

Japan tax bulletin

ASG Tax Corporation
Quarterly Newsletter
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Our newsletter keeps international companies and investors up to date with all the latest tax and business developments in Japan.

2007 Tax Reform

Japan's Tax Commission, in early December 2006, proposed to Japan's ruling coalition several changes to the tax code for fiscal 2007. The coalition has since adopted several of these reforms and plans to introduce them at the start of the 2007 fiscal year. There have also been significant reforms to Japan tax treatment of trusts and these changes will be addressed in our next newsletter. Further details of the 2007 reforms are expected to be released in the coming months. What follows are details of the reforms currently to hand.

Depreciation

The allowable limit for depreciable assets has been increased from 95% to 100% and will apply to assets purchased after March 31st, 2007*. Below is an outline of the changes.

* For assets bought after April 1st, 2007 the depreciation rate for the declining balance method will be 2.5 times the depreciation rate for the straight-line method (1/useful life).

Pre and post reform comparison of Japan's depreciation rules

Japan's Depreciation Rules	Pre-reform	Post-reform
Allowable limit for the depreciation of assets	95% (Residual value remaining = 5%)	100% (Book Value when asset has been fully depreciated = 1 Yen)
Percentage of cost able to be depreciated annually	90%	100%

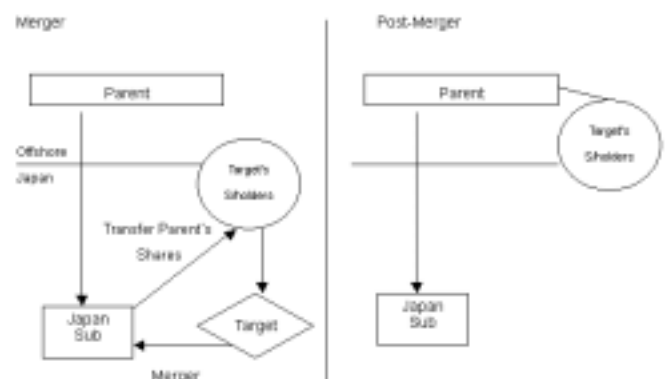
The 95% limit will still apply to assets purchased on or before March 31st, 2007, however the remaining 5% can

be depreciated over five years from the time the limit has been reached.

Depreciation periods for companies will be reduced, with the ceiling on depreciation rules removed to better align Japanese policy with OECD standards. Another corporate asset depreciation rule provision in the reform shortens the depreciation period for plasma and liquid crystal display panel equipment, and other high-tech manufacturing equipment from 10 years to five years.

Triangular mergers

Amendments to Japan's Corporation's Law, effective 1 May 2007, will allow foreign corporations to acquire Japanese corporate targets by allowing them to use shares of the foreign corporations as consideration (referred to as a "triangular merger"). Foreign corporations are prohibited from merging directly with Japanese corporations under current Japanese law.



In a triangular merger, the shareholders of the target company receive shares in the foreign parent company in consideration for their shares in the target company. Therefore, if the purchase price of the shares in the target company was 100 and the value of the parent's shares at the time of the merger transaction is 150, the target's shareholders will realize a gain of 50 on the merger.

The 2007 reform proposals with respect to the taxation of triangular mergers is as follows:

If the target company's Japan resident shareholders receive only shares in the parent company as consideration for the merger, taxation of such capital gain can be deferred until such shares are subsequently sold. Any cash or assets other than shares received by the target company's Japan resident shareholders will not be able to defer such taxation. In the case of non-resident shareholders of the target company, tax deferral on any gain made on the receipt of shares in the parent company will not be allowed.

In cases where the foreign parent company is deemed to be a "tax haven company", and the merging Japanese company has no business substance, the merger will not be treated as qualified one, in which case the deferral of capital gains will not be allowed.

Dividend income from owning shares in Japanese listed companies

For individuals resident of Japan, dividend income earned from owning shares in Japanese listed companies is taxed separately from other income and currently subject to a reduced rate of 10% (7% national and 3% local), instead of the usual 20% (15% national and 5% local). This treatment has been extended until 31 March 2009 under the reforms.

In cases where the investor is a non-resident of Japan and the dividend income is not attributable to a Permanent Establishment (PE) in Japan, the dividend will only be subject to withholding tax at the national tax rate of 7%.

Capital gains from sale of shares in Japanese listed companies

For individuals resident of Japan, any capital gain earned from the sale of shares in Japanese listed companies is taxed separately and currently subject to a reduced rate of 10% (7% national and 3% local), instead of the usual 20% (15% national and 5% local). This treatment has been extended until 31 December 2008 under the reforms.

For non-residents of Japan with no PE in Japan, any gain from the sale of shares in a Japanese listed company is subject to 15% capital gains tax. However, any capital gain made by a non-resident on the sale of either listed or unlisted shares will not be subject to tax in Japan unless:

- (i) the investor owns 25% or more of the listed corporation at any time during the fiscal year of the sale or any time during the previous two fiscal years and 5% or more of the shares in corporation are disposed of during any given fiscal year,
- (ii) 50% or more of the total asset value of the Corporation is that of real properties located in Japan,

- (iii) the investor sells stocks in a domestic corporation it has previously threatened to take over back to the corporation, at a price higher than the price at which the shares were purchased. This is commonly known as a "greenmailing".

Specified Family Corporations – taxation of retained earnings

The following were first published by Tax Notes International, 23 January 2007.

A specified family corporation is defined as being a company in which one of its stockholders or related entities holds 50 percent or more of the total number or amount of stocks issued.

An additional tax is levied on excess retained earnings accumulated by such corporations. The amount of retained earnings is reduced by the greater of:

1. 40% (50% for small and medium sized companies) of the corporation's taxable income for the year,
2. JPY20 million per year, or
3. the difference between 25% of the corporation's capital and its retained earnings at the end of the year.

This additional tax for family corporations is assessed on the following amounts of retained earnings.

Excess retained earnings amount	Additional tax rate
Up to JPY30 million	10%
More than JPY30 million but not exceeding JPY100 million	15%
More than JPY100 million	20%

Under current law, however, there is an exception for small and medium sized companies, which satisfy certain conditions as prescribed in the *New Enterprise Creation Promotion Law*, for their first ten years. A family corporation with paid-in-capital of JPY100m or less, with an approved innovative business plan under the law, and a shareholders' equity ratio of not more than 50%, is not subject to the additional tax on retained earnings for tax years beginning between 1 April 2003 to 31 March 2006. The Shareholders' equity ratio is the shareholders equity amount divided by the company's total assets.

Shareholders' equity includes capital, additional paid-in capital, retained earnings and loans from shareholders to the family corporation.

Under the tax reforms all small and medium sized family companies will no longer be subject to the tax.

Special Control Family Corporations – Deductibility of Directors' salaries

A "special control family corporation" is defined as being a corporation in which an individual and / or related investors holds stocks equivalent to 90 percent or more of the total number or amount of issued stocks. Currently, if

a company's taxable income is less than JPY8m, the salary paid to its director(s) is fully deductible. Under the 2007 tax reforms, this threshold amount has been increased to JPY16m.

Gift tax tax-free threshold

Prior to the reforms, a child-recipient of a gift of unlisted stocks worth up to JPY25m from his/her parent or legal guardian, can elect for the gift to be taxed on an integrated tax basis, subject to the following conditions:

- the share transfer is made to the child between 1st January 2007 and 31st December 2008
- the parent/legal guardian must be aged over 60
- the total value of stocks issued by the company must be less than 2 billion yen
- the parent/legal guardian owns at least 50% of all issued stocks plus has more than 50% of the voting rights of the company, and
- the parent/legal guardian has effective control and is / was the representative director or managing member (in the case of a Godo Kaisha).

Under the reform, the JPY25m a year limit will be increased to JPY30m a year. Under the integrated tax system, the recipient is taxed at a 20% flat rate for the receipt of a qualified gift. The value of the gift is included in the tax base of any inheritance tax owing upon death of the recipient's parents. At that time the 20% gift tax is creditable against their inheritance tax liability. As the rates of Japan's inheritance tax (highest marginal rate of 50% starts on a taxable inheritance worth more than JPY300m) compare favourably against Japan's gift tax regime (highest marginal rate of 50% starts on taxable gifts worth more than JPY10m), the ability to make the integrated taxation election results in favourable tax consequences for the recipient.

Relief on the acquisition of owner occupied residential property

A loan deduction is available to individual taxpayers with an annual taxable income of JPY30m or less on loans taken out to finance the purchase of a residential property which is used for such a purpose in 2007 or 2008.

Occupancy commences	Loan limitation	Deduction period	Deduction available
2007	There is no restriction on the amount borrowed, however these rules only apply to financing of JPY25m or less.	15 years	For first 10 years: 0.6% of outstanding loan deductible from tax liability. For last 5 years: 0.4% of outstanding loan deductible from tax liability.
2008	As above except limit is JPY20m	15 years	As above

Individual taxpayers with annual taxable income of JPY30m or less are able to use the treatment as explained below, which is currently in effect. Taxpayers need to elect which of the deduction schemes they use.

Occupancy commences	Borrowed funds	Deduction period	Deduction available
2007	No limit	10 years	For first 6 years: 1% of outstanding loan deductible from tax liability (maximum JPY250,000). For last 4 years: 0.5% of outstanding loan deductible from tax liability (maximum JPY125,000).
2008	No limit	10 years	For first 6 years: 1% of outstanding loan deductible from tax liability (maximum JPY200,000). For last 4 years: 0.5% of outstanding loan deductible from tax liability (maximum JPY100,000).

Relief on renovation expenses in order to remove barriers within the home.

The government has made a commitment to promoting barrier-free housing, and as such is providing tax breaks for those who renovate their homes for the purpose of reducing barriers.

Barrier-free renovations

Period of occupancy	Loan limitation	Deduction period	Deduction available on renovation costs (a) + (b)
1 st April 2007 to 31 st December 2008.	There is no restriction on the amount borrowed, however these rules only apply to financing of JPY25m or less.	5 years	(a) 2% of renovations (maximum JPY2m) deductible from tax liability. (b) 1% of costs incidental to the renovations deductible from tax liability.

Examples of (a) barrier-free renovations include: widening walkways / corridors in the house; replacing stairs with ramps; making the bathroom / toilet more user-friendly; fitting railings; levelling floors.

Transfer Pricing

The reforms reiterate Japan's tax authorities desire to: (i) more aggressively audit taxpayers involved in transactions with foreign related parties and (ii) develop stronger relationships with tax authorities in foreign jurisdictions.

Mutual Agreement Reform

A payment extension plan will come into effect April 1st, 2007, with respect to taxpayers who request the Japanese tax authorities (the NTA) negotiate a "Mutual Agreement" (MA) with the competent authority of the applicable foreign jurisdiction.

Currently, if a Japanese taxpayer is subject to a transfer pricing audit and found to have failed to declare income from transactions with a foreign affiliate, the NTA will demand tax be paid on this additional income, with penalties.

As this income would ordinarily be subject to tax in the country in which the affiliate resides, double taxation will result. In such a case, the taxpayer can request the NTA negotiate an MA with the competent authority of the foreign jurisdiction, in an attempt to have the amount of income taxed there adjusted, thereby avoiding double taxation.

Under the reform, in cases where the foreign affiliate is resident of a jurisdiction with which Japan has concluded a Double Tax Agreement (DTA), the additional tax ordinarily imposed by the NTA will not be required to be paid until one month after the MA has been negotiated or at which time the NTA notifies the taxpayer the MA has failed. In addition, penalty taxes will not be levied.

In cases where the MA is not successfully negotiated, taxpayers will receive a notice to that effect from the authorities. Taxpayers will be allowed to extend their tax payment by one month from the issue of the notice. From that point, however, taxpayers will only be able to rely on litigation as an alternative to the domestic tax law.

CFC rules

A Japanese taxpayer (corporation or individual classified as a "permanent resident" for Japanese tax purposes) is generally not required to declare on its Japanese tax return retained earnings of a foreign company in which it holds an interest, unless such a company is deemed to be a controlled foreign corporation (CFC). A taxpayer with more than a 5% interest in a foreign company (more than 50% of its interests being held by residents of Japan) whose effective tax rate is less than 25%, will generally be subject to Japan's CFC rules. However, in cases where the foreign company is performing certain types of business activities an exemption from the CFC rules can be obtained.

In order to meet the active business exemption, the Japanese taxpayer with an interest in the foreign company is required to attach certain documentation with its tax return and maintain documentation showing the exemption applies. This is stipulated under Article 66-6(6) of the

Special Taxation Measures Law and Article 66-6-19 of the Circular of the Special Taxation Measures Law.

Although the current rules provide this requirement, the new law will stipulate the documentation required. Specific details of this documentation are still to be released.

Social insurance payments

If an individual resident of Japan pays social insurance of a foreign jurisdiction which has a Social Security agreement with Japan, the paid premium will be included in the social insurance deduction for Japanese income tax purposes, to a certain limit.

Consumption / Corporate tax changes

Discussion on proposed increases to Japan's consumption tax and decreases to its corporate tax have been put on hold until later in 2007.

New Japan-Philippines Tax Treaty Protocol to Reduce Withholding Tax Rates

This article was first published by Tax Notes International, 8 January 2007.

The Japan-Philippines income tax treaty protocol, signed on December 9, 2006 will see a reduction in withholding tax rates on some dividend, interest, and royalty payments. When it enters into force and effect, the protocol will amend the bilateral income tax treaty signed in Tokyo on February 13, 1980.

Once each country completes its legal procedures to approve the protocol, it will enter into force 30 days after the diplomatic notes have been exchanged. The new rates of withholding taxes will apply to amounts taxable on or after January 1 in the calendar year following the year in which the protocol enters into force, which is likely to be 2008.

Dividends

The protocol includes reductions in withholding tax rates on some dividends, interest, and royalties paid from one jurisdiction to the other. Article 10 of the current income tax treaty includes three categories of dividends, namely:

- dividends paid to a shareholder who owns at least 25 percent of the shares in the company paying the dividend;
- dividends paid by a company that is registered with the Board of Investments and engaged in "pioneer" areas of investment; and
- dividends paid in all other cases.

Under the treaty, the withholding tax rate is 10 percent for the first two categories and 25 percent for the third category.

The protocol provides that dividends paid to a shareholder holding an interest of at least 10 percent in the dividend-paying company will be subject to a 10 percent withholding tax. The withholding tax on dividends in all other cases is reduced to 15 percent.

Interest

Under the current income tax treaty, there are four categories of interest:

- interest paid and derived by the government or government-owned financial institutions;
- interest paid on government securities, bonds, or debentures;
- interest paid by a company registered with the Board of Investments and engaged in pioneer areas of investment; and
- interest paid in all other cases.

Under the treaty, the first category is exempt from withholding tax, while the second and third categories are subject to 10 percent withholding tax. The fourth category is subject to a 15 percent withholding tax.

The protocol provides that interest that falls within the first category will continue to be exempt from withholding tax; however, categories two and three have been absorbed into an expanded "interest paid in all other cases" category. Interest in that category will be subject to withholding tax rate of 10 percent.

Royalties

Currently, royalties, depending on their nature, are subject to three different withholding tax rates. Royalties paid for the right to use movies and films or tapes for radio or television broadcasting are subject to a 15 percent withholding tax rate. Royalties paid by a Philippines company registered and engaged in pioneer areas of investment are subject to a withholding tax rate of 10 percent. All other royalties are subject to a 25 percent withholding tax rate.

Under the protocol, the withholding tax rates for royalties in the first two categories remain unchanged. For all other royalties, however, the withholding tax rate has been reduced to 10 percent.

Tax Sparing

While the tax sparing credits available under the current income tax treaty (20 percent for dividends and 15 percent for interest and royalties) will remain unchanged, there has been a broadening of the types of income to which the tax sparing provision applies. That reflects the changes made to the withholding tax treatment of those types of income, as explained above.

The tax sparing credit for dividends has been expanded to include all dividends paid. Under the current income tax treaty, the tax sparing provision applies only to dividends paid by a company appropriately registered and engaged in pioneer areas of investment.

The tax sparing credit for interest has been expanded to include all forms of interest subject to withholding tax. Under the current income tax treaty, the tax sparing provision applies only to interest paid on government securities, bonds, or debentures, or paid by a company appropriately registered and engaged in pioneer areas of investment.

The tax sparing credit for royalties has been expanded to include all three categories of royalties described above. Under the current income tax treaty, the tax sparing provision applies only to royalties paid by a company appropriately registered and engaged in pioneer areas of investment.

The tax sparing provisions will apply to income derived by a resident of Japan for 10 years from the year in which the protocol enters into force.

Permanent Establishment

A slight but potentially significant change has been made to what constitutes a permanent establishment with regard to the provision of consultancy services or supervisory services in connection with a contract for a building, construction, or installation project. Under paragraph 6, article 5 of the current income tax treaty, services constitute a PE if they are performed for a period or periods amounting to more than 6 months within any taxable year; the protocol provides that those activities shall constitute a PE if performed for a period or periods amounting to more than 6 months within any 12-month period. That eliminates the planning opportunity of performing the activities for the last six months of a taxable year and for the first six months of the following taxable year.

Transfer Pricing

The provision of the income tax treaty that deals with transfer pricing (article 9) has been replaced with the standard OECD provision. Under the new provision, tax authorities have the power to adjust the income of a taxpayer resident in their jurisdiction when the taxpayer's dealings with related parties resident in the other jurisdiction have resulted in profits that, if the taxpayer had been dealing with an unrelated party, would have accrued to the taxpayer. That mirrors recent changes made to Japan's income tax treaties with the United States and the United Kingdom.

Japan, U.K. Exchange Diplomatic Notes on Tax Treaty Protocol

This article was first published in Tax Notes International, 21 September 2006.

Yoshiji Nogami, Japan's minister for foreign affairs, and Dawn Primarolo, U.K. paymaster general, exchanged diplomatic notes on September 12 regarding the Japan-U.K. income tax treaty protocol. The protocol, signed on February 2, 2006, entered into force on October 12, 2006 and amended the treaty signed in 1970.

The new rates for withholding taxes came into effect in Japan on January 1, 2007.

Article 10 of the treaty has reduced withholding tax rates on dividends, and in some cases, exempt dividends from withholding tax. The special purpose company vehicle, or *tokutei mokuteki kaisha* (TMK), that may claim dividends as an expense, is unable to claim the benefit of the reduced rates.

Under article 11, withholding taxes on interest paid to government bodies and financial institutions are exempt from withholding tax. For other interest payments, the withholding tax rate remains at 10 percent. However, under article 12, royalties are no longer subject to withholding tax. Capital gains on the sales of shares in a Japanese company are exempt from taxation in Japan if the capital gains are subject to tax in the United Kingdom. It should be noted that gains:

- (i) made by an investor who owns 25% or more of the corporation at any time during the fiscal year of the sale or any time during the previous two fiscal years and 5% or more of the shares are disposed of during any given fiscal year if not taxed in the home country, or
- (ii) from the sale of shares in a company deemed to be a real property holding company the investor,

will be subject to tax in Japan.

Under the protocol, a resident of one country who works for short periods in the other country and who is employed and paid by a nonresident employer can gain tax relief if the resident is present in the country for no more than 183 days in any 12-month period. The current treaty refers to the resident's tax year.

Under the former treaty, income from a Tokumei Kumiai (TK) arrangement distributed to TK partners resident of the UK was treated as other income and therefore not subject to tax in Japan. The protocol provides that the income is now subject to Japanese withholding tax at a rate of 20 percent.

The protocol includes a limitation on benefits article. The LOB article applies to the business profits article; the exemption from source-country withholding tax on

dividends, interest, and royalties; the benefits of the capital gains article; and the exemption from tax under the "other income" article.


Practical Issues Regarding the New Japan-U.K. Double Tax Agreement

Under the former DTA, in order for a resident of the United Kingdom to apply the reduced rates of tax in respect of dividends, interest or royalties in Japan, it had to file the relevant "Application Form for Income Tax Convention" with the tax office (through the payer of such income).

Under the New Treaty, as a limitation of benefits ("LOB") article is included, the following additional documents will be required (for payments from Japan to the UK):

- Attachment Form For Limitation On Benefits Article (Form 17);
- Certificate of United Kingdom residency; and
- If applicable, List of Members of Foreign Company or List of Partners of the Entity (Form 16) *.

The above forms are also necessary to claim treaty benefits in respect of other income and capital gains.

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