3-5-1 Bakuro-machi, Chuo-ku,
Osaka 541-0059, Japan
Tel: +81 (6) 4704 3188 Fax: +81 (6) 4704 3962

Dainagoya Building 5F, 3-28-12 Meieki, Nakamura-ku,
Nagoya 450-0002, Japan
Tel: +81 (52) 569 5420 Fax: +81 (52) 551 0580

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Contents



1	TAXATION OF COMPANIES	1
1.1	Introduction	1
1.2	Tax Status of Companies – residence and tax rates	1
1.2.1	Tax Status of Companies	1
1.2.2	Tax Rates	5
1.2.3	Tax Year of Companies	11
1.3	Taxable Income	12
1.3.1	Domestic Companies	12
1.3.2	Foreign Companies	12
1.4	Capital Gains	12
1.5	Treatment of Excess Tax Losses	14
1.6	Deduction of Expenses	15
1.6.1	Valuation of Inventories	15
1.6.2	Valuation of Marketable and Investment Securities	16
1.6.3	Provision for Bad Debts and Bad Debts Expenses	16
1.6.4	Provision for Retirement Allowance	18
1.6.5	Directors' Compensation	19
1.6.6	Stock Option Expenses	21
1.6.7	Devaluation Loss	21

1.6.8	Corporate Taxes, etc.....	22
1.6.9	Donation or Contribution.....	22
1.6.10	Entertainment Expenses.....	23
1.6.11	Interest – Thin Capitalization.....	24
1.6.12	Translation into Japanese Currency (Yen) of Assets/Liabilities in Foreign Currencies.....	24
1.6.13	Management Service Fee.....	25
1.6.14	Allocation of Head Office Administrative Expenses.....	26
1.7	Tax Depreciation.....	27
1.7.1	Fixed Assets and Depreciation.....	27
1.7.2	Deferred Charges.....	33
1.8	Revenue to be excluded from Taxable Income.....	34
1.8.1	Dividends Received from Domestic Companies.....	34
1.8.2	Revaluation Gain on Assets.....	34
1.8.3	Refunds of Corporate Tax, etc.....	34
1.9	Tax Credits.....	34
1.9.1	Withholding Income Tax Credits.....	34
1.9.2	Foreign Tax Credits.....	35
1.9.3	Tax Credits for Research and Development (R&D) Expenditure.....	35
1.9.4	Tax Credits for Staff Training Expenses.....	37
1.9.5	Tax Credits for Equipment to Strengthen Information Technology Infrastructure.....	37
1.10	Administrative Overview.....	39
1.10.1	Tax Returns and Tax Payment.....	39
1.10.2	Tax Audits and the Statute of Limitation.....	40
1.11	Tax Consolidation.....	40
1.12	Corporate Reorganizations.....	42
1.12.1	Tax Qualified Reorganizations vs Non Tax Qualified Reorganizations.....	42

1.12.2	Pre-Reorganization Losses.....	45
1.12.3	Taxation of Shareholders	45
2	TAXATION OF PARTNERSHIPS	47
2.1	NK-type Partnerships	47
2.1.1	Definition of NK-type Partnerships.....	47
2.1.2	Taxation of Partners.....	48
2.2	Tokumei Kumiai.....	50
2.2.1	Tokumei Kumiai (TK)	50
2.2.2	Taxation of the Operator	50
2.2.3	Taxation of Silent Partners	51
2.3	Limitation on Utilization of Losses Derived from Partnerships	52
2.3.1	Corporate Partners of Partnerships other than Japanese LLP - At-Risk Rule (“AR rule”).....	52
2.3.2	Individual Partners of Partnerships other than Japanese LLP.....	54
2.3.3	Corporate Partners of Japanese LLP	54
2.3.4	Individual Partners of Japanese LLP	55
3	TAXATION OF INDIVIDUALS	56
3.1	Introduction	56
3.2	Tax Rates	56
3.2.1	Tax Rates on Ordinary Income.....	56
3.2.2	Tax Rates on Capital Gains	57
3.2.3	Tax Rates on Dividends	58
3.3	Taxpayers	59
3.3.1	Classification of Individual Taxpayers.....	59
3.3.2	Domicile.....	60
3.3.3	Short-Term Visitors	61

3.4	Assessable Income	61
3.4.1	Remuneration	61
3.4.2	Treatment of Benefits.....	62
3.4.3	Exemptions and Concessions.....	65
3.5	Allowable Deductions	66
3.5.1	Standard Deductions	66
3.5.2	Specific Deductions	68
3.6	Personal Reliefs	71
3.7	Tax Credits	71
3.7.1	Credit for Dividends	72
3.7.2	Withholding Income Tax	72
3.7.3	Credit for Foreign Taxes	72
3.8	Remuneration Paid Outside Japan.....	73
3.9	Employers' Obligations	74
3.9.1	Income Taxes	74
3.9.2	Inhabitant Tax	75
4	INTERNATIONAL TAX	77
4.1	Foreign Dividend Exclusion	77
4.1.1	Outline	77
4.1.2	Foreign Subsidiary	78
4.2	Foreign Tax Credits for Domestic Companies	79
4.2.1	Basic Rules	79
4.2.2	Creditable Limit.....	80
4.2.3	Carry-Forward Systems	81
4.2.4	Tax Sparing Credit.....	81
4.2.5	Consolidated Tax Filing and Foreign Tax Credit.....	81

4.3	Transfer Pricing	82
4.3.1	Transactions subject to Transfer Pricing Legislation	82
4.3.2	Related Overseas Companies.....	82
4.3.3	Arm’s-Length Price	83
4.3.4	Submission of Information and Documents.....	85
4.3.5	Miscellaneous.....	86
4.4	Thin-Capitalization	86
4.4.1	Safe Harbor of Debt-Equity Ratio	86
4.4.2	Amount to be Disallowed	88
4.4.3	Miscellaneous.....	89
4.5	Tax Haven (CFC) Rules.....	90
4.5.1	Income inclusion.....	90
4.5.2	Specified Foreign Subsidiaries (SFS).....	91
4.5.3	Conditions for Exception.....	92
4.5.4	Tax Treatment of Dividends Paid by SFSs	93
4.5.5	Tax Treatment of Dividends Received by SFSs	94
4.5.6	Effective Date.....	95
4.6	Corporate Inversion.....	95
4.7	Taxation of Foreign Companies and Individuals / Tax Treaties.....	96
4.7.1	Tax Treaties	96
4.7.2	Dividends, Interest and Royalties.....	99
4.7.3	Real Estate	101
4.7.4	Shares in a Real Estate Holding Company	102
4.7.5	Shares in a Domestic Company.....	104
5	INDIRECT TAX	108
5.1	Consumption Tax	108
5.1.1	Taxable Transactions	108
5.1.2	Export Transactions	109
5.1.3	Taxpayers	109

5.1.4	Taxable Base	111
5.1.5	Tax Rate.....	111
5.1.6	Computation of Consumption Tax to be paid.....	111
5.1.7	Special Treatment for Small Businesses.....	113
5.1.8	Taxable Period and Tax Payment	114
5.2	Customs Duty	115
5.3	Excise Duty	115
6	OTHER TAXES AND SURCHARGES	116
6.1	Social Security and Payroll Taxes	116
6.2	Stamp Duty	117
6.3	Fixed Assets Tax and City Planning Tax.....	117
6.4	Business Occupancy Tax	117
6.4.1	Taxpayer	118
6.4.2	Taxable basis	118
6.4.3	Tax rate.....	118
6.4.4	Method of collection of business occupancy tax	118
6.5	Registration and Real Property Acquisition Tax	118
6.6	Inheritance and Gift Taxes	119

1 Taxation of Companies

1.1 Introduction

Japanese corporate income taxes consist of:

- corporation tax (national tax);
- business tax (local tax); and
- prefectural and municipal inhabitant taxes (local tax).

The relevant tax rates and details of the respective taxes are discussed later in this chapter.

With effect for accounting periods beginning on or after April 1, 2004, a new size based business tax system is applicable to taxpayer companies with paid-in capital in excess of JPY 100 million. This system is also discussed more fully below.

In addition to the normal corporate income taxes, certain closely held companies known as “specified family companies” can be subject to additional taxation on undistributed retained earnings.

1.2 Tax Status of Companies – residence and tax rates

1.2.1 Tax Status of Companies

■ Residence

In determining the residency of a company for tax purposes, Japan utilizes the “place of head office or main office” concept, not the “effective place of management” concept. A Japanese company is defined as a company whose head office or main office is located in Japan in the tax law.

■ Branch vs. Domestic Company

Generally, there is no material difference between a branch office of a foreign company and a domestic company when computing taxable income. Tax deductible provisions and reserves, the limitation of certain allowable expenses such as entertainment expenses and donations, and the corporate income tax rates are the same for both a branch and a domestic company.

However, a branch and a domestic company have differing legal characteristics and this results in differences in tax treatment in certain areas. Note in particular that a branch and the foreign company from which it extends are treated as the same entity for Japanese tax purposes and therefore, in general, a branch cannot recognize internal profits and losses from transactions with its head office or other branches of the same head office. A summary of the key differences in tax treatment is set out below.

	Branch	Domestic Company
Scope of taxable income	Income from sources with Japan ⁽¹⁾	Entire worldwide income
Applicable tax rates		
Normal effective statutory tax rate	See 1.2.2 below	See 1.2.2 below
Special tax due for a Specified Family Corporation	N/A	10% - 20%
Remittance of profits	Not taxed	Dividends subject to 7-20% WHT or lower tax treaty rate
Tax credits		
Japanese withholding income tax on:		
- Interest	Creditable	Creditable
- Dividends from domestic companies	Creditable	Creditable

	Foreign withholding taxes on:		
	- Dividends from Foreign Subsidiaries ⁽²⁾	Not creditable (but deductible from income)	Not creditable
	- Dividends from foreign portfolio investments - Interest - Royalties	Not creditable (but deductible from income)	Creditable
Charges or allocation of expenses from head office/foreign parent company			
	Head office overheads	Allowable	-
	Direct expenses	Allowable	Allowable
	Management fees	-	Allowable
	Interest cost (other than bank branches)	Not allowable if paid to head office	Allowable (subject to WHT at 20% or lower treaty rate)
	- Royalties	Not allowable if paid to head office	Allowable (subject to WHT at 20% or lower treaty rate)

(1): Where a tax treaty is applicable, only income attributable to the branch is subject to corporate income taxes in Japan.

(2): See 4.1.2 for the definition of Foreign Subsidiaries.

■ Permanent Establishment (PE)

Even where a foreign company has not established a registered branch in Japan it can be treated as having a de facto branch, or PE, in Japan in certain circumstances. The Japanese Corporation Tax Law provides the following definition of a PE for Japanese tax purposes:

(1) Branch, factory or other fixed place of business in Japan including the following facilities:

- a branch, sub-branch, a place of business or office, factory or warehouse (where operating a warehouse is the main

- business);
- a mine, quarry or other place of extracting natural resources; and
 - any other fixed place of business which is similar in nature.

However, the following exemptions from treatment as a PE exist:

- a fixed place of business solely for the purpose of purchasing goods or merchandise for the foreign company;
 - a fixed place of business solely for the purpose of storage of goods or merchandise for the foreign company;
 - a fixed place of business solely for the purpose of advertising, promotion, supply of information, market surveys, basic research or other activities having an auxiliary function in carrying on the business of the foreign company.
- (2) Construction, installation or assembly projects or similar activities or services in the supervising or superintending of such projects or activities in Japan, which a foreign company carries on for a period of over one year.
- (3) A person who has an authority to conclude contracts in Japan for or on behalf of the foreign company, including:
- A contract concluding agent - a person having and habitually exercising an authority to conclude contracts in Japan for or on behalf of the foreign company, unless the activities of such person are limited exclusively to the purchase of goods or merchandise;
 - An order-fulfilling agent - a person habitually maintaining in Japan a stock of goods or merchandise from which it regularly fills orders and delivers goods or merchandise on behalf of the foreign company; or
 - An order-securing agent - a person habitually securing orders, negotiating or performing other important activities in Japan for concluding contracts, exclusively or almost exclusively, for or on behalf of the foreign company.

If the country of residence of the foreign company has concluded a

tax treaty with Japan, the definition of a PE in the treaty generally overrides that under Japanese domestic tax laws. In the typical PE provision of tax treaties with Japan, neither an order-fulfilling agent nor an order-securing agent is explicitly described. Moreover, the PE provision in tax treaties normally includes a clause that an agent of an independent status is excluded from an agent that constitutes a PE.

Until recently, there was no provision to exclude independent agents from the scope of an agent PE under Japanese domestic tax laws. However, by virtue of the 2008 tax reform, independent agents are excluded from the scope of an agent PE on and after April 1, 2008, as a result of bringing domestic standards in conformity with those in tax treaties.

1.2.2 Tax Rates

As noted above, the tax rates applicable to a branch of a foreign company are basically the same as those for a domestic company. There is an important distinction however between companies with paid-in capital up to JPY 100 million and those with paid-in capital in excess of this amount and this is shown in the tables below.

The rates of each of the taxes applicable for each tax year are as shown below:

■ Corporation Tax

Tax base	Paid-in capital of JPY 100 million or less	Paid-in capital in excess of JPY 100 million
Taxable income up to JPY 8 million in a year	22% ^(*)	30%
Taxable income in excess of JPY 8 million	30%	

(*): 18 percent for periods ending from April 1, 2009 to March 31, 2011 by virtue of the 2009 tax reform

■ Business Tax

Tax base	Paid-in capital of JPY 100 million or less		Paid-in capital in excess of JPY 100 million	
	Standard rate	Max. rate	Standard rate	Max. rate
Taxable income up to JPY 4 million in a year	5.0%	6.0%	3.8%	4.56%
Excess over JPY 4 million and up to JPY 8 million in a year	7.3%	8.76%	5.5%	6.6%
Excess over JPY 8 million	9.6%	11.52%	7.2%	8.64%

(Companies who conduct electric/gas supply business or insurance business are liable for business tax on their adjusted gross revenue instead of their taxable income. The standard tax rate and the maximum tax rate are 1.3 percent and 1.365 percent, respectively.)

Specific business tax rates are determined by each local tax jurisdiction. Note that only the “Excess over JPY 8 million” rate is applicable where a company has offices in at least three different prefectures and capital of at least JPY 10 million.

By virtue of the 2008 tax reform, the business tax rates have been reduced and a new national tax; special local corporate tax (Chiho-Hojin-Tokubetsu-zei), will be imposed for fiscal years beginning on or after October 1, 2008. Tax revenue from special local corporate tax is reallocated by the national government to local governments, in order to decrease the gap in tax revenue between urban and rural areas. This is a temporary measure until an overhaul of the tax system is implemented at a future date. The business tax rates before the reduction are almost the same as the sum of the reduced business tax and the special local corporate tax.

The new standard and maximum marginal tax rates for business tax are as follows:

Tax base	Paid-in capital of JPY 100 million or less		Paid-in capital in excess of JPY 100 million	
	Standard rate	Max. rate	Standard rate	Max. rate
Taxable income up to JPY 4 million in a year	2.7%	3.24%	1.5%	1.8%
Excess over JPY 4 million and up to JPY 8 million in a year	4%	4.8%	2.2%	2.64%
Excess over JPY 8 million	5.3%	6.36%	2.9%	3.48%

(For companies who are liable for business tax on their gross revenue, the standard tax rate and the maximum tax rate are 0.7 percent and 0.765 percent, respectively.)

Special local corporate tax rates are as follows:

Tax base	Paid-in capital of JPY 100 million or less	Paid-in capital in excess of JPY 100 million
	Tax rate	Tax rate
Taxable income x Standard rate of business tax	81%	148%

(For companies who are liable for business tax on their gross revenue, the tax base is “adjusted gross revenue x standard rate of business tax” and the tax rate of special local tax is 81 percent.)

In addition to the taxable income based element of business tax, with effect for accounting periods beginning on or after April 1, 2004 companies with paid-in capital in excess of JPY 100 million are also

subject to a size-based element of business tax. In broad summary, this element comprises the following components:

	Tax base	Standard rate	Max. rate
Added value component	Labour costs +) Net interest payment +) Net rent payment +) Income/loss for current year	0.48%	0.576%
Capital component	Capital plus capital surplus for tax purposes	0.2%	0.24%

Once again, the specific rates applied are determined by the local tax jurisdiction. Note that both business tax and special local corporate tax are tax deductible expenses at the time of payment.

■ Prefectural and Municipal Inhabitant Taxes

Prefectural and municipal taxes consist of two elements; (i) an income tax calculated based on national corporation tax and (ii) a per capita tax.

	Standard rate (applied to national corporation tax amount)	Max. rate (applied to national corporation tax amount)
Prefectural	5%	6%
Municipal	12.3%	14.7%

Per capita prefectural tax is levied according to a published scale which varies based upon the paid-in capital amount of the company.

Per capita municipal tax is similarly levied according to a published scale which varies based upon the paid-in capital amount of the company and the number of the company's employees within the municipality.

■ Special Tax Due by Specified Family Company

A Specified Family Company is liable to a special tax on retained earnings for each accounting period.

If a Japanese company is directly or indirectly controlled by one shareholder and related persons of the shareholder, the company is a "Controlled Company". A "Specified Family Company" is defined as a company that is still a Controlled Company even if its shareholders that do not fall within the definition of Controlled Companies are excluded at the time of the judgment. Note that a Specified Family Company does not include a company with paid-in capital of JPY 100 million or less for fiscal years beginning on or after April 1, 2007.

For the purposes of this rule, if one company holds more than 50 percent of the total outstanding shares or more than 50 percent of the voting rights of another company, the latter company is treated as "controlled" by the former company. "Related persons" are (i) the shareholder's family relatives, (ii) a company controlled by the shareholder and (iii) a company commonly controlled by a person which controls the shareholder.

The taxable retained earnings (the portion of taxable income which remains as retained earnings) of an accounting period are the excess of undistributed profits over the largest of the following three amounts:

- JPY 20 million (reduced proportionately where accounting period is less than 12 months);
- 40 percent of the taxable income for the accounting period;
- 25 percent of the paid-in capital less the accumulated retained earnings at the end of the accounting period not including the earnings for that accounting period; and

The additional corporation tax is computed at the following rates per year:

Excess retained earnings	Tax rate
Up to JPY 30 million	10%

Excess over JPY 30 million and up to JPY 100 million	15%
Excess over JPY 100 million	20%

Inhabitant tax is also payable on the above corporation tax.

■ Effective Statutory Corporate Income Tax Rate

Given the potential use of graduated rates in the calculation of both corporate and business taxes, the differing local tax rates utilized and per-capita liabilities on prefectural and municipal taxes, effective statutory tax rates will vary from taxpayer to taxpayer. In addition, the effective statutory tax rate for companies with paid-in capital in excess of JPY 100 million is, following the introduction of size based business tax, partly determined by a number of factors other than taxable income.

For illustrative purposes, a simplified effective statutory tax rate calculation based upon the maximum rates applicable to a company based in Tokyo is set out below.

	Paid-in capital of JPY 100 million or less	Paid-in capital in excess of JPY 100 million
Corporation tax	30.00%	30.00%
Business tax	10.08%	7.56% ⁽¹⁾
Prefectural and municipal tax 30.0% x 20.7% (i.e., 6% + 14.7%)	6.21%	6.21%
Total	46.29%	43.77%
Effective tax rate	42.05% ⁽²⁾ (46.29% x 100/110.08)	40.69% ⁽²⁾ (43.77% x 100/107.56)

⁽¹⁾: in addition, such a company is subject to size based business tax

which increases the overall effective statutory tax rate.

- (2): the effective tax rate is calculated after taking into account the tax deductible nature of business tax payments.

As mentioned above, the business tax rates have been reduced and special local corporate tax (Chiho-Hojin-Tokubetsu-zei) will be imposed for fiscal years beginning on or after October 1, 2008. The effective statutory tax rate calculated under the new rules is shown below (based on the maximum rates applicable to a company based in Tokyo).

	Paid-in capital of JPY 100 million or less	Paid-in capital in excess of JPY 100 million
Corporation tax	30.00%	30.00%
Business tax	5.78%	3.26% ⁽¹⁾
Special local corporate tax	4.293%	4.292%
Prefectural and municipal tax 30.0% x 20.7% (i.e., 6% + 14.7%)	6.21%	6.21%
Total	46.283%	43.762%
Effective tax rate	42.05% ⁽²⁾ (46.28% x 100/110.07)	40.69% ⁽²⁾ (43.76% x 100/107.55)

- (1): in addition, such a company is subject to size based business tax which increases the overall effective statutory tax rate.

- (2): the effective tax rate is calculated after taking into account the tax deductible nature of business tax and special local tax payments.

1.2.3 Tax Year of Companies

The tax year of a company is in line with the company's accounting period. A tax year cannot exceed 12 months in duration but can be

less than 12 months.

1.3 Taxable Income

1.3.1 Domestic Companies

Taxable income represents the net of gross revenue less costs, expenses and losses, in general, on an accruals basis in accordance with fair accounting standards and as adjusted in accordance with the requirements of the tax laws.

A domestic company is subject to Japanese income tax on its worldwide income. In order to eliminate double taxation on income, the foreign taxes levied on a Japanese domestic company may be credited against Japanese corporation tax and local inhabitant tax.

1.3.2 Foreign Companies

Foreign companies operating in Japan through a branch or any other type of permanent establishment (PE) are liable for corporate income taxes on the entire income from sources within Japan under the domestic tax laws.

Japan has concluded tax treaties with a number of foreign countries. Under the tax treaties, where industrial or commercial activities are carried on through a PE maintained in Japan by a company of such foreign countries, Japanese tax is imposed only on the profits attributable to the PE. Therefore, the foreign company is not liable for corporate income taxes on industrial or commercial profits from sources in Japan which are not attributable to its PE in Japan.

Taxation for foreign companies which do not have a PE in Japan is discussed in Chapter 4.

1.4 Capital Gains

Capital gains from the sale of land, securities, etc. are subject to

normal corporate income taxes in the same manner as ordinary trading income regardless of holding period.

Taxation of income realized from assets within the categories listed below may be deferred by reducing the value of newly acquired fixed assets by the amount of that income. Note that there are a number of additional conditions with regards to accounting procedures and timing of acquisition and type of new fixed assets which must be met for this relief to apply.

- government subsidies;
- insurance loss payments;
- exchange of properties;
- acquisition of replacement property which is located in specific districts or falls under specific categories.

In addition to the above, a new capital gains rollover relief has been introduced in the 2009 tax reform. The new provision is applicable where a company acquires land in Japan in 2009 and 2010 and submits an appropriate application form by the filing due date of the final tax return for the fiscal year in which the acquisition occurred. If the company sells another piece of land within ten years after the end of the fiscal year of the acquisition of the first piece of land acquired in 2009 and 2010, capital gains rollover for the sale of the second piece of land will be available by reducing the tax basis of the first piece of land. The maximum amount of deferred capital gains is 80 percent of the capital gain (if the first piece of land is acquired in 2010, 60 percent of the capital gain). Note that this capital gains rollover can not be applicable to capital gains on land held as inventory.

A special deduction for long-term capital gains has also been implemented under the 2009 tax reform. Where a company sells their land in Japan acquired in 2009 and 2010 after they have owned it for more than five years as of January 1 of the selling year, a special deduction can be applicable. The amount of the special deduction is the lower of JPY 10 million or the amount of the capital gain.

The above two treatments for capital gains from the sale of land introduced in the 2009 tax reform also applies to individual taxpayers (See 3.2.2).

1.5 Treatment of Excess Tax Losses

Where a tax loss is realized in a given tax year, provided the company has blue-form tax return filing status (see below), that loss may be carried forward by the company for use in sheltering taxable profits of a future tax year. Such losses can be utilized against profits for the seven succeeding years (five years only in respect of losses arising in tax year commencing prior to April 1, 2001). Thereafter, any unutilized element of loss will expire. It should be noted that there is no distinction between losses of a revenue or capital nature for these purposes.

Obtaining blue-form tax return filing status confers a number of benefits upon a company, the most important of which being the ability to carry forward tax losses as explained above. The conditions attached to obtaining blue-form status are not onerous, however it is important that a timely application is made (i.e., submission of an application by whichever is the earlier, either three months from the establishment of the company or the end of the first fiscal year) to ensure tax losses are not extinguished.

Japanese tax law also provides for a tax loss carryback system at the option of the taxpayer company. This tax loss carryback system, under which a company suffering a tax loss can get a refund of the previous year's corporation tax by offsetting the loss against the income for the previous year, has been suspended since April 1, 1992 except for certain limited circumstances such as dissolution.

Under the 2009 tax reform, the loss carryback has become available for small and medium-sized companies (companies having paid-in capital of not more than JPY 100 million) without limitation for tax losses incurred in fiscal years ending on or after February 1, 2009.

1.6 Deduction of Expenses

1.6.1 Valuation of Inventories

The cost of inventories must include the entire actual cost of acquisition of such inventories. Purchase or manufacturing cost variances are required to be adjusted and recorded in the books of account. If not so adjusted, the variances, particularly those which are allocable to the year-end inventories, must be taken up as an adjustment in the tax return.

Valuation of inventories at the end of each accounting period must be made in accordance with the method(s) reported for each class of inventory to the tax office by the company. Before the 2009 tax reform, the valuation methods allowable for tax purposes are as follows: cost method (specific identification, FIFO, LIFO, weighted average, moving average, straight average, recent purchase, or retail price discount method) or lower of cost or market value method.

In September 2008, the Accounting Standards Board of Japan issued the "Accounting Standard for Measurement of Inventories" and the LIFO method has been deleted from allowable inventory valuation methods to achieve convergence with international accounting standards. This new accounting standard will be applicable for accounting years beginning on or after April 1, 2010. If a company wishes to apply it earlier, it is allowed to do so.

In response to this revision of accounting standards, the LIFO method and the straight average method (that was disallowed for accounting purposes before the amendment of the accounting standards) will no longer be allowable valuation methods for tax purposes by virtue of the 2009 tax reform. The new tax rule is applicable for fiscal years beginning on or after April 1, 2009, and there are transitional measures to cover the gap in effective dates between the new accounting standards and the new tax rule.

The valuation method selected by the company must be applied consistently. If a company wishes to change the current method, an application for change of method must be submitted to the tax office

prior to the commencement date of the accounting period in which the change is to be effected. Note that if a change is required due to the 2009 tax reform, an application can be submitted to the tax office by the due date of the first relevant corporate tax returns in which the new valuation method is adopted.

At the end of each accounting period, a physical inventory must be taken and a list thereof must be prepared (if not at the year-end, a reconciliation between the physical inventory and the year-end inventory will be required).

1.6.2 Valuation of Marketable and Investment Securities

The acquisition cost of securities is the total of the price paid and incidental expenses in the case of acquisition by purchase or by subscription. However, where shares are subscribed for at a value below market price (except where such subscription is made equally by existing shareholders), generally market value is treated as acquisition cost regardless of the price actually paid.

Valuation of securities at the end of each accounting period must be made in accordance with the following method(s):

- Securities held for trading purposes: mark-to-market valuation method
- Other securities: cost method (weighted average or moving average). The specific cost calculation basis can be determined by selection to the tax authorities. Subsequent changes to the adopted basis must be made in a similar manner as discussed under valuation of inventories above. Note that amortization and accumulation is required in respect of securities which are to be held to maturity.

1.6.3 Provision for Bad Debts and Bad Debts Expenses

- Provision for bad debts

The allowable amount of a provision for bad debts is the total of (A) and (B) below.

- (A) Specific doubtful receivables provision: a provision for a limited range of doubtful account receivables, as specifically identified under the tax law (up to the relevant limits specified under the tax law).
- (B) General bad debt provision: a provision for potential bad debts among existing receivables (other than those falling under (A) above) based upon the actual bad debt ratio for the three preceding years. The amount of (B) is calculated using the formula below:

Outstanding accounts receivable at the year end (other than those under (A))	X	$\frac{\text{Average amount of bad debts for the prior 3 years}}{\text{Average outstanding accounts receivables for prior 3 years}}$
------------------------------------------------------------------------------	---	--------------------------------------------------------------------------------------------------------------------------------------

For companies with capital not exceeding JPY 100 million, as an alternative to the formula above, standard allowable industry specific percentages for bad debt ratios may be applied against the company's outstanding accounts receivable. The standard percentages are as shown below:

Industry sector	Standard percentage
Wholesale and retail	1.0%
Manufacturing	0.8%
Finance and insurance	0.3%
Installment retailer	1.3%
Other	0.6%

- Bad debt expenses

If the following facts have occurred, the following amounts are treated as tax deductible bad debt expenses in the year the facts arise:

Facts	Bad debt expense amount
Approval of rehabilitation plans in accordance with the Corporate Rehabilitation Law or the Civil Rehabilitation Law	The amount determined to be written off
Approval of special liquidation proceedings under the Company Law	The amount determined to be written off
Resolution at creditors' meetings or a contract between related parties by arrangement by governments or banks	The amount determined to be written off
A notice issuance to a debtor who has been insolvent for a certain period	The amount declared to be written off in the notice

Also, a company can record a bad debt for a receivable from a debtor in its accounting books when it becomes certain that the debtor can not pay off the receivable considering the financial situation and insolvency of the debtor.

Moreover, for receivables incurred from continuous sales transactions, when one year has passed since the last transaction with a debtor (a sales transaction to the debtor or a collection from the debtor, whichever is later) or when expected costs to collect money exceed the outstanding receivables, a company can write off the receivables with a remaining balance of JPY 1 in its accounting books.

1.6.4 Provision for Retirement Allowance

Provision for retirement allowances used to be partially tax allowable until 2001 but it is currently not tax allowable. The remaining balance of the provision allowed under the old law had to be reversed and added to taxable income over four years (for companies having paid-in capital of more than JPY 100 million) or ten years (for companies having paid-in capital of JPY 100 million or less).

1.6.5 Directors' Compensation

Before the tax reform for 2006, any bonuses paid to company directors (e.g., members of the board of directors, officers and statutory auditors) were not deductible for corporate tax purposes. Any irregular compensation (with exceptions) from a company to its directors was treated as directors' bonuses.

With effect for fiscal years beginning on or after April 1, 2006, if the compensation (excluding retirement/severance allowances and stock option expenses discussed in 1.6.6. below) falls under one of the following, the compensation is allowable for corporate tax purposes. Otherwise, the compensation is not deductible:

(1) Fixed amount periodical compensation

Compensation which is regularly paid on a monthly/weekly/daily basis with a fixed amount through a fiscal year:

If the amount of the compensation is revised for the following reasons, regularly paid compensation of which the amounts before the change are stable and regularly paid compensation of which the amounts after the change are stable are treated as fixed amount periodical compensation:

- (i) Annual revision (revision made within three months (four months for insurance companies) from the beginning of the fiscal year).
- (ii) Extra-ordinary revision due to unavoidable reasons (e.g., reorganization)
- (iii) Revision to decrease base compensation due to significant deterioration in the company's financial situation

Fringe benefits where they are continuously provided and the value of the benefits is generally stable on a monthly basis are also categorized as fixed amount periodical compensation.

(2) Fixed compensation notified in advance

Compensation fixed in the amount and timing of the payment which falls under neither fixed amount periodical compensation nor profit-based compensation and for which advance notification is filed with the tax office:

The deadline of advanced notification is extended to the earlier of (a) one month after the resolution date of the compensation at the shareholders meeting, etc. or (b) four months (five months for insurance companies) from the beginning of the fiscal year. When such compensation is determined through irregular revisions due to unavoidable reasons is treated as an allowable compensation, provided that the notification is filed with the tax office by the later of (a) one month from when the cause of the irregular revision occurred or (b) the deadline of a regular advanced notification discussed above. There are rules to change the items that had already been notified.

(3) Profit-based compensation

Profit-based compensation satisfying the following conditions:

- The compensation is paid to all the directors involved in execution of the business operations of the company.
- The compensation is calculated based on parameters related to profit, which must be reported in a Securities Report provided in Art. 24 (1) of the Financial Instruments and Exchange Law and the calculation method satisfies the following:
 - The ceiling of the compensation is pre-determined.
 - The calculation method for a director involved in managing the business is similar to that for the other directors involved in execution of the business operations.
 - The calculation method must be determined by the Compensation Committee prescribed by the Company Law (provided that directors involved in execution of the business operations of the company or a person related to the directors are not members of the Committee) or equivalent procedures provided in the Cabinet Order within three months (four months for insurance companies) from the beginning of the fiscal year.
 - The calculation method is disclosed in a timely manner through a Securities Report or certain similar reports.

- The compensation is paid or expected to be paid to the director within one month after the result of the relevant parameters become available.
- The company records the compensation as expenses in its accounting books.

This is only applicable to a company that is not a family company and which is required to submit a Securities Report under the Financial Instruments and Exchange Law. This means, generally, only companies listed in Japan are eligible for deduction of profit-based compensation for directors.

* * *

Note that for compensation including retirement/severance allowances and stock option expenses, even if it falls under either of the above three categories, if the amount is unreasonably high, the excess portion is not deductible for corporation tax purposes. In addition, if it is paid by concealing facts or disguising the accounting books, it is not deductible.

1.6.6 Stock Option Expenses

When a company issues stock options (shin kabu yoyaku ken) as consideration for services rendered by individuals, expenses for such services (the value of the stock option at the time of issuance) are deductible expenses at the time of exercise of the stock options unless the stock options are tax-qualified stock options for Japanese individual income tax purposes. See Chapter 3 for further information on tax qualified stock options.

This rule is applicable to stock options for which issuance are determined on or after May 1, 2006.

1.6.7 Devaluation Loss

A write-down of assets, other than a write down to market value in the case of damage due to disaster or obsolescence of inventories or fixed assets, should generally be disallowed for tax purposes.

1.6.8 Corporate Taxes, etc.

Corporation tax, prefectural and municipal inhabitant taxes, interest on delinquent taxes, penalties, fines, etc., should be disallowed for tax purposes. Note that business tax and special local corporate tax (Chiho-Hojin-Tokubetsu-zei) are deductible basically when a tax return for business tax is lodged.

Japanese withholding taxes and foreign withholding taxes other than those on dividends from Foreign Subsidiaries are generally creditable (or deductible if not credited against corporation tax). Foreign withholding taxes on a dividend from a Foreign Subsidiary are not creditable. Neither are they deductible if the foreign dividend exclusion (FDE) is applied to the dividends. See 4.1 for the definition of a Foreign Subsidiary and the FDE system.

1.6.9 Donation or Contribution

Donations and contributions are partially deductible as follows:

Donations and contributions	Deductible amount
Designated by the government	All
To Specified Public Interest Facilitating Corporations	2.5% of taxable income + 0.125% of paid-in capital and capital surplus (per annum)
Other than above	1.25% of taxable income + 0.125% of paid-in capital and capital surplus (per annum)

If the amount of donations and contributions to Specified Public Interest Facilitating Corporations exceeds the above limit, the excess amount is treated as ordinary donations and contributions in the third category.

If assets are sold at an unreasonably low price, the difference between such price and the market value of such assets is treated as

a donation, which has only limited deductibility as discussed above. Since the donee will also be required to recognize taxable income equal to the amount of the undervalue, this will often result in additional net taxable income arising.

If a company makes a payment, details of which are not disclosed, such payment is disallowed for corporate tax purposes by the paying company, and a surtax of 40 percent of the payment amount is levied as a penalty for making such improper payments in addition to regular corporate taxes.

1.6.10 Entertainment Expenses

Entertainment expenses for a year in excess of the following base amounts are disallowed:

Paid-in capital	Base amount
JPY 100 million or less	Lower of JPY 5.4 million ^(*) or 90% of actual payment
Over JPY 100 million	Zero

(*) JPY 3.6 million for fiscal years ending before April 1, 2009.

Social and entertainment expenses include expenses generally disbursed for the purpose of reception, entertainment, consolation, gifts etc. However, it does not include expenses falling under contributions, discounts and rebates, welfare expenses, personnel costs, etc. which are treated differently for tax purposes.

Expenses for eating and drinking (excluding those solely for the company's directors/employees and relatives of them) which are JPY 5,000 or less per person will be excludable from entertainment expenses subject to limitation of deduction. Note that relevant documents should be maintained indicating such items as date, number of participants, name of participants (omissions may be allowed for certain cases) to apply the safe-harbor rule.

1.6.11 Interest – Thin Capitalization

Thin capitalization provisions were introduced in 1992 as a counter-measure for tax avoidance caused by a taxpayer paying interest on a loan in place of dividends on capital. Under these provisions, broadly, interest is excluded from a company's tax deductible expenses to the extent that such interest relates to borrowings from "overseas controlling shareholders" in excess of three times the company's equity. See Chapter 4 for further information on thin capitalization.

1.6.12 Translation into Japanese Currency (Yen) of Assets/Liabilities in Foreign Currencies

With respect to foreign currency receivables and payables, a company may select either: (i) the method of translation based on the exchange rate at the time such receivables or payables were created, or (ii) the method of translation based on the exchange rate at the end of each accounting period. The default translation method for short-term receivable/payable is (ii) while that for long-term receivable/payable is (i).

If a company wishes to select a non-default translation method, the company is required to submit a report on the selected method of translation to the tax authorities by the due date of the first relevant corporation tax return. If a company wishes to change the method, an application is required to be filed for approval by the chief of the tax office prior to the commencement date of the accounting period in which the change is to be effected.

If a company has a forward contract on receivables and payables in foreign currencies at the end of an accounting period, the Yen amount fixed under such forward contract is generally used for translation purposes instead of the Yen amount translated at historical exchange rates or the spot rates at the end of the year. If this is the case, exchange gains and losses caused by application of a forward exchange rate are generally dealt with as follows:

- If a forward contract is concluded before a transaction, the difference between the forward rate and the spot rate at the

transaction is spread proportionately over the period from the transaction date to the settlement date and included within taxable income/loss of the relevant taxable year.

- If a forward contract is concluded after a transaction, the difference between the forward rate and the spot rate at the day of concluding the forward contract is spread proportionately over the period from the date of concluding the contract to the settlement date and included within taxable income/loss of the relevant taxable year.

1.6.13 Management Service Fee

If a foreign parent company is operating in Japan through a subsidiary or a joint venture formed with a Japanese partner, there would be situations in which the foreign parent company provides management services to the subsidiary or JV in Japan, for example by dispatching expatriate staff to the operation in Japan, sending marketing, technical, financial and administrative information useful for the Japanese operations and training Japanese staff members. A management service fee paid pursuant to such services should be a deductible expense for Japanese tax purposes. However, to ensure full deductibility, the management service fee levied should be reasonable in view of the nature and extent of services provided and should not be used for the purpose of shifting profits from the Japanese subsidiary to the foreign parent company.

Japanese tax law contains transfer pricing provisions aimed at preventing tax avoidance by companies through transactions with their related overseas companies (see Chapter 4). This transfer pricing legislation is applicable not only to the sale or purchase of goods but also to rendering of services, charging of interest and royalties, and to any other transactions with related overseas companies that do not meet the arm's-length concept; further, the legislation obliges the taxpayer to justify the reasonableness of transfer prices. Accordingly, arrangements between a foreign parent or affiliates and related Japanese entities should be carefully reviewed to determine whether such arrangements and associated fees can be supported.

1.6.14 Allocation of Head Office Administrative Expenses

Under most tax treaties concluded by Japan, in the determination of the profits of a permanent establishment, deductions will be allowed for expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses, whether such expenses are incurred in the Contracting State in which the permanent establishment is situated or elsewhere.

Japan has a similar provision under domestic law which provides that an allocation of head office expenses should be made on the basis of respective revenues, expenses or values of fixed assets (or any other reasonable standard) of the head office and the Japan permanent establishment. Therefore, a foreign company operating in Japan through a branch etc. should set up an appropriate formula for allocation of head office administrative expenses to the Japan permanent establishment.

Details in support of the allocation should be attached to the final corporation tax return. If the tax authorities require any further justification concerning the head office expense allocation, such justification shall be made by submission of documentary evidence or by other reasonable methods. If a foreign company taxpayer does not attach a statement(s) of the head office expense allocation to its corporation tax return or does not comply with the tax authorities' request for further justification without any reason, the expenses so allocated may not be treated as a deduction from domestic source income until such time as the tax authorities' request is met.

In addition to allocable expenses, expenses directly incurred for the Japanese operations can also, subject to normal limitations on tax deductible expenses, be deducted by the Japan permanent establishment.

For Japanese tax purposes, the allocation of head office expenses need not be recorded in the books of account of the Japan branch but can be deducted directly in the tax returns.

1.7 Tax Depreciation

1.7.1 Fixed Assets and Depreciation

■ Acquisition Cost

The entire purchase or manufacturing cost, or in the case of acquisition other than by purchase or manufacture, the fair market value, as well as incidental expenses incurred directly in connection with acquisition of fixed assets or in making the fixed assets available for use, must be included in the acquisition cost.

Minor assets whose acquisition cost is less than JPY 100,000 or which are used up within one year are not required to be taken up as fixed assets and the cost of such assets can be expensed. For assets whose acquisition cost is JPY 100,000 or more but less than JPY 200,000, the cost can be amortized over three years.

■ Ordinary Depreciation

In principle, a company may generally select either the straight-line method or the declining-balance method for computing depreciation of each respective class of tangible fixed assets located at different business places. However, buildings and certain leased assets must be depreciated using the straight-line method whilst intangible assets must also generally be amortized using this method. The default depreciation method for most assets other than these assets is the declining-balance method.

The depreciation and amortization allowable for tax purposes must be computed in accordance with the rates corresponding to the statutory useful lives provided in the Ministry of Finance Ordinance. By virtue of the 2007 tax reform, the calculation methods applied to tangible fixed assets acquired on or after April 1, 2007 have been changed. Under the old rules, tangible fixed assets are depreciable only up to 95 percent of the acquisition cost, while under the new rules they are depreciable down to JPY 1. Also, the concept of residual value (10 percent of acquisition cost should be retained when the asset has been used for its useful life) is abolished.

(1) Tangible fixed assets acquired before April 1, 2007:

Depreciation rate		
For assets acquired before April 1, 2007		
Useful life	Straight-line method	Declining-balance method
2	0.500	0.684
3	0.333	0.536
4	0.250	0.438
5	0.200	0.369
6	0.166	0.319
7	0.142	0.280
8	0.125	0.250
9	0.111	0.226
10	0.100	0.206
11	0.090	0.189
12	0.083	0.175
13	0.076	0.162
14	0.071	0.152
15	0.066	0.142
16	0.062	0.134
:	:	:

- Straight-line method:
 - Annual depreciable amount:
Acquisition cost x 90% (i.e., cost less 10% residual value) x
Depreciation rate
 - Depreciable limit: 95% of the acquisition cost

- Declining-balance method:
 - Annual depreciable amount:
Tax book value at the beginning of the fiscal year x Depreciation
rate
 - Depreciable limit: 95% of the acquisition cost

Note that under the 2007 tax reform, assets depreciated to the allowable limit (95% of acquisition cost) in a particular business year can be further depreciated down to JPY 1 evenly over five years starting from the following business year. This rule is applicable for the years starting on or after April 1, 2007.

(2) Tangible fixed assets acquired on or after April 1, 2007:

New depreciation rate				
For assets acquired on or after April 1, 2007				
Useful life	Straight-line method	Declining-balance method		
	Depreciation rate (A)	Depreciation rate (X)	Modified depreciation rate (Y)	Minimum annual depreciation rate (Z)
2	0.500	1.000	---	---
3	0.334	0.833	1.000	0.02789
4	0.250	0.625	1.000	0.05274
5	0.200	0.500	1.000	0.06249
6	0.167	0.417	0.500	0.05776
7	0.143	0.357	0.500	0.05496
8	0.125	0.313	0.334	0.05111
9	0.112	0.278	0.334	0.04731
10	0.100	0.250	0.334	0.04448
11	0.091	0.227	0.250	0.04123
12	0.084	0.208	0.250	0.03870
13	0.077	0.192	0.200	0.03633
14	0.072	0.179	0.200	0.03389
15	0.067	0.167	0.200	0.03217
16	0.063	0.156	0.167	0.03063
:	:	:	:	:

- Straight-line method:
 - Annual depreciable amount:
Acquisition cost x Depreciation rate (A)
 - Depreciable limit: JPY 1

- Declining-balance method:
 - Annual depreciable amount:

(i) For the period where:

$$\begin{array}{l} \text{Tax book value at the} \\ \text{beginning of the fiscal year} \\ \times \text{ Depreciation rate (X)} \end{array} > \begin{array}{l} \text{Acquisition cost x} \\ \text{Minimum annual} \\ \text{depreciation rate (Z)} \end{array}$$

$$\begin{array}{l} \text{Tax book value at the beginning of the fiscal year} \\ \times \text{ Depreciation rate (X)} \end{array}$$

(ii) For the period where:

$$\begin{array}{l} \text{Tax book value at the} \\ \text{beginning of the fiscal year} \\ \times \text{ Depreciation rate (X)} \end{array} < \begin{array}{l} \text{Acquisition cost} \times \\ \text{Minimum annual} \\ \text{depreciation rate (Z)} \end{array}$$

Tax book value at the beginning of the first fiscal year when it falls in (ii) x Modified depreciation rate (Y)

- Depreciable limit: JPY 1

Under the declining-balance method, for the first few years (e.g. seven years for an asset whose statutory useful life is ten years) an asset is depreciated using Depreciation rate (X), which is 250% of the depreciation rate under the straight-line method, and for the remaining years (e.g., the last three years for an asset whose statutory useful life is ten years) the asset is depreciated equally using Modified depreciation rate (Y).

(3) Intangible fixed assets:

Intangible assets are amortized over statutory useful lives under the straight-line method without a depreciable limit, which was not amended under the 2007 tax reform.

■ Reports on Depreciation Methods

The depreciation method(s) needs to be reported to the tax office in a timely manner if the company wishes to select a non-default method. Such selection must be submitted by:

- the filing due date of the corporation tax return for the first accounting period in the case of a newly established company; and
- the filing due date of the corporation tax return for the accounting period in which assets of a different classification were acquired, if the selected depreciation method for such classification has not been selected previously (i.e., if the depreciation method for furniture and fixtures has been selected and trucks were newly

acquired, then a report on the depreciation method for the trucks is required).

The depreciation method must be applied consistently. If the company wishes to change the method, an application for the change must be submitted to the tax office prior to the commencement date of the accounting period in which the change is to be effected.

As assets acquired on or after April 1, 2007 are treated as assets acquired before such date with different classifications, a report to the tax office is in principle required by the filing due date of the corporation tax return for the accounting period in which such assets are acquired. However, when a company selected a depreciation method for an asset in a certain classification before April 1, 2007 and the company wishes to use the same depreciation method (which is not exactly the same because the calculation method has changed) for an asset acquired on or after April 1, 2007 falling in the same classification as if it had been acquired before April 1, 2007, the submission of the notification may be omitted (i.e., if a company selected the declining-balance method for PCs acquired before April 1, 2007 and the company wishes to depreciate new PCs under the new declining-balance method, the company does not have to submit a report to the tax office).

■ Statutory Useful Lives

A company is generally required to follow the statutory useful lives provided in the Ministry of Finance Ordinance.

Under extraordinary circumstances such as a 24-hour operation in the case of machinery and equipment at factories, an application may be submitted to the tax office for approval of shortening of useful lives or taking extra depreciation.

With regard to second-hand property if it is difficult to estimate the remaining useful life, the useful life for tax purposes can be calculated using the following formula (subject to a minimum of two years):

If statutory useful life < number of years elapsed (A)	Statutory useful life x 20%
If statutory useful life > number of years elapsed (A)	Statutory useful life – (A) + 20% of (A)

Under the 2008 tax reform, the statutory useful lives of machinery have been amended and the number of categories of machinery has been reduced from 390 to 55 based on the standard classifications pursuant to the Japan Standard Industry Classification.

■ Accounting and Tax Treatment

The depreciation and amortization must be recorded in the books of account. If the amount of such charge is more than the allowable limit for tax purposes as computed above (known as “excess depreciation”), the excess portion is required to be added back to accounting profit on the tax return pending allowance in subsequent accounting periods.

If the amount of the deductions is less than the allowable limit for tax purposes (known as “short depreciation”), the resulting tax treatment of the depreciation allowance is an effective extension of the useful life of the assets concerned, since the allowable charge for each accounting period for tax purposes is limited to the amount recorded in the books of account.

■ Special Measures for Depreciation

Special depreciation by means of either increased first year depreciation or accelerated depreciation is available for companies filing blue-form tax returns in relation to certain fixed assets as specified under the law. Such reliefs merely accelerate the timing of depreciation relief rather than increasing the amount of depreciation which can be taken. Since the special depreciation allowance is intended to help promote political objectives of the government, restrictions are placed upon the companies or assets qualifying for such benefit.

In contrast to the treatment for ordinary depreciation, short depreciation arising in respect of the special depreciation allowance may be carried forward for one year, and excess depreciation in such a year can be set off against the short depreciation.

1.7.2 Deferred Charges

Expenditures made by a company that have a useful period of more than one year from the date of the disbursement should be treated as deferred charges and subject to amortization for tax purposes.

The following expenditures fall under the category of deferred charges, which can be amortized freely for tax purposes up to the amount of amortization for accounting purposes:

- Organization expenses
- Pre-operating expenses incurred specifically in connection with commencement of operations
- Development expenses incurred specifically in connection with application of new technology or a new operating system, or development of resources
- Expenses relating to issuance of new shares
- Expenses relating to issuance of bonds

The following expenses are also treated as deferred charges and usually amortized over the period of the economic benefit:

- Expenses, the benefit of which relates to a period of more than one year, such as the cost of installation of equipment, etc. for public use, key money for leasing of property, cost of fixed assets provided to customers for advertising and sales promotion purposes, lump-sum payment for know-how, etc.

The amortization of deferred charges is computed by applying the straight-line method. Deferred charges of less than JPY 200,000 per item may be expensed immediately.

1.8 Revenue to be excluded from Taxable Income

1.8.1 Dividends Received from Domestic Companies

Dividends received by a company from other domestic companies, less the interest allocable to the shares on which those dividends were paid, are fully excluded from taxable income. However, if a company owns less than 25 percent of the shares of the domestic company which pays the dividends, only 50 percent of the dividends received, less the interest allocable to the shares on which those dividends were paid, is exempt. As discussed at 1.11 below, dividends paid within a tax consolidation group are entirely excluded from taxable income with no limitation in respect of allocable interest.

If dividends are received on shares which were acquired one month prior to the end of the business year of the issuing company and sold within two months after the end of the same business year, those dividends are not excluded from gross income.

1.8.2 Revaluation Gain on Assets

It is not permissible for tax purposes to recognize revaluation gains on assets except in certain limited cases such as on a revaluation performed under the Corporation Reorganization Law.

1.8.3 Refunds of Corporate Tax, etc.

Refunds of non-deductible items (corporation tax, prefectural and municipal inhabitant taxes, interest on delinquent taxes, penalties, fines, etc.,) are not taxable if refunded. Note that refunds of business tax and special local corporate tax (Chiho-Hojin-Tokubetsu-zei) constitute taxable income since payments of these taxes are tax deductible.

1.9 Tax Credits

1.9.1 Withholding Income Tax Credits

Income tax withheld in Japan from interest and domestic dividends received by a taxpayer company is generally creditable against corporation tax. The excess of such withholding tax over the corporation tax liability, if any, is refundable.

If a recipient company holds bonds or shares for the full period of the interest or dividend calculation period, the withholding tax on the interest or the dividend is fully creditable. If not held for the entire calculation period, the recipient company needs to calculate creditable withholding tax by one of the following two methods:

<ul style="list-style-type: none"> • <u>Pro-rata method</u> 	
Withholding tax on interest /dividends	$\times \frac{\text{Holding period of the respective bonds/shares from which interest/dividend is paid}}{\text{Calculation period for the respective interest/dividend}}$
<ul style="list-style-type: none"> • <u>Weighted average method</u> 	
Withholding tax on interest /dividends	$\times \frac{\text{No of bonds/shares held at the commencement of the base period (B)} + \{(A) - (B)\} \times 1/2}{\text{No of bonds/shares held at the end of the base period for interest/dividend calculation (A)}}$

1.9.2 Foreign Tax Credits

A domestic company is eligible for direct foreign tax credits. See Chapter 4 for details.

1.9.3 Tax Credits for Research and Development (R&D) Expenditure

A company filing a blue-form tax return is eligible for R&D tax credits. The creditable amount depends on the size of the companies and the

R&D ratio. The creditable amount is calculated based on total R&D expenditure for a fiscal year as follows:

Scale of companies	Tax credit on total R&D expenditure	
Large-scale companies	R&D ratio ⁽¹⁾ is 10% or more.	Total R&D expenditure x 10%
	R&D ratio is less than 10%.	Total R&D expenditure x (8% + R&D ratio x 0.2)
Small and medium-sized companies ⁽²⁾	Total R&D expenditure x 12%	

⁽¹⁾ R&D ratio:

Total R&D expenditure in a fiscal year divided by the average sales proceeds for the preceding three years and the current fiscal year (Average Sales Proceeds)

⁽²⁾ A small and medium-sized company for the purpose of this rule:

A company with a capital of JPY 100 million or less that is not a subsidiary of a large-scale company, etc.

In addition to the above, either of the two tax credits indicated below is available for fiscal years starting between April 1, 2008 and March 31, 2010:

(1) Tax credit on incremental R&D expenditure

If R&D expenditure in the year is larger than (i) the annual average of R&D expenditure for the preceding three fiscal years and (ii) the highest annual R&D expenditure for the preceding two fiscal years, the company is eligible for a five percent tax credit for incremental R&D expenditure (R&D expenditure in the year less the amount in (i)).

(2) Tax credit on the excess of R&D expenditure over 10 percent of Average Sales Proceeds

If R&D expenditure in the year is over 10 percent of Average Sales Proceeds, the company is eligible for a tax credit for the excess R&D

expenditure. The creditable amount is calculated by the following formula: $(\text{R\&D expenditure} - \text{Average Sales Proceeds} \times 10\%) \times (\text{R\&D ratio} - 10\%) \times 0.2$.

The maximum creditable amount is 30 percent of the corporation tax liability for the fiscal year (20 percent for the tax credit on total R&D expenditure and 10 percent for the additional tax credit), which has been increased to 40 percent (30 percent for the tax credit on total R&D expenditure and 10% for the additional tax credit) of the corporation tax liability for the fiscal years beginning from April 1, 2009 to March 31, 2011 under the 2009 tax reform.

1.9.4 Tax Credits for Staff Training Expenses

Small and medium-sized companies filing a blue-form tax return are allowed to take a tax credit for staff training expenses for the fiscal years beginning from April 1, 2008 to March 31, 2011, when the staff training expense ratio is 0.15 percent or more. The creditable amount is calculated by the following formula:

Staff training expense ratio ^(*) is 0.25% or more.	Total staff training expense x 12%
Staff training expense ratio is less than 0.25%	Total staff training expense x {(staff training expense ratio - 0.15%) x 40 + 8%}

^(*) Staff training expense ratio:

Total staff training expense for a fiscal year divided by total labor cost incurred in the same year

The maximum creditable amount is 20 percent of the corporation tax liability for the fiscal year.

1.9.5 Tax Credits for Equipment to Strengthen Information Technology Infrastructure

A company filing a blue-form tax return is eligible for a tax credit for new equipment that is designated in the Finance Ministerial Order, provided the equipment is purchased/produced and placed into use

for the business in Japan for the period from April 1, 2006 to March 31, 2010. Examples of eligible equipment are computers for servers, database management software and equipment for firewall systems, most of which are required to be certified under ISO/IEC 15408. By virtue of the 2008 tax reform, certain software for intersystem coordination has been added to eligible assets if evaluated and certified by the Information-Technology Promotion Agency.

The creditable amount is calculated as follows:

Acquisition costs	X	70%	X	10%
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The maximum creditable amount is 20 percent of the corporation tax liability for the fiscal year. An excess amount for a year is carried forward to the next fiscal year.

Note that a company which wants to apply for this tax credit system needs to satisfy the minimum requirements (the amount of the acquisition costs of equipment put into use per fiscal year) depending on the amount of paid-in capital:

Paid-in Capital	Minimum requirement per fiscal year
JPY 100 million or less	JPY 0.7 million
Over JPY 100 million and JPY 1 billion or less	JPY 30 million
Over JPY 1 billion	JPY 100 million (maximum JPY20 billion)

In lieu of the above tax credits, a company may utilize a special depreciation system for the above designated equipment, under which additional depreciation (acquisition costs x 70% x 50%) is available for the year when the equipment is placed into use for the business in Japan.

1.10 Administrative Overview

1.10.1 Tax Returns and Tax Payment

(1) Final tax returns

A company is required to file final returns (a corporation tax return to the relevant tax office and inhabitant/business tax returns to the local governments) within two months after the end of its business year, whether or not it has positive income for that fiscal year. However, generally, an extension of one month can be obtained from the tax office for a Japanese company or longer for a branch of a foreign company. The final tax liability for the tax year must be paid to the tax offices within two months after the end of the fiscal year regardless of whether a filing extension has been obtained.

A corporation final return must be accompanied by the company's balance sheet, profit and loss statement, statement of changes in net assets, details of accounts, statement of outline of business activities and, depending upon circumstances, certain other prescribed documents.

For groups using consolidated filing (see section 1.11 below) the tax return filing and payment due dates remain as above, however a two-month filing extension will generally be granted upon application.

(2) Interim tax return

A company, the fiscal year of which is longer than six months, should file interim tax returns within two months of the end of the first six months of the tax year. If the amount of the annual corporation tax for the preceding fiscal year multiplied by six and divided by the number of months of the preceding fiscal year is JPY 100,000 or less, the company is generally not required to file interim tax returns. However, a company subject to the size-based business tax or business tax imposed on gross revenue rather than net income is always required to file an interim tax return with respect to business tax regardless of the amount of the corporation tax for the preceding fiscal year.

The amounts of taxes to be reported in interim returns are chosen by the company from two methods:

- Tax for the preceding business year multiplied by six and divided by the number of months of the preceding business year; or
- Tax computed on the basis of the provisional results for the first six-month period of the present business year.

The tax reported on the interim returns should be paid to the tax office and local governments within the time limit for filing interim returns.

1.10.2 Tax Audits and the Statute of Limitation

The Japanese corporate tax filing system utilizes a self assessment basis. The tax authorities may then carry out a tax audit of returns filed and make any necessary adjustments within the limitations laid down by the law. The basic statutory time limits for such adjustments are as follows:

Nature of adjustments	Limitation period
Relating to underreporting of taxable income	5 years
Relating to amendment of excess tax losses	7 years
Relating to transfer pricing issues	6 years
Relating to fraud	7 years

1.11 Tax Consolidation

Tax consolidation provisions were introduced in 2002 and it is now possible to offset the profits and losses of qualifying group companies.

Tax consolidation can be applied by selection (ordinarily irrevocable) to a Japanese domestic parent company and the Japanese

subsidiaries in which it holds 100 percent direct or indirect ownership. Once the selection is made, all 100 percent subsidiaries are required to be included within the consolidated group. Note that tax consolidation cannot be applied between Japanese domestic sister companies commonly held by a foreign company. Filing and payment deadlines under tax consolidated filing are in principle the same as for a normal domestic Japanese company, however a two month filing extension will generally be allowed. Note also that a consolidated return can only be filed for national corporate tax purposes. For the purposes of local taxes, each member of the consolidated group must continue to file their own tax returns based upon their own taxable income without offsetting losses from elsewhere in the group. In order to mitigate the administrative burden of the recalculation of taxable income solely for local tax purposes, certain items of taxable income, as calculated on a consolidated basis, can be apportioned amongst group members as a simplified basis.

The following key benefits are available under tax consolidation:

- Consolidation allows effective offset of current year taxable profits and losses of consolidation group members;
- Consolidated tax losses incurred can be carried forward for up to seven years to offset future consolidated taxable profits (note also that pre-consolidation grouping losses of the parent company can also generally be carried forward for use in the same manner (although for five years only in respect of losses arising in tax year commencing prior to April 1, 2001));
- Capital gains on transfers of assets between consolidated group members can generally be deferred until the assets are transferred out of the group or expensed; and
- Dividends paid between consolidation group members will be entirely excluded from taxable income, without deduction for associated interest expense.

However, tax consolidation must be carefully considered as there are potential disadvantages to application of the system. Key negative issues are considered below:

- Existing losses of subsidiary companies will generally be

- extinguished upon joining consolidation group; and
- Upon joining a consolidation group, the assets of subsidiary companies may be revalued to market value so crystallizing built-in gains or losses which can result in either additional taxation or extinguishment of losses realized as described above.

In addition to the points above, the use of a consolidated tax group will also result in certain tax related treatments being calculated based not on individual companies' status but on the consolidated status. For example, the deductible limit of donations, the deductible limit of entertainment expenses, R&D tax credit limit, etc. Taking a consolidated view in such situations can have both negative and positive consequences and it is necessary for individual groups to consider how they might be effected overall by selecting consolidation. Note, however, that since consolidation does not apply to local tax for the purposes of determining the application of size-based business tax, each company should be judged separately based on its own capital amount.

1.12 Corporate Reorganizations

1.12.1 Tax Qualified Reorganizations vs Non Tax Qualified Reorganizations

The Japanese Corporation Tax Law provides for the definitions of tax qualified reorganizations and non tax qualified reorganizations for the following transactions:

- Corporate division (spin-off and split-off)
- Merger
- Contribution in kind
- Post establishment transfer
- Share-for-share-exchange (kabushiki-kokan) or share-transfer (kabushiki-iten) (as from October 1, 2006)

Under a tax qualified reorganization, assets and liabilities are transferred at tax book value (i.e., recognition of gains/losses are deferred) for tax purposes, while under a non tax qualified

reorganization, assets and liabilities are transferred at fair market value (i.e. capital gains/losses are realized). Note that when a share-for-share-exchange or a share-transfer is carried out as a non tax qualified reorganization, built-in gains/losses in assets held by the subsidiaries will be crystallized although assets and liabilities are not transferred and remain in the subsidiary.

The following is a general outline of the conditions required for a tax qualified reorganization:

Relationship	Conditions
(1) 100% ownership relationship	<ul style="list-style-type: none"> (a) Delivery of shares only as consideration for transfer (no involvement of cash or any other assets). (b) Expectation that the 100% ownership relationship will remain intact.
(2) More than 50% (but less than 100%) ownership relationship	<ul style="list-style-type: none"> (a) Delivery of shares only as consideration for transfer (no involvement of cash or any other assets). (b) Expectation that the controlling ownership relationship will remain intact. (c) Transfer of the main assets/liabilities of the transferred business. (d) Expectation for the transfer and retention of approximately 80 % or more of employees engaged in the transferred business. (e) Expectation that the transferee will continue to operate the transferred business.
(3) 50% or less ownership	<ul style="list-style-type: none"> (a) Same as (2)-(a),(c),(d) and (e) (b) The transferred business has a relationship with one of the transferee's businesses. (c) The relative business size (i.e., sales, number of employees, etc.) of

	<p>the related businesses is not considerably different (within a 1:5 ratio), or senior directors from both sides will participate in the management of the transferred business.</p> <p>(d) Expectation that the shares received for the transferred business will continue to be held.</p>
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The conditions for a tax qualified share-for-share exchange or share-transfer are similar to the above but slightly different since there is no transfer of business under these reorganizations. For example, the condition in (2)(c) will not be relevant, (2)(d) should be replaced by "Expectation that approximate 80% or more of the employees in the subsidiary will continue working for the subsidiary", and, (2)(e) should be replaced by "Expectation that the subsidiary will continue to operate its own main business".

From May 1, 2007, a triangular reorganization (a triangular merger, a triangular spin-off type corporate division and a triangular share-for-share exchange) is available in Japan, whereby the shares of the parent company of the transferee company (including the company becoming the parent company of the transferred company in a share-for-share exchange, in this section 1.12) are transferred to shareholders of the transferor company (including the transferred company becoming a subsidiary in a share-for-share exchange, in this section 1.12) instead of shares in the transferee company. Note that under the Japanese Company Law, although both the transferee company and the transferor company must be Japanese companies, the parent company of the transferee company in a triangular reorganization could be a foreign company. In connection with condition (a) above, if the shareholders of the transferor company receive solely shares in the parent company of the transferee company in a triangular reorganization, condition (a) is satisfied provided that the parent company directly holds 100 percent of the shares of the transferee company.

1.12.2 Pre-Reorganization Losses

Under a tax qualified merger, if certain conditions are met, pre-merger losses are transferred from the merged company to the surviving company. Otherwise (i.e., under a non tax qualified merger or under a tax qualified merger without satisfying certain conditions), such losses can not be transferred. This rule is also applicable to pre-reorganization losses incurred in the dividing company in the case of a corporate division that is similar to a merger in its effect.

As for pre-merger losses incurred in the surviving company, if the merger is tax qualified, certain requirements must be met in order to utilize such losses against future profits after the reorganization, while there are no such requirements if it is a non tax qualified merger. This rule is also applied to pre-reorganization losses incurred in the transferee company in the case of a corporate division and a contribution in kind as well.

Furthermore, there are number of rules to restrict utilization of built-in losses after reorganizations under certain circumstances.

1.12.3 Taxation of Shareholders

When the shareholders receive shares in the transferee company only or shares in the parent company of the transferee company (in triangular reorganizations on or after May 1, 2007) only, capital gains/losses from the transfer of the shares are deferred. However, if the shareholder is a foreign shareholder not having a permanent establishment (PE) in Japan and receives shares in the foreign parent company of the Japanese transferee company, the deferral of capital gains/losses is not applicable. Moreover, if the shareholder is a foreign shareholder with a PE in Japan and receives the shares in the foreign parent company of the Japanese transferee company, the realization of capital gains/losses may not be deferred, unless the PE has the custody in the shares as property related to its Japanese business. Note that even if the deferral is not available, if the capital gains are not Japanese source income or if tax treaty protection is available, the capital gains will not be taxed in Japan.

Moreover, in the case of a merger or a split-off type corporate division, if the reorganization is non tax qualified, the shareholders of the transferor company recognize a receipt of deemed dividends.

2 Taxation of Partnerships

In Japan, a partnership (kumiai) is not recognized as a separate taxable entity and the partners (kumiai-in) are liable for Japanese tax on the basis of their share of profits under a partnership agreement and in accordance with their own Japanese tax status.

2.1 NK-type Partnerships

2.1.1 Definition of NK-type Partnerships

There are the following three types of NK-type partnerships in Japan. These NK-type partnerships are formed by an agreement in which partners agree to jointly carry on business. Generally, assets of an NK-type partnership are deemed to belong to all partners jointly. A foreign partnership similar to these Japanese NK-type partnerships also falls under the definition of an NK-type partnership.

- Nini Kumiai (NK)

An NK is formed under the Civil Law. All partners of an NK are liable for the obligation of the NK. One or more managers may be appointed to manage the business operation of the NK. There is no limitation on the kinds of business which an NK can carry out. No registration is required.

- Investment Limited Partnership (Toshi Jigyo Yugen Sekinin Kumiai or Investment LPS)

An investment LPS is formed by general partners and unlimited partners for conducting investment business under the Investment LPS Act. A general partner has unlimited liability for the obligations of the LPS and manages the operation of the LPS business. A limited partner has limited liability for the obligations of the LPS to the extent of its capital investment. An Investment LPS must be registered at a local legal affairs bureau.

■ Limited Liability Partnership (Yugen Sekinin Jigyo Kumiai or LLP)

An LLP is formed under the LLP Act, which was enacted on August 1, 2005. All partners of an LLP have limited liability for the obligations of the LLP to the extent of their capital investment in the LLP and must participate in the management of the LLP business in principle. Either an individual or a company can be a partner of an LLP but another partnership cannot be a partner of an LLP. Furthermore, at least one of the partners must be an individual resident in Japan or a Japanese company. There is a restriction on businesses to be carried on by an LLP. For example, neither accounting firms nor law firms are able to use LLPs, unlike in some foreign countries. An LLP must be registered at a local legal affairs bureau.

2.1.2 Taxation of Partners

■ Japan resident partners

Income/loss of an NK-type partnership allocated to its partners generally retains its nature for tax purposes. Japan resident partners (both individuals and companies) are required to declare their income/loss generated from the partnership by filing tax returns during each of their taxable periods regardless of whether any actual distribution is made. If the income calculation of a partnership is made more than once a year and the income/loss is allocated to each partner within one year after the income/loss is generated, the partners can declare such income/loss for the taxable period in which the calculation period end date of the partnership falls. In certain cases, utilization of losses generated from partnerships is restricted (please see 2.3 below).

■ Foreign partners having a PE in Japan

In the same way as Japan resident partners, foreign partners (both individuals and companies) having a permanent establishment (PE) in Japan are required to declare their taxable income/loss generated from an NK-type partnership. Also, in certain cases, utilization of losses generated from partnerships is restricted (please see 2.3 below).

Profit allocations to foreign partners having a PE in Japan derived from businesses carried on in Japan using an NK-type partnership is subject to withholding tax at 20 percent. The withholding tax is creditable when declaring such income. Thus, the withholding tax does not constitute an additional tax burden for taxpayers although it may cause an administrative burden and cash flow differences.

In general, where a person makes a payment subject to withholding tax, the person is required to pay the withholding tax to the competent tax office by the tenth day of the following month. As for the profit allocation from an NK-type partnership, the income is deemed to be paid on the day when the cash or any other assets are distributed (or the day when two months have passed from the end of the accounting period of the NK-type partnership if no distribution is made within two months after the end of the accounting period). Also, a person who allocates partnership income is deemed to be the person responsible for withholding tax requirements.

It is sometimes difficult to judge whether the business carried on through an NK-type partnership arrangement is a business carried on in Japan and if it causes a foreign partner to be treated as having a permanent establishment in connection with the business carried on by the partnership.

By virtue of the 2009 tax reform, if a foreign partner of Investment LPSs or foreign partnerships similar to an Investment LPS (collectively, hereinafter referred to as "Investment Funds") falls under the scope of a "Specified Foreign Partner", the foreign partner is deemed not to have a PE in Japan.

A Specified Foreign Partner of an Investment Fund is a partner who satisfies the following conditions:

- (i) being a limited partner of the Investment Fund;
- (ii) not being involved in the operation of the Investment Fund;
- (iii) holding an interest of less than 25 percent in the assets of the Investment Fund;

- (iv) not having a special (affiliate) relationship with the general partners of the Investment Fund; and
- (v) not having a PE in Japan with respect to business other than the business carried on by the Investment Fund

A foreign partner must file an application form to the relevant tax office through a general partner along with Japanese translations of the partnership agreements. Also, the foreign partner is required to show the general partner of the Investment Fund a certificate to verify its foreign resident status. This amendment is applicable for the determination of whether a foreign partner has a PE in Japan on or after April 1, 2009.

■ Foreign partners not having a PE in Japan

Income of an NK-type partnership allocated to its partners generally retains its nature for tax purposes. Thus, it is generally taxed depending on its nature as if it was directly derived by each partner.

2.2 Tokumei Kumiai

2.2.1 Tokumei Kumiai (TK)

A Tokumei-Kumiai, or TK, is a silent partnership arrangement provided for under the Commercial Code of Japan. The silent partner(s) in the TK (kumiai-in) contributes funds under a TK agreement for the operation of a specific business carried on by an operator (eigyoshiya) and in return is able to participate in the profits or losses from that operation. In entering into a TK arrangement, the TK silent partner(s) does not obtain any interest in the underlying assets of the TK operator's business, nor generally can the TK silent partner(s) participate in the management or operation of the business. The mechanics of a TK can be used in any kind of operation.

2.2.2 Taxation of the Operator

The TK operator carrying on business in Japan is subject to normal Japanese corporate/income taxes in relation to the operation of its

business. However, when calculating taxable income, the TK operator is entitled to take a deduction for any element of profits allocated to the TK silent partner(s). Conversely, where losses are allocated to the TK silent partner(s), the TK operator is required to recognize corresponding taxable income.

2.2.3 Taxation of Silent Partners

The Japanese tax consequences for a TK silent partner relating to income under the TK arrangement depends upon whether or not the TK silent partner is Japan resident.

■ Japan resident partners

The TK profit/loss allocation is treated as normal taxable income/loss of the TK silent partner for the period in which the accounting period end date of the TK operator falls. As for corporate silent partners, utilization of losses generated from TK is restricted (please see 2.3 below). As for individual silent partners, the TK profit/loss allocation is basically classified as “miscellaneous income”, which means that a loss allocation from a TK can not be offset against any other types of income. However, if the individual silent partner is involved with managing the business operation together with the operator, the TK profit/loss allocation may be classified as other types of income that may be offset against other types of income if the result is in a loss position.

Withholding tax is levied on actual distributions of TK profit to silent partners at the rate of 20 percent, which is creditable for the partners when declaring such income in their tax returns.

■ Foreign partners having a PE in Japan

The TK profit/loss allocation is treated as normal taxable income/loss of the TK silent partner for the period in which the accounting period end date of the TK operator falls. As for corporate silent partners, utilization of losses generated from TK is restricted (please see 2.3 below)

Actual distributions from a TK to foreign partners are subject to 20% withholding tax, which is creditable for the partners when declaring such income in their Japanese tax returns.

- Foreign partners not having a PE in Japan

20 percent withholding tax is applied on actual distributions of TK profit allocations. There are no further Japanese tax obligations in respect of such TK allocations and no requirement to file a tax return in Japan.

It should be noted that non-resident TK silent partners located in certain jurisdictions with which Japan has concluded a tax treaty containing an appropriate “Other Income” article, which provides that “other income” is taxable only in the country of recipient, can apply to the tax authorities to have the withholding tax on their distributions of TK profit allocations exempted. Note that the tax treaty with the U.S. has a special provision in its Protocol to allow Japan to tax TK distributions in accordance with Japanese domestic tax law even though there is an “Other Income” article. Also, the provision in the Protocol prevents giving any treaty benefits to income derived through TKs. Also, the new tax treaties with the U.K., France and Australia include a special article for TK income whereby the Japanese tax authorities are given the taxing right with respect to TK distributions.

2.3 Limitation on Utilization of Losses Derived from Partnerships

Rules to limit the utilization of losses derived from a partnership at the level of each partner were introduced in 2005. For a foreign investor, these rules affect the investor’s taxable income in Japan only when the investor has a permanent establishment in Japan.

2.3.1 Corporate Partners of Partnerships other than Japanese LLP - At-Risk Rule (“AR rule”)

A rule similar to the At-Risk Rule in the U.S. was introduced for

corporate partners according to the 2005 tax reform. Where corporate partners of certain partnerships (*) suffer losses from the partnership in an accounting year, the following amount is not deductible in calculating taxable income:

- (i) Where a corporate partner is not at risk with respect to liabilities of the partnership due to an arrangement such as non-recourse financing: the partnership losses exceeding the amount calculated based on the capital contribution of the corporate partner (“excess partnership losses”)
- (ii) Where it is obvious that the business of the partnership results in profits due to an arrangement such as a profit guarantee contract or a residual value insurance/guarantee: the partnership losses

If the corporate partner derives profits from the partnership business in subsequent years, the excess partnership losses incurred in prior years can offset against the profits.

This rule does not apply to a corporate partner who is involved in decision-making of important transactions of the partnership activity and who participates in important management decisions and operations continuously.

Partnerships covered by this rule are as follows:

- (a) NK
- (b) Investment LPS
- (c) Tokumei-Kumiai (“TK”) and any other arrangement similar to a TK
- (d) Foreign arrangements similar to (a), (b) and (c)
- (e) Foreign arrangements similar to a Japanese LLP

Partnership contracts entered into on or after April 1, 2005 are covered by this rule. However, this rule does not apply to partnership contracts entered into before April 1, 2007 for leases of airplanes to be used for a business that is related to a license under Article 100 (1) of the Civil Aeronautics Law.

2.3.2 Individual Partners of Partnerships other than Japanese LLP

A rule to restrict utilizing losses derived from partnerships was introduced for individual partners in certain partnerships (*) in 2005.

Where individual partners of certain partnerships that are involved in rental real property activity incur losses from the rental activity, such losses are disregarded for income tax purposes and cannot be carried over to the following years. This rule does not apply to an individual partner who is involved in decision-making of important operations of the activity and who participates in operations such as negotiating contracts.

Partnerships covered by this rule are as follows:

- (a) NK
- (b) Investment LPS
- (c) Foreign arrangements similar to (a) and (b)
- (d) Foreign arrangements similar to Japanese LLP

“Rental real property activity” includes not only the rental of land and buildings but also leasing ships and aircraft. The aim of this new rule is to prevent individual taxpayers from offsetting losses incurred from investments in aircraft leasing arrangements through partnerships against any other income.

2.3.3 Corporate Partners of Japanese LLP

When a corporate partner of an LLP incurs losses from the LLP business in an accounting year, the losses exceeding the amount calculated based on the capital contribution of the corporate partner (“excess LLP losses”) are not deductible in calculating taxable income for the accounting year.

If the corporate partner derives profits from the LLP business in subsequent years, the excess LLP losses incurred in prior years can offset against the profits.

2.3.4 Individual Partners of Japanese LLP

When an individual partner of an LLP derives rental real property income, business income or forestry income from the LLP business, if the losses incurred from the LLP business in a year exceed the amount calculated based on the capital contribution of the individual partner, such excess portion is not treated as deductible expenses in calculating taxable income for the year.

While a corporate partner of an LLP can offset excess losses against profits generated from the same LLP in subsequent years, the treatment is not available if the partner is an individual.

3 Taxation of Individuals

3.1 Introduction

Individual income taxes in Japan consist of national income tax and local inhabitant tax.

The taxable year for national income tax is the calendar year. Inhabitant tax is assessed by the prefectural and municipal governments on individuals who reside or have domicile therein as of January 1 of each year, based on income for the preceding year. Moreover, those individuals who are operating certain specified businesses of their own at fixed places in Japan are liable for business tax assessable by prefectural governments.

3.2 Tax Rates

3.2.1 Tax Rates on Ordinary Income

The following tax rates are applied to the net of taxable ordinary income minus allowable deductions and personal reliefs in respect of individuals who are classified as permanent or non-permanent resident taxpayers.

■ Income Tax Rates

(JPY)

Taxable income		Tax rate applicable to taxable income band	Deduction
From	But not over		
-	1,950,000	5%	-
1,950,000	3,300,000	10%	97,500
3,300,000	6,950,000	20%	427,500
6,950,000	9,000,000	23%	636,000
9,000,000	18,000,000	33%	1,536,000
18,000,000	-	40%	2,796,000

■ Inhabitant Tax Rates

Inhabitant tax consists of a two elements; a small levy imposed regardless of the amount of income (per capita levy) and a more significant tax based upon the taxable income of the individual taxpayer (Income based levy).

- Per capita levy

(JPY)

Municipal inhabitant tax	Prefectural inhabitant tax
3,000	1,000

- Income based levy

The inhabitant tax rate is 10% regardless of the amount of taxable income.

3.2.2 Tax Rates on Capital Gains

Capital gains from real estate and securities are taxed at different tax rates separately from ordinary income.

■ Capital Gains from Sales of Real Estate

- Short-term capital gains (the period of possession is five years or less as of January 1 of the sale year) – 30 percent income tax and nine percent inhabitant tax
- Long-term capital gains (the period of possession is more than five years as of January 1 of the sale year) – 15 percent income tax and five percent inhabitant tax

Where the asset sold is a residence, further concessions such as special deductions, loss carry-forward and preferential tax rates are available.

Note that the new capital gains rollover relief and a special deduction for long-term capital gains are implemented under the 2009 tax

reform, which is discussed in 1.4.

■ Capital Gains from Sales of Shares

Capital gains from the sale of shares are taxed at 20 percent (15 percent income tax and five percent inhabitant tax). As for capital gains from certain sales of listed shares until December 31, 2008, the tax rate is reduced to 10 percent (seven percent income tax and three percent inhabitant tax). Under the 2009 tax reform, such temporary measure has extended for three years until 2011.

It is possible to carryover tax losses incurred from certain sales of listed shares for three years to set off against capital gains from sales of shares. Losses from sales of listed shares incurred from 2009 onwards can set off against not only capital gains from sales of shares but also dividend income from listed shares declared in income tax returns separately from ordinary income.

3.2.3 Tax Rates on Dividends

Dividend income, in principle, is required to be added to ordinary income; however, a taxpayer can settle their tax liability on the following dividends by withholding tax without declaration in their tax return if it is more preferable:

- A dividend received from a non-listed domestic company, provided the amount of the dividend does not exceed JPY 100,000 per annum (where the calculation period of the dividend is less than one year, instead of JPY 100,000, the amount calculated by dividing JPY 100,000 by the number of the months of the calculation period of the dividend and multiplied by 12.). (Note that such dividends are still required to be declared for inhabitant tax purposes); or
- A dividend received from a listed domestic company, provided that the recipient individual holds less than five percent of the outstanding shares of the company.

From 2009, a taxpayer has another option to declare dividend income from listed shares separately from ordinary income. Under this option, such income is taxed at a flat rate of 20 percent (15 percent national tax and five percent inhabitant tax), while a temporary measure to reduce the tax rate to 10 percent (seven percent national tax and three percent inhabitant tax) on income is available from 2009 to 2011. Note that dividend income declared under this option can be offset against capital losses from listed shares.

3.3 Taxpayers

3.3.1 Classification of Individual Taxpayers

Under the Income Tax Law of Japan, there are two categories of individual taxpayers; resident and non-resident.

(1) Resident

A resident is an individual who has his domicile in Japan or has resided in Japan for a continuous period of one year or more. Residents are further divided into either non-permanent or permanent residents with consequential tax implications as described below.

(i) Non-permanent resident

A non-permanent resident is a resident who does not have Japanese nationality and has lived in Japan for five years or less in the last ten years.

A non-permanent resident is subject to normal Japanese income and inhabitant taxes in relation to Japanese source income plus foreign source income paid in or remitted to Japan.

(ii) Permanent resident

A permanent resident is a resident other than a non-permanent resident; therefore, an individual who has Japanese nationality, or has

been domiciled or resident in Japan for a period of more than five years in the last ten years falls under this category.

A permanent resident is subject to normal Japanese income and inhabitant taxes on worldwide income.

(2) Non-resident

A non-resident is an individual other than a resident; therefore an individual who has no domicile in Japan, or has not been resident for a continuous period of one year or more in Japan, falls under this category.

In general, a non-resident is liable for Japanese income tax at the flat rate of 20 percent of the gross amount of his Japanese source income, but is not liable for inhabitant tax.

3.3.2 Domicile

“Domicile”, as provided for in the Income Tax Law of Japan, means the principal place of living. Whether or not an individual has his/her domicile in Japan is determined on the basis of objective facts, such as the fact that he/she has his/her occupation in Japan, that his/her spouse or other relatives make up his/her household in Japan, or that his/her place of business is located in Japan. In view of the nature of a domicile, an individual can never be regarded as having more than one domicile at the same moment.

Generally speaking, if a person, regardless of whether he/she is a Japanese national or a foreign national, has come to reside in Japan to engage in business or an occupation, he/she is presumed to have a domicile in Japan, unless it is made clear from the employment contract, etc., based on which he/she has come to Japan, that the period of his stay in Japan is not one year or more. It should be noted in this connection that the visa status under which a foreign national has been permitted to enter Japan is not directly relevant.

3.3.3 Short-Term Visitors

Generally, Japan's double tax treaties are in line with the OECD Model Treaty with respect to the tax-exempt treatment of foreign employees temporarily working in Japan. Such employees are generally tax exempt if they fulfill the following three criteria:

- they are present in Japan for not more than 183 days in any twelve month period commencing or ending in the fiscal year concerned;
- their salary is paid by a non-resident employer; and
- none of the salary is borne by a permanent establishment in Japan.

3.4 Assessable Income

An individual's taxable income is defined as assessable income less allowable deductions. Assessable income for these purposes consists of the following:

- interest income;
- dividend income;
- real estate income;
- business income;
- employment income;
- retirement income;
- timber income;
- capital gains;
- occasional income; and
- miscellaneous income.

3.4.1 Remuneration

When considering the tax position of expatriates assigned to work in Japan, the critical item of assessable income is likely to be employment income.

Employment income may commonly include the following items:

- basic salary;
- bonus;
- cost of living allowance;
- overseas premium;
- housing allowance or company housing;
- servant allowance;
- utility allowance;
- children's tuition allowance;
- exchange allowance;
- tax equalization;
- medical allowance;
- share or stock options;
- other economic benefits, such as company car or home leave transportation.

In addition to the foregoing, the expatriates may continue to be covered by pension and/or profit sharing plans maintained by their head offices while they are in Japan.

As can be noted from the above, whilst employment income will principally consist of cash payments, it is not limited to cash amounts, and payments in kind or economic benefits are also included within assessable income, unless specifically exempted from taxes under the tax laws, regulations or administrative rulings.

3.4.2 Treatment of Benefits

■ Company Housing

Rent paid by an employer is not included in assessable income, however the "assessed rental (legal rent)" (i.e. the value of the taxable economic benefit) is included.

Assessed rental is determined using a formula which considers the type and value of the premises. Generally, the taxable amount is in the range of five percent -10 percent of the actual rent for an employee or 50 percent for an officer (the 50 percent rate can be reduced to 35 percent if the premises are used partly for business

purposes).

■ Children's Tuition Allowance

Tuition fees for children paid by an employer are included in assessable income to the employee. However, an exception to such taxable treatment has been established by private tax rulings with respect to the contribution plan of certain international schools in Japan. Under such plans, an employer company can effectively make a donation to the school and in recognition of this, children of employees are exempted from tuition fees for attending the school. The employees are not required to report any benefit arising from this arrangement as taxable income. However, employer companies are required to treat the contribution payments as donations for corporate income tax purposes. As discussed in 1.6.9, donations have only limited deductibility for corporate tax purposes.

Certain international schools have now been granted status as Specified Public Interest Facilitating Corporations. As a result, it may be possible for companies to enjoy a tax deduction for a greater portion of donations to such qualifying schools.

■ Company Car

A company car used for the employer's business is not treated as a taxable economic benefit.

■ Home Leave Transportation

Cash or an in-kind benefit provided by an employer to an expatriate in Japan to facilitate a home leave trip to that expatriate's country of origin will generally not be treated as assessable income of the expatriate. The home leave expense can also cover the costs of the expatriate's co-habiting family members. Such home leave should, generally speaking, be limited to a single trip per year and should be in accordance with the employer's working rules, terms of the expatriate's contract etc. Further, the expense should be reasonable based upon the relevant facts, such as available routes, distance, fare etc.

■ Moving Expenses

Moving expenses are generally treated as non-taxable income.

■ Tax Reimbursements

Any tax reimbursement or settlement made by an employer for an expatriate should be included in assessable income on a cash basis.

■ Stock Options

(i) Qualified Stock Options

The income earned from qualified stock options is subject to tax when the stock is sold. Therefore, the tax on income generated by exercise of the stock option is deferred until the stock is sold as a capital gain.

When the stock is sold, the capital gain (sales price minus the exercise price) is taxed at 20 percent separately from other income. On the sale of listed shares in the period to December 31, 2008, a reduced 10 percent tax rate is applicable to any gain. Under the 2009 tax reform, such temporary measure has extended until December 31, 2011.

The conditions for qualified stock options are as follows:

- The holder of the stock options is a director (including not only a member of the board of directors but also officers) or an employee of the issuing company, or is a director or an employee of a company whose voting stock is 50 percent or more owned directly or indirectly by the issuing company.
- The stock option rights have to be exercised within the period falling between the second anniversary of the date of the resolution of the shareholders meeting for the option grant to the tenth anniversary.
- The total exercise price of all options exercised in a year must not exceed JPY12 million per annum.
- The exercise price of the option must be equal to or higher than

the fair market value of the underlying shares on the date the agreement for the option grant is concluded.

- The option rights cannot be transferred.
- Issuance of new stock pursuant to the stock options was made in compliance with the Japanese Commercial Code or Japanese Company Law relating to a shareholders' meeting resolution.
- With respect to the stock that is issued at the time the option is exercised, the share certificates must not be transferred to or held by an option holder, but must be kept in trust and custody by either a security company or a trust company (Trust) in accordance with a prearranged agreement made between a company and the Trust. That is, share certificates must be kept under the supervision and control of the Trust until such shares are sold.

(ii) Non-Qualified Stock Options

Any benefits arising from non-qualified stock options for the directors/employees are taxable at the time of exercise of the option. The director/employee is taxed on the difference between the then fair market value and exercise price on the date of exercise. The income is generally treated as additional compensation and subject to ordinary income taxes.

3.4.3 Exemptions and Concessions

The following items of income and benefits are specifically excluded from treatment as assessable income.

- Commutation allowance not exceeding the lesser of JPY 100,000 or actual monthly commutation costs.
- Reasonable cost of presents, etc. for the commendation of officers or employees for their long-service with the employer company.
- Cost of goods given to directors or employees in connection with the commemoration of anniversaries, etc. Such goods must be suitable for the commemoration, and the estimated disposal value

thereof shall not exceed JPY 10,000.

- Discount sale of merchandise. The sale price must be 70 percent or more of the ordinary selling price, and the quantity of the discounted goods sold to an employee should be such as would reasonably be required for the use of the household of the officer or employee.
- Utilities for a dormitory.
- Interest on loans in the case of emergency, such as calamity, sickness, etc., or where the amount of such interest does not exceed JPY 5,000 a year.
- Cost of recreation, such as outings, etc. up to a reasonable amount.
- Life insurance or casualty insurance premiums borne by the employer on behalf of directors and employees provided that the insurance proceeds are to be made to the employer upon expiration of the insurance term. If such insurance premiums are paid on behalf of directors or certain employees only, the economic benefit is taxable. Moreover, a rebate, etc., if paid under the insurance contract, is taxable.
- Insurance premiums, provided the amount borne by the employer shall not exceed JPY 300 a month.
- Compensation for damage paid to a third party and legal fees in connection therewith where such damage was caused by an officer or employee while on duty and not due to his fault.
- Golf club or social club membership fees, etc. are not taxable if they are connected with the business of the employer.

3.5 Allowable Deductions

3.5.1 Standard Deductions

The following standard deductions are allowable to a resident taxpayer.

■ Employment income:

(JPY)

Amount of compensation		Standard deduction
Up to	1,800,000	40% of income (subject to 650,000 minimum)
Excess over Up to	1,800,000 3,600,000	30% of income + 180,000
Excess over Up to	3,600,000 6,600,000	20% of income + 540,000
Excess over Up to	6,600,000 10,000,000	10% of income + 1,200,000
Excess over	10,000,000	5% of income + 1,700,000

■ Retirement income:

(JPY)

Circumstances	Standard deduction
Up to first 20 years of service	400,000 per year of service
For each year of service over 20 years	700,000 per year of service
Minimum deduction	800,000 per case
Special deduction for those retiring due to physical handicap	Amount of the above deduction + 1,000,000

Note that taxable retirement income is calculated as 50 percent of retirement income after the standard deduction, and it is taxed at the ordinary tax rates but separately from ordinary income.

3.5.2 Specific Deductions

The following deductions are applicable to a resident taxpayer.

■ Casualty losses

A deduction is available for losses incurred on a taxpayer's assets, or those of family members living in the same household, from a disaster or a robbery. The deductible amount is equivalent to any loss not covered by insurance proceeds, etc. in excess of the smaller of JPY 50,000 or 10 percent of assessable income. A non-resident taxpayer subject to progressive tax rates may also enjoy relief for casualty losses incurred on the assets in Japan.

■ Medical expenses

A deduction is available for medical expenses for the taxpayer and family members living in the same household. The deductible amount is equivalent to medical expenses not covered by insurance proceeds, etc. in excess of the smaller of JPY 100,000 or 5 percent of assessable income. The maximum deduction is limited to JPY 2,000,000.

■ Social insurance premiums

Only premiums paid under Japanese social insurance schemes for a taxpayer and family members living in the same household are deductible. Foreign social insurance premiums are not deductible. However, in accordance with the protocol of the Japan-France tax treaty signed in January 2007, contributions paid to the French social security system may be deductible under certain circumstances.

■ Life insurance premiums

The maximum deductible amount for certain life insurance premiums paid is JPY 50,000 for national income tax purposes and JPY 35,000 for inhabitant tax purposes. Life insurance premiums paid on policies concluded abroad by foreign insurance companies are not deductible.

An additional deduction of JPY 50,000 and JPY 35,000 for national income tax and inhabitant tax purposes, respectively, is available if the premiums are paid under a private pension plan which meets certain conditions.

■ Fire and other household casualty insurance premiums

The income deduction for casualty insurance premiums is basically abolished. However, the deduction for long-term casualty insurance premiums remains available provided that the policies are entered into before January 1, 2007. The maximum deduction for long-term casualty insurance premiums is JPY 15,000 and JPY 10,000 for income tax purposes and for inhabitant tax purposes respectively.

If an individual applies for both a deduction for earthquake insurance premiums (discussed below) and a deduction for long-term casualty premiums, the maximum deductible amount in total is JPY 50,000 for income tax purposes and JPY 25,000 for inhabitant tax purposes.

■ Earthquake insurance premiums

A new income deduction for earthquake insurance premiums has been introduced in the 2006 tax reform. Under the new rule, certain earthquake insurance premiums up to the value of JPY 50,000 can be deducted from income for income tax purposes, and a half of the premiums for inhabitant tax purposes (up to JPY 25,000). This deduction is available from 2007 for income tax purposes (tax on 2007 income) and from 2008 for inhabitant tax purposes (tax on 2007 income).

■ Contributions or donations

Contributions or donations qualifying as a deduction do not mean charitable contributions or donations in general but those to the government or local authorities, institutions for educational, scientific or other public purposes as designated by the Minister of Finance, and to institutions for scientific study or research specifically provided for in the regulations. The deductible amount is equivalent to the amount of the contributions or donations paid during the year

(subject to a ceiling of 40 percent of the total of assessable income) in excess of JPY 5,000. Receipts are required as evidence to support the deduction.

This deduction was also applicable, in principle, for inhabitant tax purposes (subject to the 25 percent of assessable income limitation) if the amount of the contributions or donations was JPY100,000. However the scope of contributions and donations qualified as a deduction for inhabitant tax purposes is more restricted than that for income tax purposes.

Under the 2008 tax reform, a deduction for donations for inhabitant tax purposes has been replaced by credits for donations, which will be applied to income from 2008. Under the new rule, 10 percent of the net amount of eligible donations (donations to local governments and charitable donations designated by laws and donations for public welfare designated by each local government, to the extent of 30 percent of total taxable income) less JPY 5,000 is creditable against inhabitant tax.

In addition to the above, if donations are made to any local governments or other entities designated by each local government, a special credit (called "hometown contribution program") is available. The amount of the additional credit varies dependent on the marginal national income tax rate, subject to a limitation (10 percent of inhabitant tax before deducting tax credits).

For instance, assuming the marginal national income tax rate is 40 percent, an additional credit equivalent to 50 percent of the amount of donation is available (i.e., 50 percent = 100 percent minus marginal income tax rate of 40 percent minus ordinary local tax credit of 10 percent). As such, a 40 percent deduction for national tax, and 10 percent and 50 percent ordinary and additional credits for local tax are available, subject to the aforementioned limitations (including JPY 5,000 threshold).

A non-resident taxpayer subject to progressive tax rates is also entitled to relief for contributions and donations.

3.6 Personal Reliefs

The reliefs described below are available to reduce taxable income for income tax and inhabitant tax purposes. Reliefs are separately applied to each individual taxpayer. Note that a non-resident taxpayer is only entitled to the basic deduction.

(JPY)

Relief	Income tax	Inhabitant tax
Basic deduction for taxpayer	380,000	330,000
Spouse	380,000	330,000
Spouse, 70 years or older	480,000	380,000
Dependent - 16-22 years of age	630,000	450,000
Dependent - 70 years or older	480,000	380,000
Parent, 70 years old or older, of the taxpayer or his or her spouse living under the same roof	580,000	450,000
Dependent other than the above	380,000	330,000

Additional reliefs for specific cases

(JPY)

Relief	Income tax	Inhabitant tax
Physically handicapped person	270,000	260,000
Severely physically handicapped person	400,000	300,000
If severely physically handicapped person is living with the taxpayer	750,000	530,000
Widow (or widower), divorcee or working student	270,000	260,000

3.7 Tax Credits

The following tax credits can, where applicable, be claimed by filing a

final tax return.

3.7.1 Credit for Dividends

This credit is applicable to domestic dividend receipts only. The amount of the credit is calculated at the following rates:

Income band into which the dividend income falls *	Income tax purposes	Inhabitant tax purposes
Up to JPY 10,000,000 • Dividend • Distribution of securities investment trust	10% 5%	2.8% -
Over JPY 10,000,000 • Dividend • Distribution of securities investment trust	5% 2.5%	1.4% -

Dividend income is treated as the top slice of a taxpayer's income. Note that alternatively, more complex tax credit arrangements are also applicable to certain other types of distributions.

A taxpayer may declare dividend income from listed shares separately from ordinary income. In this case, the above tax credit is not available.

3.7.2 Withholding Income Tax

Income tax withheld from employment income, from dividends not subject to separate taxation and from other income reportable in a final return should be credited against income tax due on the final return.

3.7.3 Credit for Foreign Taxes

Where there is foreign source income on which foreign tax has been

paid, a credit calculated by the following formula can be deducted from the Japanese income tax payable.

Creditable amount	=	Japanese income tax	X	$\frac{\text{Foreign sourceincome}}{\text{Entire incometaxable in Japan}}$
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Any excess foreign tax can be credited against inhabitant tax to the extent of 18 percent of the income tax credit amount (municipal inhabitant tax) and 12 percent of the income tax credit amount (prefectural inhabitant tax).

Any remaining excess of foreign tax suffered can be carried forward for crediting in the three succeeding years. Similarly, any unused element of the tax credit limitation can be carried forward for up to three years.

3.8 Remuneration Paid Outside Japan

As discussed at section 3.3 above, expatriates with not more than five years residence in Japan are generally treated as non-permanent residents and are liable for Japanese taxes only on income from sources within Japan (plus any income from sources abroad which is deemed to be paid in Japan or is remitted to Japan). As a result of this treatment, it is possible for expatriates (other than corporate officers) to mitigate their Japanese income tax burden for the first five years of an assignment in Japan where their salaries are administered and paid outside Japan (offshore payroll).

Where an offshore payroll is used, the element of the expatriate's employment income treated as non-Japan source can be determined based upon the number of days spent outside Japan on business during the year. Such income will not be taxable in Japan provided no part of the relevant amount is remitted to Japan. For these purposes remittance would include drawings from the offices in Japan of an employer company, foreign currency brought into Japan, borrowings

in Japan to be repaid outside Japan, etc. Where an offshore payroll arrangement is utilized, it would be necessary for relevant employees to keep a record of remittances made to Japan.

As noted above, this benefit is effective only for expatriate staff having non permanent resident status in Japan. If an expatriate employee has lived in Japan for more than five years in the last ten years, the expatriate employee will become permanent resident for tax purposes and will be taxed in Japan on their worldwide income.

An additional benefit from the utilization of an offshore payroll is that payments made outside Japan should not be subject to Japanese withholding tax. In such cases, the tax liabilities would be settled by filing an income tax return and the associated tax payment dates would be as follows:

- Income tax:

First prepayment	July 31
Second prepayment	November 30
Final payment	March 15 of the following year

- Inhabitant tax (based on income for the preceding year):

First installment	June 30
Second installment	August 31
Third installment	October 31
Fourth installment	January 31 of the following year

3.9 Employers' Obligations

3.9.1 Income Taxes

The employer company is required to withhold monthly from salaries, wages, remuneration, bonuses and other employment income, including taxable economic benefits paid and/or provided in Japan to officers and employees, such tax amounts as are provided for in the tax tables and to pay such tax amounts so withheld to the

government by the 10th of the following month. With respect to non-residents however, the withholding tax rate is 20 percent, which is applied to the gross amount of their employment income. Moreover, if the employer company of a non-resident has a permanent establishment in Japan, employment income paid to such non-resident outside Japan is regarded as having been paid by the permanent establishment and the 20 percent tax thereon is required to be paid to the government by the end of the month following the month of payment of such employment income outside Japan.

It is common practice for foreign companies operating in Japan to pay expatriates' salaries on a net basis through an offshore payroll (see section 3.8 above). However, in such situations it can often be the case that certain taxable economic benefits continue to be provided in Japan and these would give rise to withholding tax administration obligations. Such economic benefits might include:

- provision of company housing;
- payment of utility costs;
- payment of school fees for children of expatriates;

Therefore, it is important to review the arrangements with regard to the compensation packages of expatriate members of an organization in Japan, including taxable fringe benefits, in order to ensure that any withholding requirements are being properly met.

The employer company of residents (except those whose gross employment income exceeds JPY 20 million and daily-employed workers) is required to make year-end adjustments of withholding income tax for the calendar year concerned in connection with the last payment of salaries or bonuses for that year. It should be noted that, of the allowable deductions, the deductions for casualty losses, medical expenses and contributions or donations are not deductible in connection with the year-end adjustments. Therefore, those who are entitled to such deductions must file final returns.

3.9.2 Inhabitant Tax

Payers of employment income are required to submit a report on the

employment income subjected to withholding income tax for the preceding year, in respect of officers and employees of such payers as of January 1 of the current year, to the appropriate offices of the municipalities in which the officers and employees resided as of such date.

The municipal offices are to assess inhabitant tax to be collected from the officers and employees in 12 equal installments, from June of the current year to May of the following year. The payers of the officers' and employees' salaries are then required to deduct from monthly salaries the amount of each installment and pay it to the municipalities.

4 International Tax

4.1 Foreign Dividend Exclusion

The 2009 tax reform introduced the foreign dividend exclusion (FDE) system in order to facilitate the repatriation of foreign earnings to Japan, replacing the indirect foreign tax credit system with a more simple method to mitigate double taxation on foreign dividends.

The FDE system is applicable for dividends received from Foreign Subsidiaries in fiscal years of the recipient (i.e. Japanese parent company) beginning on or after April 1, 2009.

For dividends not from Foreign Subsidiaries, e.g., less than 25 percent shareholdings, there are no changes to the old tax treatment (i.e., fully taxable without the indirect FTC but with the direct FTC)

4.1.1 Outline

The tax treatment under the FDE is as follows:

- 95 percent of dividends (before deduction of withholding taxes thereon) from a Foreign Subsidiary are exempt from corporate income tax in the hands of the Japanese parent company.
- Foreign withholding taxes on dividends from Foreign Subsidiaries are not creditable regardless of whether the FDE is applied to the dividends.
- Foreign withholding taxes on dividends from Foreign Subsidiaries are not deductible if the FDE is applied to the dividends.

Attaching a schedule to the final corporate tax returns and retention of certain related documents is required in order to apply the FDE. Due to the introduction of the FDE, the indirect foreign tax credit system has been abolished.

4.1.2 Foreign Subsidiary

A Foreign Subsidiary for the purposes of the FDE is a foreign company which satisfies the following two tests:

(1) 25 percent test

- 25 percent or more of the shares are held directly by a Japanese company. The holding ratio for this purpose is determined based on the number of outstanding shares or the number of shares with voting rights.
- Where a tax treaty with Japan and the country of residence of the foreign company has a reduced holding threshold for indirect FTC, such reduced holding ratio will be used instead of 25 percent, for determining whether the foreign company is a Foreign Subsidiary under the FDE (e.g., 10 percent for the U.S. (in terms of shares with voting rights only) and Australia, 15 percent for France).
- For Japanese companies applying the tax consolidation system, the holding ratio is determined by the holding ratio of the consolidated group. Note that in this case, the reduced holding ratios under tax treaties are not available.

(2) 6 month test

- The 25 percent test should be continuously satisfied for at least 6 months prior to the point in time when the obligation to pay the dividends is determined.
- For foreign companies established within 6 months prior to the date on which the obligation to pay the dividends is determined, continuous shareholding from the date of establishment to the date when the obligation is determined should be treated as fulfilling the 6 month test.
- In the case of a tax qualified reorganization (such as a tax qualified merger), if 25 percent or more of the outstanding shares or the voting rights held by the merged company are transferred to the

surviving company, the holding period before the reorganization should be counted.

4.2 Foreign Tax Credits for Domestic Companies

4.2.1 Basic Rules

A domestic company used to be eligible for the following two types of foreign tax credits before the 2009 tax reform. However, by the introduction of the foreign dividend exclusion (FDE) system, the indirect foreign tax credit (FTC) system has been abolished.

(1) Direct foreign tax credits

Under the direct FTC, a Japanese company is allowed to take credits for foreign corporation tax or counterpart of Japanese corporation tax, including foreign local tax and withholding tax, suffered directly by the domestic company. Note that certain foreign taxes are not eligible for the FTC; e.g., withholding tax on deemed dividends generated under the secondary adjustment as a result of a transfer pricing settlement and withholding tax on dividends from a Foreign Subsidiary.

A Japanese company can take a deduction from its taxable income for foreign taxes directly paid by itself in lieu of a direct foreign tax credit. In either case, all foreign taxes need to be dealt with in the same way, i.e., if a company chooses to take a direct FTC for a foreign tax, the other foreign taxes directly paid by the company for the year are not deductible.

(2) Indirect foreign tax credits

Under the indirect FTC, a Japanese company was allowed to take credits for foreign corporation tax deemed assessed on dividends received from first-tier and second-tier foreign subsidiaries in which 25 percent or more of the total outstanding shares or the voting shares are held by the dividend receiving company for over six months.

Note that the indirect FTC system has been abolished under the tax reform 2009, leaving a transitional period of three years for certain cases.

4.2.2 Creditable Limit

The amount of foreign tax for which credit can be taken is limited to the lower of:

- (i) the adjusted creditable foreign tax; and
- (ii) the creditable limit.

In calculating adjusted creditable foreign tax, where foreign income tax is paid at a high rate (generally a rate in excess of 50 percent), an amount relating to the excess tax must be excluded from the creditable foreign tax. However, this amount does qualify as a tax deductible expense.

The creditable limit for corporation tax purposes is calculated as follows:

Creditable limit	=	Japanese corporation tax amount for the taxable year	×	$\frac{\text{Foreign source incomefor the taxable year}}{\text{Worldwide income forthe taxable year}}$
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The following points should be noted in relation to the formula above:

- Japan utilizes an over-all limitation system rather than a country limitation system or a separate basket limitation system.
- Foreign source income for the taxable year should be reduced by 2/3 of the amount of foreign source income which is exempted from foreign taxation.
- The ratio of foreign source income to worldwide income for the purposes of the calculation is generally limited to a maximum of 90percent.

- Any allocation of expenses between domestic source and foreign source income should be done on a reasonable basis.
- Foreign tax credits are also available for prefectural and municipal inhabitant tax purposes with additional creditable limits (i.e., the creditable limit indicated in the above formula multiplied by inhabitant tax rates)

4.2.3 Carry-Forward Systems

If due to the application of the creditable limit restriction there remains eligible foreign tax which has not been credited in the taxable year, this amount may be carried forward for up to three years to enjoy as a credit in future taxable years.

Conversely, where there have been insufficient eligible foreign taxes in a period to make full use of the creditable limit for that period, the residual amount of the creditable limit can be carried forward for up to three years to increase the creditable limit applicable in subsequent taxable years.

4.2.4 Tax Sparing Credit

Tax sparing credit is allowed under a very limited number of the double tax treaties concluded by Japan. In relation to those applicable treaties, if, for example, interest payable on an approved investment incentive loan is exempt from withholding tax in the treaty partner country, the tax which has been “spared” is nevertheless creditable in Japan in connection with the calculation of the foreign tax credit of a Japanese company. A tax sparing credit provision can accordingly be of considerable benefit. Note that such provision is generally being repealed under Japan’s recent tax treaty policy.

4.2.5 Consolidated Tax Filing and Foreign Tax Credit

Where a domestic corporate group has selected for consolidated tax filing (see Chapter 1 for additional details) the creditable limit for foreign tax credit purposes for the group as a whole is determined

using the normal formula set out above but with the amounts included in the formula being consolidated amounts.

Following determination of the group's overall creditable limit, this limit is allocated between group members based on their respective share of overall group foreign source income. The adjusted foreign tax credit of each member, subject to the limitations of the allocated creditable limit, is then aggregated to determine the foreign tax credit which can be taken by the consolidated group as a whole.

Individual group members can carry forward unutilized foreign tax credits and unutilized allocated creditable limits for up to three years with non-consolidated companies.

4.3 Transfer Pricing

The transfer pricing legislation is set out under the Special Taxation Measures Law for the purpose of preventing tax avoidance by companies through transactions with their related overseas companies.

4.3.1 Transactions subject to Transfer Pricing Legislation

The sale of assets, purchase of assets, rendering of services and any other transactions with related overseas companies which do not meet the arm's-length concept are subject to the transfer pricing legislation. Transactions with related overseas companies conducted through unrelated companies could also be subject to this legislation.

4.3.2 Related Overseas Companies

A related overseas company for these purposes is a foreign company which has any of the following specific relationships with a domestic company:

- (i) Share holding relationship
- Relationship in which a company directly or indirectly owns 50

- percent or more of the total issued shares of the other company,
or
- Relationship in which 50 percent or more of the total issued shares of each of two companies are directly or indirectly held by the same person
- (ii) Substantial control relationship
- Direct or indirect relationship in which a company is in a position to determine the business policies of the other company, or
 - Direct or indirect relationship in which the same person is in a position to determine the business policies of each of two companies

Examples of such relationships include:

- 50 percent or more of the board of directors, or the representative directors, of a company have or used to have the position of directors or employees of the other company;
 - a substantial portion of one company's business activities relates to transactions with the other company; or
 - a substantial portion of the operating funds of one company are provided by the other company or are backed by guarantees provided by the other company.
- (iii) Combination of shareholding relationship and substantial control relationship

4.3.3 Arm's-Length Price

The transfer legislation provides for three basic methods to reach an arm's length price: (1) comparable uncontrolled price method, (2) resale price method, or (3) cost-plus method. However, it is possible to use certain other reasonable methods if the basic three methods are difficult to apply to the transactions.

- (1) Comparable uncontrolled price method

Under this method the price is determined based upon the pricing of a transaction carried out between unrelated parties which is similar in nature to the subject transaction. Where there are differences in the conditions between the comparable transaction and the subject transaction, price adjustments should be taken into account.

With respect to comparable transactions for this purpose, there are two types: (1) transactions made by one of the related companies with an unrelated company, and (2) transactions made between third parties.

(2) Resale price method

Under this method the price is calculated based on the selling price of the buyer to unrelated companies minus a gross profit which is applicable to similar transactions with unrelated companies (subject to adjustment depending upon the circumstances).

(3) Cost-plus method

Under this method the price to be applied to the transactions with related overseas companies is calculated at cost for the seller plus an ordinary profit on similar transactions with unrelated companies (subject to adjustment depending upon the circumstances).

(4) Other reasonable methods

- (i) The price calculated based on a method similar to the above three principal methods.
- (ii) Profit split method - the price calculated based on allocating the total profit arising from the overall transaction of which the transaction between the related parties is a part, based of the respective amount of expenses, fixed assets or other reasonable factors.
- (iii) Transactional net margin method - the price determined by reference to net profit on comparable uncontrolled transactions expressed as a percentage of a base factor (e.g. cost, sales, assets etc.).

4.3.4 Submission of Information and Documents

If a company has any transactions with related overseas companies, the company must attach to its corporation tax return a statement providing information on the related overseas companies and details of the transactions as follows:

Information concerning related overseas companies:

- name;
- address of head office or principal office;
- main business;
- total number of employees;
- amount of paid-in capital;
- classification of related overseas companies by nature of relationship, such as capital relationship, management relationship, business relationship and financial relationship;
- percentage of shareholding relationship of related overseas companies;
- operating revenue, expenses, operating profits and profits before tax for the preceding year;
- amount of earned surplus.

Information concerning transactions with related overseas companies:

- total amount of sales or purchases of inventories and the transfer pricing method;
- receipt or payment of compensation for services and the transfer pricing method;
- receipt or payment of rental fees for tangible assets and the transfer pricing method;
- receipt or payment of royalties for intangible assets and the transfer pricing method;
- receipt or payment of interest on loans and the transfer pricing method;
- Advance Pricing Agreement (APA) status.

For the purpose of recalculation of income derived from the transactions based on the arm's-length concept, the tax authorities may ask the company to submit necessary documents or books

maintained by the related overseas companies. In this event, the company must make efforts to submit such information or documents requested by the tax authorities as soon as possible.

If the company does not take immediate action on the request, the tax authorities may assess the arm's-length price based on an appropriate general transfer pricing methodology and recalculate taxable income as a result of such changes. If the company does not agree with the price so determined and the assessment made by the tax authorities, the company has the responsibility to prove that the price applied to the transactions with the related overseas companies is arm's-length in nature.

4.3.5 Miscellaneous

In a case where the transactions subject to this legislation are those with Specified Foreign Subsidiaries (SFSs), the taxable income of the SFS should be calculated based on the adjusted arm's-length price in order to eliminate double taxation (see Tax Haven (CFC) Rules at 4.5 below).

The statute of limitations in relation to tax investigations of transfer pricing issues is six years. The storage period of related documents is seven years. Additionally, the tax authorities are allowed to investigate the books of account of companies engaged in the same business in relation to the investigation of a taxpayer company.

A grace period for the payment of corporate tax and penalties thereon may be granted for those requesting a Mutual Agreement Procedure (MAP) under the relevant tax treaty.

4.4 Thin-Capitalization

4.4.1 Safe Harbor of Debt-Equity Ratio

The thin-capitalization rule is applicable if the ratios in (a) and (b) below for a Japanese company are both more than 3:1.

(a)	$\frac{\text{Interest-bearing debts due to overseas controlling shareholders}^{(2)} \text{ and third parties in specified cases}^{(3)}}{\text{Net equity owned by overseas controlling shareholders}^{(1)}}$
AND	
(b)	$\frac{\text{Total interest-bearing debts}}{\text{Net equity}^{(4)} \text{ of the Japanese company}}$

Alternatively, a company has the option to use the debt-equity ratio of a comparable Japanese company operating the same business, and having similar characteristics relating to size, etc., as opposed to the 3:1 safe harbor ratio.

The definitions of the key words relating to the debt-equity ratio formula above are as follows:

(1) Overseas controlling shareholders:

- A foreign company or a non-resident individual owning directly or indirectly 50 percent or more of the total outstanding shares of the Japanese company
- A foreign company in which 50 percent or more of the total outstanding shares are directly or indirectly held by a person who directly or indirectly owns 50 percent or more of the total outstanding shares in the Japanese company
- A foreign company or a non-resident individual who has control of the Japanese company's business, partly or entirely, through substantial business transactions, financing, personnel, etc.

(2) Interest bearing debts due to overseas controlling shareholders:

The average balance (daily, monthly or quarterly average) of interest bearing debts due to overseas controlling shareholders, excluding debts on which interest is subject to Japanese corporation tax in the hands of the lender.

(3) Interest bearing debts due to third parties in specified cases:

The average balance (daily, monthly or quarterly average) of interest bearing debts due to third parties in the specified cases, including debts on which interest is subject to Japanese corporation tax in the hands of the lender. The specified cases include:

- (i) back-to-back loan from overseas controlling shareholders through third parties,
- (ii) debts from a third party with a guarantee by overseas controlling shareholders, and
- (iii) debts from a third party by providing bonds borrowed from overseas controlling shareholders as collateral for the debts.

(4) Net equity:

The average balance of the net of total assets minus total liabilities. If the net is less than the total of paid-in capital and capital surplus, the latter is treated as "net equity" for the purpose of this rule.

4.4.2 Amount to be Disallowed

The amount to be disallowed under the thin-capitalization rule is calculated as follows:

(1) Where { (A) + (B) } is less than (D)

$$(c)' \quad x \quad \frac{\{ (A) + (B) + (C) - (D) \}}{(C)}$$

(2) Where { (A) + (B) } exceeds (D)

$$(c)' \quad + \quad \{ (a) + (b) + (b)' \} \quad x \quad \frac{\{ (A) + (B) - (D) \}}{\{ (A) + (B) \}}$$

The letters used in the above formula refer to the following amounts:

Debts	Interest on the debts	Guarantee fees/ Bond-borrowing fees relating to the debts (*)
(A) Interest bearing debt due to overseas controlling shareholders (Interest is <i>not</i> subject to Japanese corporation tax for the lender)	(a)	-
(B) Interest bearing debt due to third parties in specified cases (Interest is <i>not</i> subject to Japanese corporation tax for the lender)	(b)	(b)'
(C) Interest bearing debt due to third parties in specified cases (Interest is subject to Japanese corporation tax for the lender)	-	(c)'

(*): Guarantee fees and bond-borrowing fees subject to Japanese corporation tax for the recipient are not included.

(D): Net equity owned by overseas controlling shareholders x 3
(or comparable ratio)

4.4.3 Miscellaneous

- The amount to be disallowed for corporation tax purposes is not treated as a dividend for withholding income tax purposes.
- If a Japanese company has debts related to specified repo transactions, the company can choose the 2:1 threshold with exclusion of the debts related to specified repo transactions instead of the 3:1 ratio. Specified repo transactions for the purpose of this rule are lending bonds under a Japanese Repo transaction (Genkin tanpo tsuki saiken taishaku torihiki) or selling

bonds under a Gensaki transaction (Saiken gensaki torihiki) where the bonds are borrowed under a Japanese Repo transaction or purchased under a Gensaki transaction.

A foreign company which carries on business in Japan is also subject to the thin capitalization rule.

4.5 Tax Haven (CFC) Rules

The introduction of the foreign dividend exclusion (FDE) system in the tax reform of 2009 has also have a significant impact on the tax haven (CFC) rules.

4.5.1 Income inclusion

- Before the 2009 tax reform

Where a Japanese corporate or individual investor holds at least five percent ownership of a Specified Foreign Subsidiaries (SFS) at the end of an accounting period of that subsidiary, that investor is required to report, as taxable income, its proportionate share of the “taxable retained earnings” of the SFS. Such income was subject to normal corporate or income taxes alongside the investor’s other taxable income before the tax reform 2009.

Note that, at the time of the income inclusion, the foreign corporate tax incurred on the taxable retained earnings of the SFS was creditable against Japanese corporate taxes.

- After the 2009 tax reform

By virtue of the introduction of the FDE in the 2009 tax reform, the proportionate share of the “taxable income of the SFS” has become subject to corporate tax under the CFC rules instead of the “taxable retained earnings”. The creditable amount of foreign tax has also changed from the foreign corporate tax incurred on the taxable retained earnings of the SFS to the foreign corporate tax incurred on the taxable income of the SFS.

4.5.2 Specified Foreign Subsidiaries (SFS)

A Specified Foreign Subsidiary for these purposes is a company:

- (i) more than 50 percent of which is directly or indirectly owned by Japanese companies, Japanese resident individuals or non-resident individuals having a special relationship with the Japanese companies or the Japanese resident individuals. ; and
- (ii) which either:
 - has its main or head office in a country which does not impose tax on income; or
 - has an income tax burden of 25 percent or less.

In determining more than 50 percent ownership, the largest percentage of the following will be used:

- (i) the percentage of the total outstanding shares
- (ii) the percentage of the total voting rights
- (iii) the percentage of earnings allocable to shares based on dividend distribution rights

In calculating the income tax burden for these purposes, the following formula is utilized:

Tax burden (%)	=	$\frac{\text{Foreign corporation tax paid on income for the accounting period in the country in which the foreign related company's head office is located and other countries}}{\text{Taxable income for the accounting period calculated in accordance with the tax law of the country where the foreign related company's head office is located}}$
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Depending on the circumstances, it may also be necessary for certain adjustments to be made to the denominator and/or numerator when determining the tax burden under the above formula. Thus, for example, income exempted from taxation under the foreign country's

domestic laws should generally be added back to the denominator. However, there are certain exceptions to this rule, including exempt domestic dividend income and exempt foreign dividend income, the exemption on which has been granted by virtue of a minimum shareholding requirement (i.e., foreign dividends subject to a participation exemption).

4.5.3 Conditions for Exception

The tax haven rules will not be applied to a company which would otherwise be a SFS in a situation where the company meets certain substance and operational requirements.

These requirements are broadly as follows:

- (i) The SFS maintains an office, store, factory or other fixed place of business necessary to conduct its business in the country in which the head office of the subsidiary is located.
- (ii) The SFS functions with its own administration, control and management in the country in which the head office of the subsidiary is located.
- (iii) The business of the SFS is conducted mainly in the country in which the head office of the subsidiary is located.
- (iv) The business of the SFS is conducted mainly with unrelated parties.

A company conducting wholesale, banking, trust, securities, insurance, ocean transport or air transport business is required to meet (i), (ii) and (iv) above. A company conducting other forms of business is required to meet (i), (ii) and (iii). Certain businesses, however, including the holding of shares or securities, licensing of rights, or leasing of ships and aircraft cannot qualify for the exemption.

When a SFS satisfies tests (i) and (ii) but not (iii) or (iv), its taxable income subject to income inclusion is reduced by 10 percent of

certain of its personnel costs.

4.5.4 Tax Treatment of Dividends Paid by SFSs

- Before the 2009 tax reform

A dividend paid by an SFS was taxed in the hands of its Japanese parent company in the same way as a dividend paid by a foreign company that is not an SFS. The foreign tax credit (FTC) system was available for withholding tax on the dividends and foreign corporate taxes subject to certain conditions.

When such dividend was received, the amount of the dividend was generally deducted in calculating the amount of income inclusion, or such amount was treated as deductible in calculating taxable income to the extent of the amount that was already included in taxable income in the past ten years, so that double taxation of the same income in Japan (taxation under the income inclusion rule and taxation as a dividend) should not occur. If a certain amount that had already been included in taxable income in the past ten years was treated as deductible in calculating taxable income, the foreign tax credit that was recognized at the time of income inclusion was canceled.

- After the 2009 tax reform

After the 2009 tax reform, due to the introduction of the FDE, a dividend paid by an SFS is treated as follows and such amount is neither deducted in calculating the amount of income inclusion nor deductible in calculating taxable income:

SFS	Amount up to the Specified Taxed Amount ⁽¹⁾		Amount over the Specified Taxed Amount	
	Dividends	Withholding tax	Dividends	Withholding tax
Foreign Subsidiary ⁽²⁾	Fully exempt	Deductible but No Direct FTC	95% exempt (FDE)	Non-deductible No Direct FTC
Not Foreign Subsidiary			Fully taxable	Deductible or Direct FTC

- ⁽¹⁾ Specified Taxed Amount: The amount that has been taxed under the income inclusion rule in the fiscal year the dividend is received or in the fiscal years beginning within ten years before receiving the dividend⁽²⁾ Foreign Subsidiary: A foreign company 25 percent or more of whose shares are held directly by a Japanese company continuously for six months or longer as at the date on which the obligation to pay the dividends is determined.

Although the mechanism to make adjustments to avoid double taxation of the same income from an SFS (taxation under the income inclusion rule and taxation as a dividend) has been changed, in general, taxation of SFS income remains the same before and after the 2009 tax reform

4.5.5 Tax Treatment of Dividends Received by SFSs

- Before the 2009 tax reform

Before the 2009 tax reform, dividends received by an SFS constituted part of the taxable income subject to the income inclusion in the hands of its Japanese parent company, except for dividends received from another SFS of the Japanese parent company.

- After the 2009 tax reform

After the 2009 tax reform, dividends received by an SFS from its subsidiary, of which 25 percent or more of its outstanding shares are held by the SFS continuously for six months or longer as at the date on which the obligation to pay the dividends is determined, are also excluded from the amount of income inclusion, in addition to dividends received by another SFS of the Japanese parent company.

This amendment would generally mean that a Japanese company having an intermediate holding company in a low tax jurisdiction to manage various foreign subsidiaries has the same tax burden compared to a case where the Japanese company directly holds those various foreign subsidiaries without an intermediate holding company, in terms of dividends from those various foreign subsidiaries.

4.5.6 Effective Date

The new income inclusion rule is applied to income earned by an SFS for the fiscal years of the SFS beginning on or after April 1, 2009. The new rules in terms of dividends paid by an SFS are applied to dividends related to the fiscal years of the SFS beginning on or after April 1, 2009.

As there are complex transitional measures in connection with the FDE, careful consideration for dividends from an SFS is required for the time being.

4.6 Corporate Inversion

Triangular mergers may enable a Japanese company to become a subsidiary of a foreign company located in a low-tax jurisdiction and to reduce the global effective tax rate of the group. This is a so called corporate inversion. Thus, the 2007 tax reform has introduced anti-tax avoidance rules to cover corporate inversions.

If certain conditions (e.g., the foreign parent company is a paper company) are met, such reorganization is treated as a non-qualified reorganization and the deferral of the recognition of capital gains from the transfer of shares is not applicable.

Moreover, under certain circumstances, a Japanese shareholder of the foreign parent company may be required to include in its taxable income an appropriate portion of the taxable income of the foreign parent company, even if the ownership of the foreign parent company by the Japanese shareholder is less than five percent.

4.7 Taxation of Foreign Companies and Individuals / Tax Treaties

This section covers the main items of the tax treatment of foreign companies and non-resident individuals not having a permanent establishment (PE) in Japan and the effect of relevant tax treaties.

Chapter 2 covers the taxation of income derived through a partnership and Chapter 3 covers the short-term visitor rule for non-resident individuals. Also, with regards to the taxation of a foreign company having a PE in Japan, please see Chapter 1.

4.7.1 Tax Treaties

Japan has concluded tax treaties with the following countries as at the time of writing:

Australia	Fiji	Malaysia	Spain
Austria	Finland	Mexico	Sri Lanka
Bangladesh	France	Netherlands	Sweden
Belgium	Germany	New Zealand	Switzerland
Brazil	Hungary	Norway	Thailand
Brunei Darussalam ^(*)	India	Pakistan	Turkey
Bulgaria	Indonesia	Philippines	UK
Canada	Ireland	Poland	US
China (PRC)	Israel	Romania	USSR ⁽²⁾
Czechoslovakia ⁽¹⁾	Italy	Singapore	Vietnam
Denmark	Kazakhstan ^(*)	South Africa	Zambia
Egypt	Luxembourg	South Korea	

- (1) Covers Czech Republic and Slovakia
 (2) Covers Russia, Georgia, Kyrgyz, Tajikistan, Uzbekistan, Ukraine, Turkmenistan, Armenia, Moldova, Azerbaijan and Belarus
 (*) Concluded but not yet effective as of November 20, 2009.

Recently, the Japanese government has been quite actively updating the existing tax treaties and concluding new tax treaties and tax agreement as follows:

	Status	Effective dates of the amendments for Japanese taxes
U.S.	Revised tax treaty - signed in November 2003.	- Withholding tax (WHT): July 1, 2004 - Tax other than WHT: Taxable year beginning on or after January 1, 2005
U.K.	Revised tax treaty - signed in February 2006.	- WHT: January 1, 2007 - Tax other than WHT: Taxable year beginning on or after January 1, 2007
India	Revised protocol – signed in February 2006	- WHT: July 1, 2006 - Tax other than WHT: Taxable year beginning on or after January 1, 2007
France	Revised protocol – signed in January 2007	- WHT: January 1, 2008 - Tax other than WHT: Taxable year beginning on or after January 1, 2008
Philippines	Revised protocol – signed in December 2006	- WHT: January 1, 2009 - Tax other than WHT: Taxable year beginning on or after January 1, 2009

Pakistan	Revised tax treaty – signed in January 2008	- WHT: January 1, 2009 - Tax other than WHT and business taxes: Taxable year beginning on or after January 1, 2009
Australia	Revised tax treaty – signed in January 2008	- WHT: January 1, 2009 - Tax other than WHT: Taxable year beginning on or after January 1, 2009
Kazakhstan	New tax treaty – signed in December 2008	
Brunei Darussalam	New tax treaty – signed in January 2009	- WHT: January 1, 2010 - Tax other than WHT: Taxable year beginning on or after January 1, 2010
Netherlands	Negotiation to revise the current tax treaty – started in June 2004	
UAE	Negotiation to conclude a tax treaty – started in November 2006	
Kuwait	Basic agreement for conclusion of a tax treaty – reached in January 2009	
Saudi Arabia	Basic agreement for conclusion of a tax treaty – reached in June 2009	
Switzerland	Basic agreement to revise the current tax treaty – reached in June 2009	

In addition, Japan and Bermuda agreed in principle on an Agreement centered on the exchange of information in June 2009, which is the first agreement centered on the exchange of information for Japan.

The tax treaties entered into by Japan generally accord with the principles of the OECD Model Tax Treaty and tax treaties recently signed tend to include provisions dealing with hybrid/transparent entities and anti-treaty shopping provisions (e.g., the Limitation on Benefits provision, anti-conduit provisions and main-purpose test provisions).

4.7.2 Dividends, Interest and Royalties

Japanese withholding income tax will ordinarily be imposed on dividend, interest and royalty payments to foreign companies and non-resident individuals. The normal withholding rate is 20 percent (but for dividends from certain listed shares, etc., is reduced to 7 percent until December 31, 2011 and, is 15 percent thereafter, and in certain limited cases for interest is 15 percent), however reduced tax rates are available under Japan's tax treaties for foreign investors not having a PE in Japan. In order to obtain the reduction (or exemption) of Japanese withholding tax under a tax treaty, the recipient or his/her agent should, before the date of payment, submit an application form for relief from Japanese income tax to the chief of the relevant district tax office through the payer of the income.

The rates of withholding tax under the respective tax treaties are as set out below. Note that these are general rates only and different rates or exemptions may apply to specific cases. The percentages in parentheses under the dividends heading represent the minimum ownership ratio of the parent company in, broadly, the capital stock of the subsidiary to qualify for the reduced parent/subsidiary tax rate.

Name of country	Dividends		Interest	Royalties	
	Between Parent and Subsidiary	Other			
Australia	0%	(80%)	5-10%	0-10%	5%
Austria	10%	(50%)	20%	10%	10%

Bangladesh	10%	(25%)	15%	10%	10%
Belgium	10%	(25%)	15%	10%	10%
Brazil	12.5%		12.5%	12.5%	12.5-25%
Brunei Darussalam	5%	(10%)	10%	0-10%	10%
Bulgaria	10%	(25%)	15%	10%	10%
Canada	5%	(25%)	15%	10%	10%
China (PRC)	10%		10%	10%	10%
Czechoslovakia ⁽¹⁾	10%	(25%)	15%	10%	0-10% ⁽⁵⁾
Denmark	10%	(25%)	15%	10%	10%
Egypt	15%		15%	-	15%
Fiji ⁽²⁾	-	-	-	-	10%
Finland	10%	(25%)	15%	10%	10%
France	0%	(15% directly or- 25% directly or indirectly)	5-10%	0-10%	0%
Germany	10%	(25%)	15%	10%	10%
Hungary	10%		10%	10%	0-10% ⁽⁵⁾
India	10%		10%	10%	10%
Indonesia	10%	(25%)	15%	10%	10%
Ireland	10%	(25%)	15%	10%	10%
Israel	5%	(25%)	15%	10%	10%
Italy	10%	(25%)	15%	10%	10%
Kazakhstan	5%	(10%)	15%	0-10%	5%
Luxembourg	5%	(25%)	15%	10%	10%
Malaysia	5%	(25%)	15%	10%	10%
Mexico	0-5%	(25%)	15%	10-15%	10%
Netherlands	5%	(25%)	15%	10%	10%
New Zealand	15%		15%	-	-
Norway	5%	(25%)	15%	10%	10%
Pakistan	5%	(50%)	7.5%-10%	10%	10%
Philippines	10%	(10%)	15%	0-10%	10-15%
Poland	10%		10%	10%	0-10% ⁽⁵⁾
Romania	10%		10%	10%	10-15%
Singapore	5%	(25%)	15%	10%	10%
South Africa	5%	(25%)	15%	10%	10%

South Korea	5%	(25%)	15%	10%	10%
Spain	10%	(25%)	15%	10%	10%
Sri Lanka	20%		20%	-	0-10% ⁽⁴⁾
Sweden	0-5%	(25%)	15%	10%	10%
Switzerland	10%	(25%)	15%	10%	10%
Thailand	15-20%	(25%)	-	10-25%	15%
Turkey	10%	(25%)	15%	10-15%	10%
UK	0%	(50%)	5-10%	0-10%	0%
US	0%	(50%)	5-10%	0-10%	0%
USSR ⁽³⁾	15%		15%	10%	0-10% ⁽⁵⁾
Vietnam	10%		10%	10%	10%
Zambia	0%		0%	10%	10%

(1) Covers Czech Republic and Slovakia

(2) The original tax treaty with the U.K. is eligible for Fiji, with exceptions for dividends and interest, to which domestic tax rates are applied.

(3) Covers Russia, Georgia, Kyrgyz, Tajikistan, Uzbekistan, Ukraine, Turkmenistan, Armenia, Moldova, Azerbaijan and Belarus

(4) 50% of certain royalties are exempt and royalties for copyright or cinema films are fully exempt.

(5) Cultural royalties are exempt.

4.7.3 Real Estate

Capital gains from the transfer of real estate located in Japan by a non-resident individual or a foreign company are subject to income tax or national corporation tax, respectively. The law also provides for a surtax on such gains for companies at a rate in the range 5-10 percent. However, this surtax is currently suspended until December 31, 2013.

Withholding tax at 10 percent is generally assessed on the proceeds from a transfer of real estate by a non-resident individual or foreign company. Final settlement of the tax liability on any capital gain arising will be computed on an individual or corporation tax return. The income tax withheld from the sale proceeds will be creditable on this return against the final tax liability, or will be refundable to the extent that the withholding tax amount is greater than the tax on the capital gain.

Japan's tax treaties have no provisions to reduce the tax burden under the domestic tax law as detailed above.

4.7.4 Shares in a Real Estate Holding Company

■ Taxation under Japanese domestic tax law

Capital gains from a disposition of shares in real estate holding companies or a beneficial interest in real estate holding specified trusts by a foreign investor (both individuals and companies) are taxed in Japan and the foreign investor is required to file a tax return to declare such income.

- Real estate holding company

A real estate holding company is defined as a company where the fair market value of its real property interests prescribed below equals or exceeds 50 percent of the fair market value of its total assets. Either domestic companies or foreign companies can be real estate holding companies.

- (i) Land, buildings, attachments to buildings and structures situated in Japan
- (ii) Beneficial interests in real estate holding specified trusts
- (iii) Shares in other real estate holding companies

A real estate holding specified trust is defined in a similar way to the above.

- Safe harbor rule

There is a safe harbor rule, which excludes minority shareholders from this taxation system. If either of the following cases applies, a foreign investor is not taxed on capital gains on a disposal of shares in real estate holding companies and beneficial interests in real estate holding specified trusts.

- (i) Where the aggregate shareholding in the real estate holding company of the foreign investor and related persons* as of the day prior to the beginning of the year including the disposal day

was five percent or less (two percent or less for unlisted companies) of the total issued shares of the company

- (ii) Where the aggregate beneficial interest in the real estate specified trust of the foreign investor and related persons as of the day prior to the beginning of the year including the disposal day was five percent or less (two percent or less for unlisted trusts) of the total interest of the trust

- Related persons

“Related persons” of the foreign investor in the above are

- (i) family relatives of the foreign investor (if the investor is an individual),
- (ii) a company directly or indirectly controlled ⁽¹⁾ by the foreign investor,
- (iii) a company directly or indirectly controlled by a person which controls the foreign investor, and
- (iv) where the foreign investor holds shares in a real estate holding company through an NK-type partnership ⁽²⁾, any other partners of the partnership.

⁽¹⁾: If a company holds more than 50 percent of the total outstanding shares or more than 50 percent of the voting rights in another company, the latter company is treated as being “controlled” by the former company.

⁽²⁾: The definition of NK-type partnerships for the purposes of this rule is the same as that described in Chapter 2 above.

If the foreign investor owns shares in a real estate holding company through two or more partnerships, all partners of those partnerships are treated as “related persons” for the foreign investor. Note that the aggregate shareholding in a real estate holding company does not include shares that these other partners hold not through those partnerships.

- Taxation under tax treaties

The tax treaties which Japan has concluded with the following countries protect foreign shareholders fully from Japanese tax on capital gains from sales of shares in a real estate holding company.

Belgium	Hungary	Poland
Brazil	Indonesia	Romania
Czechoslovakia	Ireland	Spain
Finland	Italy	Switzerland
Germany	Netherlands	Zambia

The following countries and Japan have concludes tax treaties which give the taxing right to Japan only when the real estate company is a domestic company.

Bulgaria	Korea	US
India	USSR	

A foreign investor who is a resident of the following countries will be liable to Japanese tax on capital gains from sale of a real estate holding company only if the foreign shareholder falls under the substantial shareholder criteria discussed in 4.7.5.) and the real estate holding company is a domestic company.

Austria	Denmark
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4.7.5 Shares in a Domestic Company

■ Taxation under Japanese domestic tax law

Capital gains from the sale of shares in a domestic company by a foreign investor (both individuals and companies) are subject to Japanese national corporation or income tax in the circumstances described below:

- (i) Gains arising from the sale of forestalled shares (shares acquired for the purpose of a takeover of a company or a demand sale of such shares) in a domestic company; or

- (ii) Gains arising from the sale of a substantial interest in a domestic company, being a sale made by a foreign investor of 5 percent or more of the outstanding shares of a domestic company within one taxable year, where the seller investor has held 25 percent or more of such outstanding shares at any time during the taxable year of sale or during the two preceding years.

When judging the threshold of 25 percent and five percent in (ii) above, the judgment should be made by looking at the aggregate shareholding in the domestic company of the foreign shareholder and related persons of the foreign shareholder.

“Related persons” of the foreign investor in the above are

- (i) family relatives of the foreign shareholder (if the shareholder is an individual),
- (ii) a company directly or indirectly controlled ⁽¹⁾ by the foreign shareholder,
- (iii) a company directly or indirectly controlled by a person which controls the foreign shareholder, and
- (iv) where the foreign shareholder holds shares in a Japanese company through an NK-type partnership ⁽²⁾, any other partners of the partnership.

⁽¹⁾: If a company holds more than 50 percent of the total outstanding shares or more than 50 percent of the voting rights in another company, the latter company is treated as being “controlled” by the former company.

⁽²⁾: The definition of NK-type partnerships for the purposes of this rule is the same as that described in Chapter 2.

If the foreign shareholder owns shares in a Japanese company through two or more partnerships, all partners of those partnerships are treated as “related persons” for the foreign shareholder. Note that the aggregate shareholding in a Japanese company does not include shares that these other partners hold not through those partnerships.

An exceptional rule introduced under the 2009 tax reform is

applied to disposals on or after April 1, 2009. Under the rule, in either of the following cases, “related persons” of a foreign investor do not include other partners of the partnership in determining the shareholding ratio, except for cases where the holding period of the shares is less than one year, or where shares in a bankrupt financial institution are transferred:

- (i) disposals of shares by a Specified Foreign Partner ^(*) through an Investment Fund ^(*), or
- (ii) disposals of shares by a foreign partner of an Investment Fund^(*) through the Investment Fund, provided that the foreign partner has no PE in Japan, and has been a limited partner of the Investment Fund and has not been involved in the operation of the Investment Fund for the year of disposal and the past three years.

^(*) Please see Chapter 2.1.2 for the definition of the “Specified Foreign Partner” and “Investment Fund”.

■ Taxation under tax treaties

If a foreign investor is a resident of a country that has concluded a tax treaty with Japan and the tax treaty provides for protection from Japanese taxation on capital gains from a disposal of shares, taxation in Japan will be avoided.

Certain modifications and limitations on the above rules regarding taxation of capital gains on the sales of shares in domestic companies are included under a number of Japan’s double tax treaties. Full exemption from Japanese taxation on capital gains on the sale of shares exists in Japan’s double tax treaties with the following countries:

Australia ⁽¹⁾	Indonesia	Spain
Belgium	Ireland	Switzerland
Brazil	Italy	UK ⁽¹⁾
Czechoslovakia	Netherlands	US ⁽³⁾
Finland	Philippines ⁽²⁾	Zambia

Germany	Poland	
Hungary	Romania	

- (1) Exemption is available if the Japanese company in which shares are sold is not a real estate holding company and the capital gains are subject to tax in the foreign investor's country of residence. Note that due to a U.K. domestic tax rule, the capital gains on shares in a Japanese subsidiary are most likely not subject to tax in the U.K.
- (2) Exemption is not applicable in relation to real estate holding companies.
- (3) Exemption is not applicable in relation to real estate holding companies or certain government resuscitated companies.

5 Indirect Tax

5.1 Consumption Tax

Japanese consumption tax is a sales based tax applied on supplies of certain goods and services within Japan. It is similar in nature to European VAT and Australian GST. The current rate of consumption tax applied to taxable transactions is five percent.

5.1.1 Taxable Transactions

Taxable transactions for consumption tax purposes are the following transactions when carried out for consideration as part of a business carried on by an individual or company:

- (i) the sale or lease of an asset in Japan; and
- (ii) the supply of services in Japan;

However, there are a number of transactions which are specifically excluded from being taxable transactions as non-taxable transactions. The main non-taxable transactions are:

- Sales or leases of land.
- Sales of securities and similar instruments (not including golf-club membership rights and other similar items, but including foreign securities).
- Monetary transactions including loans, guarantees, distributions from joint operation trusts or other investment trusts and insurance premiums.
- Transfers of postage stamps, revenue stamps, etc. by the central and local governments (including foreign postage stamps, etc).
- Specified activities carried out by the central and local governments, such as registration and certification activities, as well as handling charges for foreign-exchange transactions.
- Medical treatment under public medical insurance law.
- Social welfare activities.
- School tuition and examination services.

- Rental of housing.
- Services related to childbirth, burial, homehelp and welfare centers for aged and handicapped persons.

From the perspective of the vendor/service supplier in a domestic taxable transaction, the transaction is a “domestic taxable sales transaction” whilst from the perspective of the purchaser/service recipient, the transaction is a “domestic taxable purchase transaction”. Consumption tax imposed on a taxable transaction is called “output tax” for the vender/service supplier and “input tax” for the purchaser/service recipient.

In addition to the taxable transactions identified above (domestic taxable transactions), the removal of foreign goods from a bonded area (i.e. import of goods) also represents a taxable transaction for consumption tax purposes (import taxable transactions). Consumption tax imposed on importation is called “import input tax” for the importer.

5.1.2 Export Transactions

Export transactions, including the transfer or lease of goods representing an export from Japan as well as other export-related activities such as international transportation are treated as export exempt transactions, to which an effective zero percent consumption tax rate is applied. It is not necessary to collect or account to the government for consumption tax on such transactions.

Services provided to a non-resident will also be treated as export transactions, except in the case of transport or storage of assets in Japan, provision of accommodation and food in Japan, or provision of services of a similar nature in Japan.

5.1.3 Taxpayers

(1) Consumption taxpayer required to file a consumption tax return

Whilst broadly anyone, whether a consumer or a business enterprise, acquiring goods and services in Japan will suffer a consumption tax

charge on those transactions, the concept of a “taxpayer” for consumption tax purposes specifically relates only to those companies or individuals which are required to file a consumption tax return to the Japanese government.

For any taxable year in which the annualized value of a business operator’s domestic taxable sales transactions and export exempt sales transactions in the taxable year prior to the preceding year did not amount to more than JPY 10 million, the operator will not be treated as a consumption taxpayer unless a selection is made for such status. Note however that a newly established company having share capital of at least JPY 10 million, or equivalent, will have mandatory taxpayer status for the first two taxable years.

One consequence of the consumption taxpayer criteria above is that in certain circumstances even large businesses commencing operations in Japan can have no obligation to take on consumption taxpayer status for the first two taxable years of operations in Japan. Not having consumption taxpayer status can have both positive and negative impacts depending upon the specific activities of the business and its sales and purchase profile. For example, where the total amount of input tax exceeds the total amount of output tax for a taxable period, a person not having taxpayer status can not claim a refund, while a consumption taxpayer can claim a refund of the excess portion. It is thus necessary to consider carefully whether or not a voluntary selection for consumption taxpayer status should be made in such circumstances.

A selection for voluntary consumption taxpayer status must ordinarily be made prior to the commencement of the first taxable year for which it will apply. However, in the first taxable year of a business enterprise, the selection can apply from the commencement of business where the selection is made prior to the end of that taxable year. Where a selection is made, this cannot then be cancelled for at least two years.

(2) Importer

For the purposes of import taxable transactions, an importer (any

individual or company importing goods into Japan) must pay consumption tax to the government (Customs Office) unless the importation is tax-exempt under a threshold rule.

Consumption tax on importation is imposed on any importer regardless of whether the importation is carried out for business purposes. Thus, individuals importing goods as consumers can be an import input taxpayer. Where an individual or company pays consumption tax on its importation, that individual or company does not automatically become a consumption taxpayer required to file a consumption tax return.

5.1.4 Taxable Base

The taxable base for a domestic taxable transaction is the consideration for the transaction.

In the case of import taxable transactions, the taxable base is the value of the imported goods for customs duty purposes (i.e. normally, the CIF price) plus the amount of any customs duties and other excise taxes.

5.1.5 Tax Rate

The current rate is five percent, effectively comprising four percent for national consumption tax and one percent for local consumption tax.

5.1.6 Computation of Consumption Tax to be paid

Consumption tax to be declared in a consumption tax return and to be paid over to the government by a consumption taxpayer should generally be calculated based on the net of consumption tax received on domestic taxable sales transactions for the taxable period (output tax) minus consumption tax suffered on domestic taxable purchase transactions and import taxable transactions for the same taxable period (input tax), but to the extent of the creditable amount. When creditable input tax suffered in a taxable period exceeds the output tax in the same period, a refund of the difference will be made.

The creditable input tax is calculated depending on the taxable revenue ratio as follows:

Taxable revenue ratio	Creditable input tax
95% or more:	Total input tax (i.e., fully creditable)
less than 95%:	Creditable input tax is calculated by [1] Individual method, or [2] Pro-rata method

Note:

- Taxable revenue ratio

$\frac{\text{Domestic taxable sales} + \text{Export exempt sales}}{\text{Domestic taxable sales} + \text{Export exempt sales} + \text{Domestic non-taxable sales}^{(*)}}$

Note:

The amounts of sales do not include output tax.

(*) As for sales proceeds of securities, only five percent of the proceeds should be included.

- Total input tax

$\text{Total gross value of domestic taxable purchase transactions (including input tax)} \times \frac{5}{105} + \text{Input tax on import transactions}$

- Individual method

$(a) + (c) \times \text{Taxable revenue ratio}^{(*)}$

Note:

(a) Input tax relating to the acquisition of goods/services solely

attributable to sales transactions other than domestic non-taxable sales transactions

- (b) Input tax relating to the acquisition of goods/services solely attributable to domestic non-taxable sales transactions
- (c) Input tax other than above

(*) An appropriate alternative ratio may be utilized where this is approved in advance by the tax authorities

- Pro-rata method

$\text{Total input tax} \times \text{Taxable revenue ratio}$

If this method is chosen, it should be used at least for two years.

5.1.7 Special Treatment for Small Businesses

There are special provisions aimed at easing the administrative burden of consumption taxpayer compliance for small business operators.

- Simple calculation method

A simple calculation method, as described below, is applicable to individual and corporate taxpayers the annualized value of whose domestic taxable sales and export exempt sales for the taxable year prior to the preceding taxable year was JPY 50 million or less. The taxpayer must submit an appropriate report to the competent tax office in order to utilize this method and once applied, this method must be put to use for at least two years.

Taxpayer business	Consumption tax to be paid
Wholesale	Domestic taxable sales x 10% (assumed profit margin) x 5%
Retail	Domestic taxable sales x 20% (assumed profit margin) x 5%

Manufacturing, construction, mining, agriculture and fishing	Domestic taxable sales x 30% (assumed profit margin) x 5%
Service, transportation, communication and real estate	Domestic taxable sales x 50% (assumed profit margin) x 5%
Other than above	Domestic taxable sales x 40% (assumed profit margin) x 5%

■ Tax exemption status

As discussed at section 5.1.3 above, individual and corporate taxpayers the annualized value of whose domestic taxable sales and export exempt sales for the taxable year prior to the preceding year was not more than JPY 10 million will not be treated as consumption taxpayers for the current taxable year. The applicability of this exemption decreased considerably with the reduction of the threshold limit from JPY 30 million to JPY 10 million from taxable years starting on or after April 1, 2004.

5.1.8 Taxable Period and Tax Payment

The taxable period is the calendar year in the case of individuals and the respective accounting period in the case of companies. However, upon selection, the taxable period may be on a quarterly basis rather than on an annual basis (i.e. the periods from January to March, April to June, July to September, and October to December in the case of individuals and every three months starting from the commencement date of the respective accounting period in the case of companies). A monthly period is also available upon selection.

Consumption tax is payable within two months after the end of the taxable period together with submission of the final tax return. Provisional payment of consumption tax is also required for the first six months of an annual taxable period either on a pro-rata basis (i.e. , one-half of the tax paid for the preceding taxable year), or on an

interim basis (i.e., tax calculated based on actual operating results for the first six months of the annual taxable year concerned). However, a provisional payment of consumption tax is not required if the consumption tax payable for the prior taxable period was not more than JPY 600,000. Also, quarterly filing is mandatory if consumption tax payable for the previous taxable period exceeded JPY 5 million; in such a case, consumption tax for the first three quarterly filings is one-quarter of the consumption tax paid for the previous taxable year or, by selection, the actual results for the current quarter. Taxpayers who paid consumption tax in excess of JPY 60 million for the prior taxable period will be required to make a monthly interim payment of taxes during the current taxable period.

In the case of import taxable transactions, consumption tax is generally payable at the time of delivery from the bonded area.

5.2 Customs Duty

Customs duty is levied on goods entering Japan. The rates vary by product type.

5.3 Excise Duty

Excise duty is imposed on gasoline, tobacco, and liquor, etc.

6 Other Taxes and Surcharges

6.1 Social Security and Payroll Taxes

Contributions to the national social and labor insurance systems are required in respect of employees in Japan.

Premiums are borne by employers and employees as of September 1, 2009, as shown below.

(JPY)

	Employee share	Employer share	Maximum monthly premium
Health Insurance ⁽¹⁾			
On salaries ⁽²⁾	4.09%	4.09%	98,978
On bonuses	4.09%	4.09%	⁽⁴⁾ 441,720
Health Insurance ⁽¹⁾ (including nursing care premium)			
On salaries ⁽²⁾	4.685%	4.685%	113,377
On bonuses	4.685%	4.685%	⁽⁴⁾ 505,980
Welfare pension insurance			
On salaries ⁽²⁾	7.852%	7.852%	97,364.80
On bonuses	7.852%	7.852%	235,560
Labour insurance ⁽³⁾			
Employment insurance	0.4-0.5%	0.7-0.9%	-
Workman's accident compensation:			
- Non-manufacturing	-	0.3-0.4% (generally)	-
- Manufacturing	-	Variable	-

⁽¹⁾ Premiums for health insurance were set at a flat rate regardless of the domicile of the employer's office before September 2009.

However, a variable premium rate in the range of 8.15 percent to 8.26 percent is set in each prefecture depending on the domicile of the employer's office, effective from September 2009. Rates and maximum monthly/annual premiums above are those for offices located in Tokyo

- (2) Applied to standard monthly remuneration amount
- (3) Applied to total salary, bonus and other compensation paid to employees
- (4) Maximum annual premium

Contributors who are 40 years of age or older are required to join a supplementary health insurance system, the nursing care insurance system (Kaigo hoken). In the above table, total health insurance premiums for Kaigo Hoken and non-Kaigo Hoken members are separately shown. Kaigo Hoken is specifically intended to support elderly residents who require nursing care.

6.2 Stamp Duty

Stamp duty is imposed on certain taxable documents such as deeds and contracts. The levy is either based on the value involved or a flat rate. The maximum stamp duty liability is generally JPY 600,000.

6.3 Fixed Assets Tax and City Planning Tax

Fixed assets tax is assessable on both real property and depreciable assets which are in use in a business as at 1 January each year. The tax is levied at 1.4 percent of the higher of the net book value and the assessed value of depreciable assets, and 1.4 percent of the assessed value of real estate.

In addition, city planning tax is assessable on real property at 0.3 percent of the assessed value.

6.4 Business Occupancy Tax

This tax is assessable by "designated cities" (determined from

among those having a population of 300,000 or more), as follows:

6.4.1 Taxpayer

Companies or individuals operating a business at a place of business in a designated city.

6.4.2 Taxable basis

- (1) Space of premises for business use
- (2) Gross payroll

6.4.3 Tax rate

- (1) On space for business use: JPY600 per square meter (not assessable where the total space is not more than 1,000 square meters).
- (2) On gross payroll: 0.25 percent (not assessable where the number of staff members, including officers, is not more than 100).

6.4.4 Method of collection of business occupancy tax

- (1) Companies:
A return is required to be filed within two months after the end of each accounting period and the tax paid thereon.
- (2) Individuals:
A return is required to be filed for each calendar year by March 15 of the following year and the tax paid thereon.

6.5 Registration and Real Property Acquisition Tax

When certain information is legally registered, this is subject to a registration tax. Key registration events giving rise to such tax include the registration of a domestic company or a branch of a foreign company and registration of a change in the legal ownership of real estate.

The following registration taxes apply on the establishment of an ordinary domestic company or branch:

- Kabushiki Kaisha – 0.7 percent of paid-in capital (minimum JPY 150,000)
- Godo Kaisha – 0.7 percent of paid-in capital (minimum JPY 60,000)
- Branch of a foreign company – JPY 90,000 (or JPY 60,000 in certain limited circumstances)

On the transfer of real estate, the rate of registration tax will depend upon the nature of the transfer. The tax rates applied to the appraised value of the property are summarized below.

	As of April 1, 2009
Transfer of ownership by sale	1% (Land) ^(*) 2% (Buildings)
Transfer of ownership by merger	0.4%
Entrusting of real estate	0.2% (Land) ^(*) 0.4% (Buildings)

(*) Applicable for the period from April 1, 2006 through March 31, 2011

On the acquisition of real estate, a local tax, real estate acquisition tax, will also be applied. This tax is levied at four percent of the appraised value of the property, however this has been reduced to 3 percent until March 31, 2012 for land and residential buildings. Furthermore, when land is acquired by March 31, 2012, the tax base of such land will be reduced by 50 percent.

6.6 Inheritance and Gift Taxes

Generally, beneficiaries domiciled in Japan are subject to inheritance or gift taxes on assets received regardless of the location of those assets, whilst beneficiaries not domiciled in Japan are subject to tax only if the particular assets is situated in Japan. However, a non-domiciled person who satisfies both of the following conditions

becomes subject to Japanese inheritance/gift tax even when he/she inherits or is gifted non-Japanese assets:

- He/she has Japanese nationality
- Either the heir or deceased/donor had domicile in Japan at any time within five years before the deceased's death or the gift.

Rates for both taxes range from 10 percent to 50 percent.

KPMG Tax Corporation

Tokyo Office

Izumi Garden Tower,
1-6-1 Roppongi, Minato-ku, Tokyo
106-6012

Tel 03-6229-8000

Fax 03-5575-0766

Osaka Office

Epson Osaka Building 14F,
3-5-1, Bakuro-machi, Chuo-ku,
Osaka 541-0059

Tel 06-4704-3188

Fax 06-4704-3962

Nagoya Office

Dainagoya Building 5F,
3-28-12 Meieki, Nakamura-ku,
Nagoya 450-0002

Tel 052-569-5420

Fax 052-551-0580

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