Taxation in Japan 2015

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 1 October 2015.

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.

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1 Taxation of Companies

1.1 Introduction

Japanese corporate income taxes consist of:

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

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

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

1.2.1 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.

1.2.2 Branch of a Foreign Company vs. Japanese Company

Generally, there is no material difference between a branch of a foreign company and a Japanese 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 Japanese company.

However, a branch and a Japanese company have differing legal characteristics and this results in differences in tax treatment in certain areas including the following:

- Scope of taxable income: please see 1.5.
- Special tax due by 'Specified Family Company' (discussed in 1.3.4): not applied to a branch of a foreign company
- Tax Consolidation (discussed in 1.14): not applied to a branch of a foreign company
- Foreign Dividend Exclusion (discussed in 4.1): not applied to a branch of a foreign company
- Foreign Tax Credits (discussed in 4.2): not applied to a branch of a foreign company for fiscal years beginning before 31 March 2016(*)
- Thin-Capitalization Rules (discussed in 4.4): not applied to a branch of a foreign company for fiscal years beginning on or after 1 April 2016(*)
- Anti-Tax Haven (CFC) Rules (discussed in 4.6): not applied to a branch of a foreign company

(*) The tax treatment of a branch of a foreign company was amended under the 2014 and 2015 tax reform. The amendments will be applied to a branch for its fiscal years beginning on or after 1 April 2016. See 1.5.2 (taxable income), 4.2 (foreign tax credits) and 4.4 (thin-capitalization rules) for more details.

1.2.3 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) Fixed Place PE

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
- 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 purposes of purchasing goods or merchandise for the foreign company
- a fixed place of business solely for the purposes of storage of goods or merchandise for the foreign company
- a fixed place of business solely for the purposes 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 PE

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 1 year

(3) Agent PE

A person who has an authority to conclude contracts in Japan for or on behalf of the foreign company, including the following:

- 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)

- 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)

- 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)

An agent of independent status is excluded from the definition of an agent that constitutes a PE.

***

If the country of residence of a 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.

1.3 Tax Rates

1.3.1 Corporation Tax

The corporation tax is imposed on taxable income of a company at the following tax rates:

<table>
<tr><th>Tax base</th><th>Small and medium-sized companies[1]</th><th>Other than small and medium-sized companies</th></tr>
<tr><td>Taxable income up to JPY8 million in a year</td><td>19%
(15%[2])</td><td rowspan="2">23.9%
(25.5% for fiscal years beginning before 1 April 2015)</td></tr>
<tr><td>Taxable income in excess of JPY8 million</td><td>23.9%
(25.5% for fiscal years beginning before 1 April 2015)</td></tr>
</table>

[1] A small and medium-sized company is a company whose stated capital is JPY100 million or less, except for either of the following cases:

- where 100 percent of the shares of the company are directly or indirectly held by one large sized company (a company whose stated capital is JPY500 million or more).
- where 100 percent of the shares of the company are directly or indirectly held by two or more large sized companies in a 100 Percent Group defined in 1.13.1.

[2] 15 percent is applied to fiscal years beginning prior to 31 March 2017.

1.3.2 Business Tax

Business tax is basically imposed on taxable income of a company. However, if the amount of capital is over JPY100 million, size-based business tax is also levied. Moreover, if a company conducts electricity/gas supply business or insurance business, business tax is imposed on the adjusted gross revenue instead of its taxable income.

Please note the following:

- Part of business tax levied on income/adjusted gross revenue is collected as special local corporation tax by the national government, which is allocated to local governments in order to decrease the gap in tax revenue between urban and rural areas.
- Under the 2014 tax reform, the tax rates for business tax and special local corporation tax were amended for fiscal years beginning on or after 1 October 2014 to change the allocation ratio between the two taxes. The total tax burden of the two taxes remains the same after the amendment.
- Under the 2015 tax reform, the tax rates for business tax and special local corporation tax were amended again only for companies discussed in (1) below for fiscal years beginning on or after 1 April 2015 to reduce the tax burden on income for such companies. Moreover, size-based business tax rates were also amended to double the pre-amended tax rates over 2 years.
- Both business tax and special local corporation tax are tax deductible expenses when tax returns for such taxes are filed.
- Business tax rates indicated below are the standard tax rates. Specific rates applied are determined by local tax jurisdictions within the maximum tax rates (standard tax rates x 1.2).

(1) Companies with Stated Capital in excess of JPY100 million (other than companies indicated in (3))

■ Business tax levied on income

Taxable base (taxable income)		Standard tax rates (Fiscal years beginning in the following periods)			
In excess of	Up to	before 1/10/2014	from 1/10/2014 to 31/3/2015	from 1/4/2015 to 31/3/2016	on or after 1/4/2016
-	JPY4 million	1.5%	2.2%	1.6%	0.9%
JPY4 million	JPY8 million	2.2%	3.2%	2.3%	1.4%
JPY8 million	-	2.9%	4.3%	3.1%	1.9%

Only the highest rate is applicable where a company has offices in at least three different prefectures and capital of at least JPY10 million.

■ Special local corporation tax

Taxable base	Tax rates (Fiscal years beginning in the following periods)			
	before 1/10/2014	from 1/10/2014 to 31/3/2015	from 1/4/2015 to 31/3/2016	on or after 1/4/2016
Taxable income x Standard rate of business tax	148%	67.4%	93.5%	152.6%

■ Size-based business tax

Size-based business tax consists of two components and the tax bases of each component are as follows:

Components	Taxable base
Added value component	(a) Labour costs + (b) Net interest payment + (c) Net rent payment + (d) Income/loss for current year
Capital component	Larger amount of the following: • Stated capital + Capital surplus for tax purposes • Stated capital + Capital reserve for accounting purposes (not applicable for fiscal years beginning before 1 April 2015)

Where (a) (labour costs) is larger than 70 percent of the total of (a), (b), (c) and (d), the tax base of the added value component will be reduced by the excess portion. Moreover, there is a temporary measure applied for 3 years (fiscal years beginning between 1 April 2015 and 31 March 2018) to reduce tax base of the added value component if the three conditions for the tax credits for salary growth discussed in 1.11.5 are met.

Size-based business tax rates will be increased as follows:

Components	Standard tax rates (Fiscal years beginning in the following periods)		
	before 1 April 2015	from 1 April 2015 to 31 March 2016	on or after 1 April 2016
Added value component	0.48%	0.72%	0.96%
Capital component	0.2%	0.3%	0.4%

As indicated above, while the tax rates for business tax on income will be reduced, the tax rates for size-based business tax will be increased over 2 years from April 2015 due to the 2015 tax reform. With the aim of minimizing any rapid increase in the tax burden due

to the increase in size-based business tax rates, special measures to reduce the tax burden will be applied to companies whose tax base for the added value component is less than JPY4 billion for fiscal years beginning between 1 April 2015 and 31 March 2017.

(2) Companies with Stated Capital of JPY100 million or less (other than companies indicated in (3))

■ Business tax levied on income

Taxable base (taxable income)		Standard tax rates (Fiscal years beginning in the following periods)	
In excess of	Up to	before 1 October 2014	on or after 1 October 2014
-	JPY4 million	2.7%	3.4%
JPY4 million	JPY8 million	4%	5.1%
JPY8 million	-	5.3%	6.7%

Only the highest rate is applicable where a company has offices in at least three different prefectures and capital of at least JPY10 million.

■ Special local corporation tax

Taxable base	Tax rates (Fiscal years beginning in the following periods)	
	before 1 October 2014	on or after 1 October 2014
Taxable income x Standard rate of business tax	81%	43.2%

■ Size-based business tax

Not applicable.

(3) Companies Conducting Electricity/Gas Supply Business or Insurance Business

■ Business tax levied on revenue

Taxable base	Standard tax rates (Fiscal years beginning in the following periods)	
	before 1 October 2014	on or after 1 October 2014
Adjusted gross revenue	0.7%	0.9%

■ Special local corporation tax

Taxable base	Tax rates (Fiscal years beginning in the following periods)	
	before 1 October 2014	on or after 1 October 2014
Adjusted gross revenue x Standard rate of business tax	81%	43.2%

■ Size-based business tax

Not applicable.

1.3.3 Prefectural and Municipal Inhabitant Taxes

Prefectural and municipal taxes consist of two elements; (1) an income tax calculated based on national corporation tax and (2) a per-capita tax. Specific rates applied are determined by the local tax jurisdiction.

(1) Inhabitant Tax Levied on Corporation Tax

Part of inhabitant tax levied on corporation tax is collected as newly introduced local corporation tax by the national government, which is allocated to local governments in order to decrease the gap in tax revenue between urban and rural areas for fiscal years beginning on or after 1 October 2014.

■ Inhabitant tax

Taxable base	Tax rates			
			(Fiscal years beginning in the following periods)	
			before 1 October 2014	on or after 1 October 2014
Corporation tax (National tax)	Standard rate	Prefectural	5.0%	3.2%
		Municipal	12.3%	9.7%
		Total	17.3%	12.9%
	Maximum rate	Prefectural	6.0%	4.2%
		Municipal	14.7%	12.1%
		Total	20.7%	16.3%

■ Local corporation tax

Taxable base	Tax rates (Fiscal years beginning in the following periods)	
	before 1 October 2014	on or after 1 October 2014
Corporation tax (National tax)	-	4.4%

(2) Per-Capita Tax

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

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

(*) The capital amount means the larger amount of the following:

- Stated capital + Capital surplus for tax purposes
- Stated capital + Capital reserve for accounting purposes (not applied for fiscal years beginning before 1 April 2015)

1.3.4 Special Tax Due by Specified Family Company

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

A 'Specified Family Company' is defined as a Japanese company that is still a Controlled Company (defined below) 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 small and medium-sized company as defined in 1.3.1.

If a Japanese company is directly or indirectly controlled by one shareholder and related persons of the shareholder, the company is a 'Controlled Company.' For the purposes of this rule, if one shareholder and its related persons hold more than 50 percent of the total outstanding shares or more than 50 percent of the voting rights of another company, the company is treated as 'controlled' by the shareholder and its related persons. '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 fiscal year are the excess of undistributed profits over the largest of the following three amounts:

- JPY20 million (reduced proportionately where fiscal year is less than 12 months)
- 40 percent of the taxable income for the fiscal year
- 25 percent of the stated capital less the accumulated retained earnings at the end of the fiscal year not including the earnings for that fiscal year

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

Excess retained earnings	Tax rate
Up to JPY30 million	10%
Excess over JPY30 million and up to JPY100 million	15%
Excess over JPY100 million	20%

Inhabitant tax is also payable on the above corporation tax.

1.3.5 Effective Statutory Corporate Income Tax Rate

Given the potential use of graduated rates in the calculation of both corporation 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 stated capital in excess of JPY100 million is, following the introduction of size-based business tax, partly determined by a number of factors other than taxable income.

For illustrative purposes, the simplified effective statutory tax rate based upon the maximum rates in Tokyo applicable to a company whose stated capital is over JPY100 million will be as follows:

	Fiscal years beginning in the following period			
	1/4/2014 to 30/9/2014	1/10/2014 to 31/3/2015	1/4/2015 to 31/3/2016	on or after 1/4/2016
Corporation tax	25.5%	25.5%	23.9%	23.9%
Business tax(1)	3.26%	4.66%	3.4%	2.14%
Special local corporation tax	4.292% (2.9% x 148%)	2.898% (4.3% x 67.4%)	2.899% (3.1% x 93.5%)	2.899% (1.9% x 152.6%)
Inhabitant tax	5.279% (25.5% x 20.7%)	4.157% (25.5% x 16.3%)	3.896% (23.9% x 16.3%)	3.896% (23.9% x 16.3%)
Local corporation tax	-	1.122% (25.5% x 4.4%)	1.052% (23.9% x 4.4%)	1.052% (23.9% x 4.4%)
Total	38.331%	38.337%	35.147%	33.887%
Effective tax rate(2)	35.64%	35.64%	33.06%	32.26%

(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 corporation tax payments.

1.4 Taxable Year of Companies

The taxable year of a company is in line with the company's accounting period (i.e. fiscal year). A taxable year can not exceed 12 months in duration but can be less than 12 months.

1.5 Taxable Income

1.5.1 Japanese 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.

Generally speaking, a Japanese 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 company may be credited against Japanese corporation tax and local inhabitant tax. Note that dividends received from Foreign Subsidiaries are exempt in calculation of a Japanese company's taxable income under the foreign dividend exclusion (FDE) system as discussed in 4.1.

1.5.2 Foreign Companies having a PE in Japan

(1) Fiscal Years Beginning before 1 April 2016

A foreign company operating in Japan through a branch or any other type of permanent establishment (PE) is liable for corporate income taxes on the entire income from sources within Japan under the domestic tax laws, whether or not such income is attributable to the PE.

However, 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 corporate tax is imposed only on the business 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.

Profits/losses derived from internal dealings (i.e. transactions between a PE and its head office (or other branches located outside

Japan)) are not recognized, except for internal interest for banks.

(2) Fiscal Years Beginning on or after 1 April 2016

The international taxation principle in Japan was amended by virtue of the 2014 and 2015 tax reform and the amendments will be applied to a foreign company for its fiscal years beginning on or after 1 April 2016.

Under the amended tax law, a foreign company operating in Japan through a PE will be liable for corporate income taxes only on the income attributable to the PE under the domestic tax laws. (Please note that certain Japanese source income (e.g. capital gains from sales of real estate located in Japan and shares in certain Japanese companies) should still be subject to corporate income taxes even if it is not attributable to the PE basically in the same way as for a foreign company not having a PE.)

The new rules including the following will be applied in calculating income attributable to a PE in line with the Authorized OECD Approach (AOA)[(1)]:

- Income attributable to a PE will be the income that the PE would have earned if it were a distinct and separate enterprise from its head office.

- Profits/losses derived from internal dealings will be recognized at an arm's length price in general. (Note that internal interest for non-financial institutions and internal royalties on intangibles will not be recognized if a tax treaty including a provision equivalent to the pre-amended Article 7[(2)] is applied.)

- When the amount of capital of a PE is smaller than the capital attributable to the PE (capital to be attributable to the PE if the PE were a distinct and separate enterprise from its head office), interest expenses corresponding to such deficient portion will not be allowed in calculating income attributable to the PE.

(1) 'AOA' is an approach to calculate income attributable to a PE set

out in the 'Report on the Attribution of Profits to Permanent Establishments' released by the OECD in 2008 and 2010.

(2) 'The pre-amended Article 7' is Article 7 of the OECD Model Tax Convention before the 2010 amendment. As the AOA was fully adopted in Article 7 of the OECD Model Tax Convention when it was amended in 2010, the pre-amended Article 7 adopted only partially the AOA. Thus, the tax treatment may differ depending on which type of Article 7 is included in the applicable tax treaty.

1.6 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.

1.6.1 Capital Gain Rollover Rules

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 regard 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

1.6.2 Special Rules for Land Acquired in 2009 and 2010

In addition to the above, there are two special rules for land acquired in 2009 and 2010, which were introduced in the 2009 tax reform:

(1) Capital Gains Rollover Relief

This relief 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 10 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.

(2) Special Deduction for Long-Term Capital Gains

Where a company sells their land in Japan acquired in 2009 and 2010 after they have owned it for more than 5 years as of 1 January of the selling year, a special deduction can be applicable. The amount of the special deduction is the lower of JPY10 million or the amount of the capital gain.

The above two special rules for land acquired in 2009 and 2010 also apply to individual taxpayers (See 3.2.2).

1.7 Treatment of Excess Tax Losses

1.7.1 Tax Losses Carry-forward

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.

The maximum deductible amount of tax losses brought forward will be reduced as follows:

Fiscal years beginning before 1 April 2015	Fiscal years beginning between 1 April 2015 and 31 March 2017	Fiscal years beginning on or after 1 April 2017
Up to 80% of taxable income of the fiscal year	Up to 65% of taxable income of the fiscal year	Up to 50% of taxable income of the fiscal year

There are exceptional rules whereby tax losses can be offset against the total amount of taxable income of the fiscal year, which are applied to the following companies:

- Small and medium-sized companies defined in 1.3.1.

- Tax qualifying Tokutei Mokuteki Kaisha (TMKs) and Toushi Houjin (THs), etc.

- Companies which commenced rehabilitation procedures, etc.

  This rule is applicable for fiscal years with days falling within a 7-year period from the day on which the rehabilitation plan was confirmed. If the company is re-listed on a Financial Instruments Exchange, the company will not be eligible for the fiscal years ending on or after the date when the company is re-listed.

  (Although a similar rule was provided as a transitional measure for companies which commenced rehabilitation procedures, etc.

before 1 April 2012, the above rule is applicable for fiscal years beginning on or after 1 April 2015 regardless of the timing of the commencement of the rehabilitation procedures.)

- Newly established companies

  This rule is applicable for fiscal years with days falling within a 7-year period from the establishment date. If the company is listed on a Financial Instruments Exchange, the company will not be eligible for the fiscal years ending on or after the date when the company is listed.

  Note that this rule is applicable for fiscal years beginning on or after 1 April 2015 except for the following companies:

  - a company in which 100 percent of the shares are directly or indirectly held by one large sized company (a company whose stated capital is JPY500 million or more).
  - a company in which 100 percent of the shares are directly or indirectly held by two or more large sized companies in a 100 Percent Group defined in 1.13.1.
  - a parent company established under a Share-Transfer (Kabushiki-Iten) transaction.

Tax losses can be utilized against taxable income for the following periods depending on when the tax losses are suffered:

- 7 succeeding years - tax losses incurred in fiscal years ending before 1 April 2008
- 9 succeeding years - tax losses incurred in fiscal years ending on or after 1 April 2008 and beginning before 1 April 2017
- 10 succeeding years - tax losses incurred in fiscal years beginning on or after 1 April 2017

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 3 months from the establishment of the company or the end of the first fiscal year) to ensure tax losses are not extinguished.

1.7.2 Tax Losses Carry-back

The Japanese Corporation Tax Law also provides for a tax loss carry-back system at the option of the taxpayer company. This tax loss carry-back 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 1 April 1992 except for certain limited circumstances, including the following:

- small and medium-sized companies defined in 1.3.1
- fiscal years including the date of dissolution
- fiscal years ending during liquidation procedures

1.7.3 Change of Control

When an ownership change occurs for a company which has tax losses incurred in prior years or assets having built-in losses, if one of certain specified events occurs within 5 years from the date of the ownership change, utilization of the tax losses of the company may be restricted.

An ownership change for the purposes of this rule occurs when a new shareholder directly or indirectly acquires more than 50 percent of the outstanding shares in a company except for acquisitions through certain events such as a tax-qualified merger.

The specified events include the following:

(i) (a) When a company was a dormant company just before the ownership change, (b) the company starts its business after the ownership change.

(ii) (a) When a company ceased (or plans to cease) its business carried on just before the ownership change after the ownership change, (b) the company receives loans or capital contributions, the amount of which exceeds five times the previous business scale.

(iii) In the case of (i)(a) or (ii)(a), (b) the company is merged into another company under a tax-qualified merger.

In the above cases, deduction of built-in losses of assets of the company may be restricted as well.

1.8 Deduction of Expenses

1.8.1 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 fiscal year must be made in accordance with the method(s) reported for each class of inventory to the tax office by the company. The valuation methods allowable for tax purposes are cost method (specific identification, FIFO, weighted average, moving average, recent purchase, or retail price discount method) or lower of cost or market value method.

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 fiscal year in which the change is to be effected.

At the end of each fiscal year, 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).

1.8.2 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 fiscal year must be made in accordance with the following method(s):

Kind of securities	Valuation methods
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.

1.8.3 Provision for Bad Debts

The allowable amount of a provision for bad debts is the total of (i) and (ii) below:

(i) 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)

(ii) General bad debt provision

A provision for potential bad debts among existing receivables (other than those falling under (i) above) based upon the actual bad debt ratio for the 3 preceding years

The amount of (ii) is calculated using the formula below:

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

By virtue of the 2011 tax reform, provisions for bad debts are allowable only for companies categorized into (A) or (B) below for tax purposes for fiscal years beginning on or after 1 April 2012. Moreover, for companies categorized into (B), provision for bad debts for tax purposes is limited to only certain receivables.

	(A)	(B)
Companies	• Small and medium-sized companies defined in 1.3.1 • Banks, insurance companies and similar companies	Certain companies which hold certain monetary claims (e.g. receivables incurred in finance lease transactions)
Receivables subject to the provision	Monetary claims	Finance lease receivables, etc.

There is a 3-year transitional measure whereby the following amounts should be allowed for companies categorized into (B) or companies not categorized into (A) or (B):

- Fiscal years commencing from 1 April 2012 to 31 March 2013: Allowable limit before the 2011 tax reform x 3/4

- Fiscal years commencing from 1 April 2013 to 31 March 2014: Allowable limit before the 2011 tax reform x 2/4

- Fiscal years commencing from 1 April 2014 to 31 March 2015: Allowable limit before the 2011 tax reform x 1/4

For a small and medium-sized company defined in 1.3.1, 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%

1.8.4 Bad Debt Expenses

If the following facts have occurred, the following amounts are treated as tax deductible bad debt expenses in the fiscal 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 1 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 JPY1 in its accounting books.

1.8.5 Provision for Retirement Allowance

A provision for retirement allowances used to be partially tax allowable until 2001 but it is currently not tax allowable.

1.8.6 Directors' Compensation

If compensation (excluding retirement/severance allowances and stock option expenses discussed in 1.8.7 below) paid to company directors (e.g. members of the board of directors, officers and statutory auditors) falls under one of the following, the compensation is allowable for corporate tax purposes:

(1) Fixed Amount Periodical Compensation

'Fixed amount periodical compensation' means 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 3 months (4 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

'Fixed compensation notified in advance' means 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) 1 month after the resolution date of the compensation at the shareholders meeting, etc. or (b) 4 months (5 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) 1 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' is 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 3 months (4 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 1 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.

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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.

1.8.7 Stock Option Expenses

When a company issues stock options 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.

1.8.8 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.

1.8.9 Corporate Taxes, etc.

Corporation tax, prefectural and municipal inhabitant taxes, local corporation tax, interest on delinquent taxes, penalties and fines, etc. should be disallowed for tax purposes. Note that business tax and special local corporation tax are deductible basically when a tax return for such taxes is lodged.

Japanese withholding taxes and foreign withholding taxes 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.

1.8.10 Donations/Contributions

Donations and contributions are partially deductible as follows:

Donations and contributions	Deductible amount
Designated by the government	All
To Specified Public Interest Facilitating Corporations	3.125% of taxable income + 0.1875% of stated capital and capital surplus (per annum)
Other than above	0.625% of taxable income + 0.0625% of stated 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 a lower price than the fair market value, the difference between them 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.

Please see 1.13.4 for donations between Japanese companies within a 100 Percent Group.

1.8.11 Entertainment Expenses

Entertainment expenses for a year in excess of the following deductible limits are disallowed:

Size of company	Deductible limit
A small and medium-sized company defined in 1.3.1	JPY8 million or 50% of eating and drinking expenses
Other than small and medium-sized company	50% of eating and drinking expenses

Social and entertainment expenses include expenses generally disbursed for the purposes 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.

A company is required to keep relevant documents indicating details of eating and drinking expenses in order to have such expenses to be subject to the 50% deduction. The following items are excluded from eating and drinking expenses subject to the 50% deduction:

- eating and drinking expenses solely for the company's directors/employees and relatives of them
- eating and drinking expenses which are not treated as entertainment expenses, such as:
  - expenses for business meetings
  - expenses for welfare activities
  - expenses whose cost is JPY5,000 or less per person that are justified by relevant records (excluding those solely for the company's directors/employees and relatives of them).

1.8.12 Interest – Thin Capitalization Rules/Earnings Stripping Rules

Thin capitalization rules 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 rules, 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.

Earnings stripping rules were introduced in 2012 with the aim of preventing tax avoidance by limiting the deductibility of interest paid to related persons where it is disproportionate to income. Under the rules, if 'Net Interest Payments to Related Persons' exceed 50 percent of 'Adjusted Taxable Income', the excess portion is disallowed.

See Chapter 4 for further information on the above rules.

1.8.13 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 fiscal year. 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 fiscal year 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 a fiscal year, 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 fiscal 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.

1.8.14 Management Service Fees

If a foreign parent company is operating in Japan through a subsidiary or a joint venture (JV) 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 purposes 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.

1.8.15 Allocation of Head Office Expenses

Where common costs incurred for businesses of both a PE and the head office are allocated to the PE based on reasonable allocation keys, such allocated costs are allowable in the hands of the PE provided that a document regarding the cost allocation is attached to the tax returns for fiscal years beginning before 1 April 2016 (preserved for fiscal years beginning on or after 1 April 2016).

1.9 Tax Depreciation

1.9.1 Fixed Assets and Depreciation

(1) 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 JPY100,000 or which are used up within 1 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 JPY100,000 or more but less than JPY200,000, the cost can be amortized over 3 years.

(2) 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.

The calculation methods and depreciation rates vary depending on when the tangible fixed assets are acquired as discussed below.

■ Tangible fixed assets acquired Before 1 April 2007

Depreciation rates		
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
:	:	:

Calculation methods	Annual depreciable amount
Straight-line method	Acquisition cost x 90% (i.e. cost less 10% residual value) x Depreciation rate
Declining-balance method	Tax book value at the beginning of the fiscal year x Depreciation rate

(Minimum residual value: 5% of the acquisition cost)

Note that under the 2007 tax reform, assets depreciated to the allowable limit (95 percent of acquisition cost) in a particular fiscal year can be further depreciated down to JPY1 evenly over 5 years starting from the following fiscal year. This rule is applicable for fiscal years starting on or after 1 April 2007.

■ Tangible fixed assets acquired on or after 1 April 2007 but before 1 April 2012

Depreciation rates				
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
:	:	:	:	:

Calculation methods	Annual depreciable amount		
Straight-line method	Acquisition cost x Depreciation rate (**A**)		
Declining-balance method	(i) For the period where:		
	Tax book value at the beginning of the fiscal year x Depreciation rate (**X**)	>	Acquisition cost x Minimum annual depreciation rate (**Z**)
	Tax book value at the beginning of the fiscal year	x	Depreciation rate (**X**)
	(ii) For the period where:		
	Tax book value at the beginning of the fiscal year x Depreciation rate (**X**)	<	Acquisition cost x Minimum annual depreciation rate (**Z**)
	Tax book value at the beginning of the first fiscal year when it falls in (ii)	x	Modified depreciation rate (**Y**)

(Minimum residual value: JPY1)

Under the declining-balance method, for the first few years (e.g. 7 years for an asset whose statutory useful life is 10 years) an asset is depreciated using Depreciation rate (**X**), which is 250 percent of the depreciation rate under the straight-line method, and for the remaining years (e.g. the last 3 years for an asset whose statutory useful life is 10 years) the asset is depreciated equally using Modified depreciation rate (**Y**).

■ Tangible fixed assets acquired on or after 1 April 2012

Depreciation rates				
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	0.667	1.000	0.11089
4	0.250	0.500	1.000	0.12499
5	0.200	0.400	0.500	0.10800
6	0.167	0.333	0.334	0.09911
7	0.143	0.286	0.334	0.08680
8	0.125	0.250	0.334	0.07909
9	0.112	0.222	0.250	0.07126
10	0.100	0.200	0.250	0.06552
:	:	:	:	:

The calculation methods for assets under this category are the same as those acquired on or after 1 April 2007 but before 1 April 2012.

The depreciation rate (**X**) is calculated as 200 percent of the depreciation rate under the straight-line method.

■ Intangible Fixed Assets

Intangible assets are amortized over statutory useful lives under the straight-line method without a depreciable limit.

(3) 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 fiscal year in the case of a newly established company; and

- the filing due date of the corporation tax return for the fiscal year 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 fiscal year in which the change is to be effected.

(4) 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 2 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)

(5) 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 fiscal years.

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 fiscal year for tax purposes is limited to the amount recorded in the books of account.

(6) 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 1 year, and excess depreciation in such a year can be set off against the short depreciation.

1.9.2 Deferred Charges

Expenditures made by a company that have a useful period of more than 1 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 1 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 JPY200,000 per item may be expensed immediately.

1.10 Revenue to be excluded from Taxable Income

1.10.1 Dividends Received from Japanese Companies

Dividends received by a company from other Japanese companies are excludable in calculating taxble income as indicated below:

[For fiscal years beginning before 1 April 2015]

Categories of shares	Ownership requirements	Excludable ratios
Shares in 100% subsidiaries	100% throughout the calculation period (the maximum period: 1 year up to the end of the calculation period)	Dividends received x 100%
Shares in related companies	25% or more more than 6 months prior to the effective day	(Dividends received – Interest on debts) x 100%
Shares other than the above	less than 25%	(Dividends received – Interest on debts) x 50%

[For fiscal years beginning on or after 1 April 2015]

Categories of shares	Ownership requirements	Excludable ratios
Shares in 100% subsidiaries	100% throughout the calculation period (the maximum period: 1 year up to the end of the calculation period)	Dividends received x 100%
Shares in related companies	more than 1/3 throughout the calculation period (the maximum period: 6 months up to the end of the calculation period)	(Dividends received – Interest on debts) x 100%
Other shares	(more than 5% but 1/3 or less)	Dividends received x 50%
Non-controlling shares	5% or less as of the record date	Dividends received x 20% (40% for insurance companies)

If dividends are received on shares which were acquired 1 month prior to the end of the fiscal year of the issuing company and sold

within 2 months after the end of the same fiscal year, those dividends are not excluded from gross income.

1.10.2 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.

1.10.3 Refunds of Corporate Tax, etc.

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

1.11 Tax Credits

1.11.1 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:

Pro-rata method

$$\text{Withholding tax on interest/dividends} \times \frac{\text{Holding period of the respective bonds/shares from which interest/dividend is paid}}{\text{Calculation period for the respective interest/dividend}}$$

Weighted average method

$$\text{Withholding tax on interest/dividends} \times \frac{\text{No. of bonds/shares held at the commencement of the base period (B)} + \{(A) - (B)\} \times 1/2}{\text{No. of bonds/shares held at the end of the base period for interest/dividend calculation (A)}}$$

By virtue of the 2013 tax reform, withholding tax on bond interest received on or after 1 January 2016 by a taxpayer company will become fully creditable regardless of the holding period.

Note that special reconstruction income tax will be imposed on withholding tax at 2.1 percent from 2013 to 2037. Such special reconstruction income tax is creditable/refundable in a similar way as discussed above.

1.11.2 Foreign Tax Credits

See Chapter 4 for details.

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

(1) Tax Credit on Total 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:

[For fiscal years beginning before 1 April 2015]

(i) Tax credit for total R&D expenditure

<table>
<tr><th>Scale of company</th><th colspan="2">Tax creditable amount</th></tr>
<tr><td>Small and medium-sized companies[2]</td><td colspan="2">Total R&D expenditure x 12%</td></tr>
<tr><td rowspan="2">Other than small and medium-sized companies</td><td>R&D ratio[1] is 10% or more</td><td>Total R&D expenditure x 10%</td></tr>
<tr><td>R&D ratio is less than 10%</td><td>Total R&D expenditure x (8% + R&D ratio x 0.2)</td></tr>
</table>

(ii) Tax credit for specified R&D expenditure

Specified R&D expenditure x 12%

The total maximum creditable amount of (i) and (ii) is 20 percent of the corporation tax liability for the fiscal year, which is increased to 30 percent of the corporation tax liability for the fiscal years beginning from 1 April 2013 to 31 March 2015.

[For fiscal years beginning on or after 1 April 2015]

By virtue of the 2015 tax reform, the tax creditable amount for specified R&D expenditure was expanded in order to facilitate open innovation for companies and the maximum creditable amounts for (i) and (ii) were set out separately. R&D expenditure which falls under specified R&D expenditure is applicable to either (i) or (ii) below.

(i) Tax credit for total R&D expenditure

<table>
<tr><th>Scale of company</th><th colspan="2">Tax creditable amount</th></tr>
<tr><td>Small and medium-sized companies[2]</td><td colspan="2">Total R&D expenditure x 12%</td></tr>
<tr><td rowspan="2">Other than small and medium-sized companies</td><td>R&D ratio[1] is 10% or more</td><td>Total R&D expenditure x 10%</td></tr>
<tr><td>R&D ratio is less than 10%</td><td>Total R&D expenditure x (8% + R&D ratio x 0.2)</td></tr>
</table>

The maximum creditable amount for (i) is 25 percent of the corporation tax liability for the fiscal year.

(ii) Tax credit for specified R&D expenditure

Specified R&D expenditure x 20% or 30%

The maximum creditable amount for (ii) is 5 percent of the corporation tax liability for the fiscal year.

(1) R&D ratio
Total R&D expenditure in a fiscal year divided by the average sales proceeds for the preceding 3 years and the current fiscal year (Average Sales Proceeds)

(2) A small and medium-sized company for the purposes of this rule
A company with stated capital of JPY100 million or less,

excluding the following cases:

- at least 50 percent of the shares are held by one large-scale company (a company whose stated capital is over JPY100 million)
- at least two-thirds of the shares are held by two or more large scale companies

(2) Additional Tax Credit on R&D expenditure

In addition to the above, either of the two tax credits indicated below is available for fiscal years beginning before 1 April 2017:

(i) Tax credit on incremental R&D expenditure

When R&D expenditure in the fiscal year is larger than the highest annual R&D expenditure for the preceding 2 fiscal years, a tax credit on incremental R&D expenditure is available to the extent of the following amount:

If the incremental ratio(2) is over 5% but less than 30%	Incremental R&D expenditure(1)	x	Incremental ratio
If the incremental ratio(2) is 30% or more	Incremental R&D expenditure(1)	x	30%

(1) Incremental R&D expenditure

$$\text{R\&D expenditure for the fiscal year} - \text{Annual average of R\&D expenditure for the preceding 3 fiscal years}$$

(2) Incremental ratio

$$\frac{\text{Incremental R\&D expenditure}}{\text{Annual average of R\&D expenditure for the preceding 3 fiscal years}}$$

(ii) 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 to the extent of the following amount:

$$(\text{R\&D expenditure} - \text{Average Sales Proceeds} \times 10\%) \times (\text{R\&D ratio} - 10\%) \times 0.2$$

The maximum creditable amount is 10 percent of the corporation tax liability for the fiscal year.

1.11.4 Tax Credits for Job Creation

As a political measure to boost employment, a tax credit for job creation was introduced under the 2011 tax reform and expanded under the 2013 and 2014 tax reform. If a blue-return filing company which submits a job creation plan to a public job placement agency satisfies all of the conditions in (i) to (iv), tax credits are available to the company.

(i) Increase in number of employees

Increased number of employees (the number of employees at the end of the current fiscal year less the number of employees at the end of the previous fiscal year) is equal to or larger than five (two for small and medium-sized companies).

The scope of small and medium-sized companies for the purposes of this rule is the same as that discussed in 1.11.3.

(ii) Increase in ratio of employees

Increased ratio of employees (the increased number of employees/the number of employees at the end of the previous fiscal year) is equal to or greater than 10 percent.

(iii) Zero terminations

There are no terminations (there are no people who had to leave the company due to reasons of the company) in the current year and the preceding fiscal year.

(iv) Reasonable increase in the amount of salary payments

The amount of (a) is equal to or greater than (b):

(a) Salary payments in the current year

(b) (Salary payments in the preceding year) + {(Salary payments in the preceding year) x (percentage increase in number of employees) x 30%}

The creditable amount is JPY400,000 per person for the increased number of employees. The maximum creditable amount is 10 percent (20 percent for a small and medium-sized company defined in 1.11.3) of the corporation tax liability for the fiscal year. An excess amount for a fiscal year is carried forward to the next fiscal year.

This tax credit is applicable for all fiscal years commencing between 1 April 2011 and 31 March 2016, except for fiscal years in which the tax credits for salary growth discussed in 1.11.5 are applied.

1.11.5 Tax Credits for Salary Growth

In order to raise the general level of personal income, tax credits for salary growth were introduced under the 2013 tax reform and expanded in the 2014 and 2015 tax reform. If a blue-return filing company satisfies all of the following conditions, tax credits are available to the company:

(i) The amount of salary paid to employees in the current year was increased by the designated ratio (see below) compared to the 'base year' (generally, the fiscal year preceding the first fiscal year commencing on or after 1 April 2013).

Scale of company	Fiscal years beginning in the following period			
	Before 1/4/2015	1/4/2015 to 31/3/2016	1/4/2016 to 31/3/2017	1/4/2017 to 31/3/2018
Small and medium-sized companies defined in 1.11.3	2%	3%	3%	3%
Other than small and medium-sized companies	2%	3%	4%	5%

(ii) The amount of salary paid to employees in the current year was not less than such amount paid in the preceding fiscal year.

(iii) The average of salary paid to employees in the current year was not less than such average paid in the preceding fiscal year.

The creditable amount is 10 percent of the amount of the increase in salary paid in the fiscal year from the base year. The maximum creditable amount is 10 percent (20 percent for a small and medium-sized company defined in 1.11.3) of the corporation tax liability for the fiscal year.

This tax credit is applicable for all fiscal years commencing between 1 April 2013 and 31 March 2018 unless the tax credits for job creation discussed in 1.11.4 are applied.

1.11.6 Tax Incentives for Investment in Production Facilities

With the aim of strengthening industrial competitiveness through renewal of production facilities, a new measure was introduced under the 2013 tax reform.

If a blue-return filing company acquires production facilities and puts them into use for business in Japan during the fiscal years commencing from 1 April 2013 to 31 March 2015, the company may claim increased initial depreciation of 30 percent of the acquisition cost of new machinery (attributable to the acquired production facilities) provided that all of the following conditions are met:

(i) The total acquisition cost of production facilities in the current year exceeds the total depreciation cost of depreciable assets recorded in the current year.

(ii) The total acquisition cost of production facilities in the current year was increased by more than 10 percent compared to that in the preceding year.

'Production facilities' for the purposes of this rule are facilities consisting of depreciable assets directly used for income-producing business activities. For example, a head office building and welfare facilities would not be treated as production facilities.

A tax credit equivalent to 3 percent of the acquisition cost of new machinery (attributable to the acquired production facilities) may be applied instead of the increased initial depreciation, up to the limitation of 20 percent of the corporation tax liability for the fiscal year.

1.11.7 Tax Incentives for Investment in Productivity Improvement Facilities

Under the 2014 tax reform, an additional measure to encourage companies to make investment in production facilities has been introduced.

If a blue-return filing company acquires production facilities that are treated as Productivity Improvement Facilities and are meeting the minimum acquisition cost requirements and puts them into use for business in Japan during the period from 20 January 2014 to 31 March 2017, the company may claim increased initial depreciation (25 percent to 100 percent of the acquisition cost) or take a tax credit (2 percent to 5 percent of the acquisition cost) up to the limitation of 20 percent of the corporation tax liability for the fiscal year.

'Productivity Improvement Facilities' consist of 'high-technology facilities' and 'facilities to improve production line/operation" defined under the Industrial Competitiveness Enhancement Act.

1.12 Administrative Overview

1.12.1 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 2 months after the end of its fiscal year, whether or not it has positive income for that fiscal year. However, generally, an extension of 1 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 fiscal year must be paid to the tax offices within 2 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 1.14 below) the tax return filing and payment due dates remain as above, however a 2-month filing extension will generally be granted upon application.

A tax return for special reconstruction corporation tax should also be filed within 2 months after the end of each fiscal year. A filing extension obtained for corporation tax purposes automatically applies to filing a tax return for special reconstruction corporation tax.

(2) Interim Tax Return

A company, the fiscal year of which is longer than 6 months, should file interim tax returns within 2 months of the end of the first 6 months of the fiscal 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 JPY100,000 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 2 methods:

(i) tax for the preceding fiscal year multiplied by six and divided by the number of months of the preceding fiscal year
(ii) tax computed on the basis of the provisional results for the first 6-month period of the present fiscal year

In case of either of the following, it is not possible to file an interim tax return based on provisional results:

- the amount calculated under (i) ≤ JPY100,000
- the amount calculated under (i) < the amount calculated under (ii)

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.

1.12.2 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	9 years(*)
Relating to transfer pricing issues	6 years
Relating to fraud	7 years

(*) 10 years for tax losses incurred in fiscal years beginning on or after 1 April 2017

1.13 Group Taxation Regime

The Group Taxation Regime is provided in order to make the Japanese taxation system more in line with a business environment where business operations are managed on a unified basis across a corporate group.

Although the Consolidated Tax Return Filing System discussed in 1.14 applies to Japanese companies that have made an election for the system, the Group Taxation Regime automatically applies to certain transactions carried out by companies belonging to a 100 Percent Group, including a tax consolidated group.

1.13.1 100 Percent Group

A 100 Percent Group under the Group Taxation Regime is a group comprising companies having a 100 Percent Control Relationship, which is:

- relationship in which a person holds directly or indirectly 100 percent of the outstanding shares in a company; or
- relationship in which 100 percent of the outstanding shares in a company and 100 percent of the outstanding shares in another company are directly or indirectly held by the same person.

A 'person' as described above should include not only a Japanese company but also a foreign company or an individual. Even if foreign companies are interposed between Japanese companies, they could have 100 Percent Control Relationships. Note that, however, the Group Taxation Regime is applicable only to the transactions between Japanese companies in a 100 Percent Group, in principle.

When determining whether a 100 Percent Control Relationship exists, the number of shares owned by an employee stock ownership plan or the number of shares owned by employees and directors that were acquired through exercises of stock option plans can be disregarded if the total number of those shares is less than 5 percent of the total number of outstanding shares.

A structure diagram showing 100 Percent Control Relationships should be included in the statement of outline of business activities to be attached to corporate tax returns.

1.13.2 Dividends Received Deduction (DRD)

When a Japanese company receives dividends from a 100 percent Japanese subsidiary, such dividends should be fully excluded from taxable income without deducting interest expenses attributable to such dividends.

This rule is also applicable to a Japanese branch of a foreign

company when it receives dividends from a 100 percent Japanese subsidiary.

A 100 percent Japanese subsidiary for the purposes of this rule is defined as follows:

- In the case of a dividend other than deemed dividends

A Japanese company that had a 100 Percent Control Relationship with the company receiving the dividend for the whole of the calculation period for the dividend

- In the case of a deemed dividend

A Japanese company that had a 100 Percent Control Relationship with the company receiving the dividend on the day prior to the effective date of the deemed dividend

***

The same rule is included in the Consolidated Tax Return Filing System. This rule is applicable for companies not electing for the Consolidated Tax Return Filing System.

1.13.3 Deferral of Capital Gains/Losses

(1) Deferral of Capital Gains/Losses

When a Japanese company transfers certain assets to another Japanese company having a 100 Percent Control Relationship with the first mentioned company, capital gains/losses arising from the transfer should be deferred.

(2) Assets Covered by this Rule

Assets covered by this rule are fixed assets, land (if land is not treated as a fixed asset), securities, monetary receivables and deferred charges, excluding those whose tax book value just before the transfer is less than JPY10 million, and securities held for trading purposes for either the transferor company or the transferee company.

(3) Realization of Capital Gains/Losses

The deferred capital gains/losses on a transfer of an asset under this rule will be realized in the hands of the transferor company, for example, when the transferee company transfers the asset to another person.

The following table shows the main trigger events for realization of deferred gains/losses and the amount of realized gains/losses:

Trigger events	Amount of realized capital gains/losses
Transfer of the asset by the transferee company	Amount of deferred capital gains/losses
The asset becoming a bad debt, or retirement/revaluation and similar events related to the asset by the transferee company	Amount of deferred capital gains/losses
Depreciation or amortization of the asset by the transferee company (Depreciable assets or deferred charges)	Amount of deferred capital gains/losses x (Depreciation or amortization amount included in deductible expenses of the transferee company) / (Acquisition cost of the asset) Instead of the above, it is possible for the transferor company to realize the amount of deferred capital gains/losses over the useful life being applied to the asset in the transferee company (Simplified Method).
Losing the 100% Control Relationship between the transferor company and the transferee company	Amount of deferred capital gains/losses

(4) Notification

- When assets subject to this rule are transferred within a 100 Percent Group, the transferor company should notify the transferee company of that fact (including the intention that the transferor company will use the Simplified Method for depreciable assets/deferred charges, if this is the case) after the transfer without delay.

- When the transferred assets are the securities held for trading purposes by the transferee company, the transferee company should notify the transferor company about that fact, after the above notification without delay. Also if the transferor company has said that it intends to use the Simplified Method for depreciable assets/deferred charges, the transferee company should notify the transferor company of the useful lives for such assets, after the above notification without delay.

- If an event to realize deferred capital gains/losses happens, the transferee company should notify the transferor company about that fact and the day of the event (including tax deducted depreciation/amortization amount, if the transferor company does not use the Simplified Method) as soon as possible after the closing date of the fiscal year in which the event happens.

***

This rule is almost the same as the rule provided for under the Consolidated Tax Return Filing System. This rule is applicable for transfers of assets for companies not electing for the Consolidated Tax Return Filing System.

1.13.4 Donations

(1) Donations

When a Japanese company pays donations to another Japanese company which has a 100 Percent Control Relationship (excluding such relationship controlled by an individual), the donations are treated as non-deductible for the donating company and non-taxable for the recipient company.

Donations under the Japanese Corporation Tax Law have a broader meaning than simply donations to charitable entities/political parties.

(2) Adjustments to Tax Book Value of Shares

In order to prevent a shareholder company of the donating/recipient company from conducting tax-avoidance through a transfer of value of the shares in these companies by taking advantage of the new rule for donations within a 100 Percent Group, the shareholder company is required to make adjustments to the value of the shares as follows:

- If a company has a 100 Percent Control Relationship with the donating company, the shareholder company should decrease the tax book value of the shares in the donating company by the amount of the donation attributable to the direct holding ratio of the shareholder company.

- If a company has a 100 Percent Control Relationship with the recipient company, the shareholder company should increase the tax book value of the shares in the recipient company by the amount of the receipt attributable to the direct holding ratio of the shareholder company.

Although the above adjustments should be applied to indirect shareholders in the 100 Percent Group in theory, in consideration of the administrative burden, the adjustments are required only for direct shareholders. If the shareholder company belongs to a tax consolidated group to which the donating company or the recipient

company belongs, instead of this rule, another rule for adjustments to the value of shares under the Consolidated Tax Return Filing System is applied.

1.13.5 Tax Qualified Dividends-in-Kind

(1) Tax Qualified Dividends-in-Kind

■ Dividends-in-kind

Dividends-in-kind are where a company distributes assets other than money as dividends of profits or deemed dividends to its shareholders. A deemed dividend should be recognized in the following circumstances:

- return of capital or distribution of residual assets due to dissolution
- acquisition of shares by a company issuing the shares
- retirement of investments
- change of the corporate type of a company (when assets other than shares in the company are distributed to shareholders)

■ Tax qualified dividends-in-kind

When a Japanese company distributes a dividend-in-kind to its shareholders, if all the shareholders are Japanese companies which have a 100 Percent Control Relationship with the dividend paying company at the time of the payment, the dividends-in-kind are treated as tax-qualified dividends-in-kind.

Therefore, in a case where a foreign company is one of the recipients of a dividend-in-kind, such dividend is not treated as a tax-qualified one for all shareholders.

(2) Tax Treatment of Tax Qualified Dividends-in-Kind

- When an asset is transferred under a tax-qualified dividend-in-kind, as the asset is treated as being transferred at the tax book value for the dividend paying company, there is no recognition of

capital gains/losses in the hands of the dividend paying company. The recipient company records the asset at the tax book value for the dividend paying company, which does not constitute taxable income for the recipient.

- Withholding tax is not imposed on tax-qualified dividends-in-kind.

- As a tax-qualified dividend-in-kind is a kind of corporate reorganization for tax purposes, specific rules for corporate reorganizations are applied. For example, if certain conditions are not met, utilization of tax losses of the recipient company and deductions incurred on specified assets will be restricted.

1.13.6 Non-Recognition of Capital Gains/Losses from Transfers of Shares to the Share Issuing Company

When a Japanese company holds shares in another Japanese company having a 100 Percent Control Relationship with the first mentioned company, if the shareholder company receives money or assets other than money from the share issuing company for the following reasons or surrenders the shares in the share issuing company for the following reasons (including a case where it becomes certain that the share issuing company has no residual assets after its dissolution), the shareholder company does not recognize any capital gains/losses from the shares.

- non tax-qualified merger
- non tax-qualified horizontal type corporate division
- return of capital or distribution of residual assets due to dissolution
- acquisition of shares by a company issuing the shares
- retirement of investments
- change of the corporate type of a company (when assets other than shares in the company are distributed to shareholders)

Under this rule, for example, when a Japanese company is liquidated, a shareholder company having a 100 Percent Control Relationship with the liquidated company does not recognize capital gains/losses from shares. (Note that, however, tax losses incurred

by the liquidated company may be transferred to the shareholder company subject to certain conditions.)

1.13.7 Valuation Losses of Liquidating Companies /Merged Companies

Valuation losses of shares in a Japanese subsidiary in a 100 Percent Group are not deductible by its shareholder companies in the same group if the Japanese subsidiary is:

- in the process of liquidation,
- expected to be dissolved (excluding dissolution by merger), or
- expected to be dissolved due to a tax qualified merger within a 100 Percent Group.

1.14 Tax Consolidation

1.14.1 Tax Consolidated Group

The Consolidated Tax Return Filing system is applied by election (ordinarily irrevocable) to a Japanese domestic parent company and its Japanese subsidiaries having 100 Percent Control Relationships discussed in 1.13.1 without foreign companies being interposed. Once the election is made, all subsidiaries having 100 Percent Control Relationships are required to be included within the consolidated group.

1.14.2 Tax Consolidation Rules

In addition to the Group Taxation Regime discussed in 1.13, the following rules are applied to a tax consolidated group:

(1) Offsetting Profits and Losses

Current year taxable profits and tax losses within a tax consolidated group are offset for corporation tax purposes, which is the most beneficial treatment under the Consolidated Tax Return Filing System.

(2) Crystallization of Built-in Gains/Losses

Upon starting a tax consolidation or a subsidiary joining an existing tax consolidated group, assets of the subsidiary will be revalued to market value in principle. Crystallizing built-in gains/losses could result in either additional taxation or increase of extinguished losses described in (3).

However, certain subsidiaries of a tax consolidated group including the following are not subject to this rule:

■ Upon starting a tax consolidation:

- a subsidiary underneath the parent company that was established by a Share-Transfer (Kabushiki-Iten)
- a subsidiary held by the parent company for more than 5 years,
- a subsidiary established within a tax consolidated group
- a company that has become a subsidiary of a tax consolidated group through a tax-qualified Share-for-Share Exchange (Kabushiki-Kokan)
- a company that has become a subsidiary of a tax consolidated group through a tax-qualified merger whereby its parent company holding the company for more than 5 years is merged into the parent company of the tax consolidated group

■ Upon joining an existing tax consolidated group:

- a subsidiary established within a tax consolidated group
- a company that has become a subsidiary of a tax consolidated group through a tax-qualified Share-for-Share Exchange (Kabushiki-Kokan)
- a company that has become a subsidiary of a tax consolidated group through a tax-qualified merger whereby its parent company holding the company for more than 5 years is merged into the parent company of the tax consolidated group

Assets covered by this rule are fixed assets, land (if land is not treated as a fixed asset), securities, monetary receivables and deferred charges. There are some exceptions.

(3) Extinguishment of Pre-Consolidation Tax Losses

Upon starting a tax consolidation or a subsidiary joining an existing tax consolidated group, tax losses incurred by the subsidiary prior to joining a tax consolidated group will be extinguished in principle.

However, a subsidiary that is not subject to the rule discussed in (2) is not captured by this rule, although the pre-consolidation tax losses are available only to offset against taxable income generated by the subsidiary.

(4) Others

- The use of a consolidated tax system will also result in certain tax related treatments being calculated based not on the status of individual companies but on the consolidated status (for example; the deductible limit of donations, R&D tax credit limit, etc.).

- Filing and payment deadlines under tax consolidated filing are in principle the same as for a normal Japanese company, however a 2-month filing extension will generally be allowed.

- A consolidated return can only be filed for national corporation 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.

1.15 Corporate Reorganizations

1.15.1 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:

- merger
- corporate division (horizontal type and vertical type)
- contributions-in-kind
- dividends-in-kind
- Share-for-Share-Exchange (Kabushiki-Kokan) or Share-Transfer (Kabushiki-Iten)

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) unless the merged company and the surviving company have a 100 Percent Control Relationship.

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 unless the parent company and the subsidiaries (the subsidiaries for a Share-Transfer) have a 100 Percent Control Relationship.

(1) Mergers/Corporate Divisions/Contributions-in-Kind

The following is a general outline of the conditions required for a tax-qualified reorganization with respect to mergers, corporate divisions and contributions-in-kind:

Relationship	Conditions
(1) 100% Control Relationship	(a) Delivery of shares only as consideration for transfer (no involvement of cash or any other assets). (b) Expectation that the 100% Control Relationship will remain.
(2) More than 50% Control Relationship	(a) Delivery of shares only as consideration for transfer (no involvement of cash or any other assets). (b) Expectation that the More than 50% Control Relationship will remain. (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 relationship	(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 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. (d) Expectation that the shares received for the transferred

	business will continue to be held.

Under a triangular merger or a triangular horizontal type corporate division, the shares of the parent company of the transferee company are delivered to shareholders of the transferor company instead of shares in the transferee 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.

(2) Share-for-Share Exchanges/Share-Transfers

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.

The following is a general outline of the conditions required for a tax-qualified Share-for-Share Exchange and Share-Transfer:

(Note that in the table below, a transferred company and a company which becomes the holder of all shares in the transferred company under a Share-for-Share Exchange or Share-Transfer are referred to as the Subsidiary and the Parent Company, respectively.)

Relationship	Conditions
(1) 100% Control Relationship	(a) Delivery of shares only as consideration for transfer (no involvement of cash or any other assets) to shareholders of the Subsidiaries. (b) Expectation that the 100% Control Relationship will remain.
(2) More than 50% Control Relationship	(a) Delivery of shares only as consideration for transfer (no involvement of cash or any other assets) to shareholders of the

	Subsidiaries. (b) Expectation that the More than 50% Control Relationship will remain. (c) Expectation that approximately 80% or more of the employees in the Subsidiary will continue working for the Subsidiary. (d) Expectation that the Subsidiary will continue to operate its own main business.
(3) 50% or less relationship	(a) Same as (2)-(a),(c) and (d) (b) The main business of the Subsidiary has a relationship with one of the Parent Company's businesses (the other Subsidiary's businesses for a Share-Transfer). (c) The relative business size (i.e. sales, number of employees, etc.) of the related businesses is not considerably different (within a 1:5 ratio), or senior directors of the Subsidiary will not resign upon the reorganization. (d) Expectation that the shares received for the reorganization will continue to be held. (e) Expectation that 100% Control Relationship between the Parent Company and the Subsidiary after the reorganization will continue.

Under a triangular Share-for-Share Exchange, the shares of the parent company of the Parent Company are transferred to shareholders of the Subsidiary instead of shares in the Parent Company. In connection with condition (a) above, if the shareholders of the Subsidiary receive solely shares in the parent company of the Parent Company in a triangular Share-for-Share Exchange, condition (a) is satisfied provided that the parent

company directly holds 100 percent of the shares of the Parent Company.

(3) Dividends-in-Kind

When a Japanese company distributes a dividend-in-kind to its shareholders, if all the shareholders are Japanese companies which have a 100 Percent Control Relationship with the dividend paying company at the time of the payment, the dividends-in-kind are treated as tax-qualified dividends-in-kind.

Therefore, in a case where a foreign company is one of the recipients of a dividend-in-kind, such dividend is not treated as tax-qualified for all shareholders.

1.15.2 Pre-Reorganization Losses

(1) Pre-Reorganization Losses Incurred by a Merged Company, etc.

While under a non tax-qualified merger, pre-merger losses are not transferred from the merged company to the surviving company, under a tax-qualified merger, the pre-merger losses are transferred from the merged company to the surviving company in principle. However, if the following conditions are not met, the amount of the transfer of such losses may be restricted.

<table>
<tr><th>Relationship</th><th>Conditions</th></tr>
<tr><td>(1) 100% Control Relationship</td><td rowspan="2">(a) 5 year control relationship requirements
or
(b) Joint business operations requirements</td></tr>
<tr><td>(2) More than 50% Control Relationship</td></tr>
<tr><td>(3) 50% or less relationship</td><td>No conditions (therefore, no restriction)</td></tr>
</table>

(a) 5 year control relationship requirements

If there has been a More than 50 Percent Control Relationship

between the surviving company and the merged company continuously since the latest day among the following, this requirement should be passed:

- 5 years before the first day of the fiscal year including the merger date
- establishment day of the surviving company
- establishment day of the merged company

(b) Joint business operations requirements

If the following conditions ((i) to (iv) or (i) and (v)) are satisfied, this requirement should be passed:

(i) The business of the merged company has a relationship with one of the surviving company's businesses.

(ii) The relative business size (i.e. sales, number of employees, etc.) of the related businesses does not exceed around 1 to 5.

(iii) The relative business size of the merged company at the time when the More than 50 Percent Control Relationship was formed and the size at the time of the merger does not exceed around 1 to 2.

(iv) The relative business size of the surviving company at the time when the More than 50 Percent Control Relationship was formed and the size at the time of the merger does not exceed around 1 to 2.

(v) One or more senior directors of both the merged company and the surviving company become senior directors of the surviving company after the merger.

When a Japanese company under liquidation procedures determines the amount of its residual assets, if the shareholders of the company are Japanese companies having a 100 Percent Control Relationship, tax losses incurred by the liquidating company are transferred to the shareholders provided that the 5 year control

relationship requirement is satisfied.

(2) Pre-Reorganization Losses Incurred by a Surviving Company, etc.

As for pre-merger losses incurred in the surviving company, if the merger is tax-qualified and requirements discussed in (1) are not met, there may be restrictions on utilization of such losses against future profits after the merger.

This rule is also applied to the following reorganizations:

- non tax-qualified merger between companies having a 100 Percent Control Relationship
- tax-qualified corporate divisions
- tax-qualified contributions-in-kind
- tax-qualified dividends-in-kind

Furthermore, there is a rule to restrict utilization of built-in losses after the above reorganizations unless requirements discussed in (1) are met.

1.15.3 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) 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 horizontal 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 partnership 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.

(1) Nini Kumiai (NK)

An NK is formed under the Civil Law. All partners of an NK are liable for the obligations 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 and no registration is required.

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

An investment LPS is formed by general partners and limited 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.

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

An LLP is formed under the LLP Act. 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 can not 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

(1) Japanese Resident Partners

Income/loss of an NK-type partnership allocated to its partners generally retains its nature for tax purposes. Japanese resident partners (both Japanese resident individuals (individuals who have their domicile in Japan or who have resided in Japan for a continuous period of 1 year or more) and Japanese 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 1 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).

(2) Foreign Partners Having a PE in Japan

In the same way as Japanese resident partners, foreign partners

(both foreign individuals and foreign 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 are subject to withholding tax at 20 percent (20.42 percent from 2013 to 2037, including a special reconstruction income tax). The withholding tax is creditable when declaring such income in the partner's Japanese tax return.

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 10th 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 2 months have passed from the end of the calculation period of the NK-type partnership if no distribution is made within 2 months after the end of the calculation period). Also, a person who allocates partnership income is deemed to be the person responsible for the withholding obligations.

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 whether it causes a foreign partner to be treated as having a permanent establishment in connection with the business carried on by the partnership.

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
(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 in order to apply the above rule. Also, the foreign partner is required to show the general partner of the Investment Fund a certificate to verify its foreign resident status.

(3) 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 were 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 (Tokumei 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 business.

2.2.2 Taxation of the Operator

A 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 a TK arrangement depends upon whether or not the TK silent partner is Japanese resident.

(1) Japanese 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 calculation period end date of the TK arrangement falls.

As for corporate silent partners, utilization of losses generated from a 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 income if the result is a loss.

Withholding tax is levied on actual distributions of TK profit to silent partners at the rate of 20 percent (20.42 percent from 2013 to 2037, including a special reconstruction income tax), which is creditable for the partners when declaring such income in their tax returns.

(2) Foreign Partners Having a PE in Japan

The TK profit/loss allocation to foreign partners (both foreign individuals and foreign companies) having a permanent establishment (PE) in Japan is treated in the same way as Japanese resident partners.

(3) Foreign Partners not Having a PE in Japan

20 percent withholding tax (from 2013 to 2037, 20.42 percent withholding tax, including a special reconstruction income tax) is applied on actual distributions of TK profit allocations. There is no requirement to file a tax return in Japan.

It should be noted that foreign 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 the recipient, can apply to the tax authorities to have the withholding tax on their distributions of TK profit allocations exempted. Note that tax treaties with some countries such as the US, the UK, France, Hong Kong and the Netherlands 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

There are rules to limit the utilization of losses derived from a partnership at the level of each partner as discussed below. 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 LLPs - At-Risk Rule (AR rule)

Where a corporate partner of a certain partnership suffers losses

from the partnership in its fiscal year, the following amount is not deductible in calculating taxable income for the fiscal year:

(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 be 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

2.3.2 Individual Partners of Partnerships other than Japanese LLPs

Where an individual partner of a certain partnership that is involved in rental real property activity incurs losses from the rental activity, such losses are disregarded for income tax purposes and can not 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.

2.3.3 Corporate Partners of Japanese LLPs

When a corporate partner of an LLP incurs losses from the LLP business in its fiscal 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 fiscal year.

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

2.3.4 Individual Partners of Japanese LLPs

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 municipal governments on individuals who reside or have domicile therein as of 1 January 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 Taxpayers

3.2.1 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 their domicile in Japan or who has resided in Japan for a continuous period of 1 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 5 years or less in the last 10 years.

A non-permanent resident is subject to normal Japanese income and inhabitant taxes on 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 5 years in the last 10 years falls under this category.

A permanent resident is subject to 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 1 year or more in Japan, falls under this category.

Note that in this chapter, the tax treatment of a non-resident is discussed on the assumption that the non-resident has no permanent establishment in Japan.

3.2.2 Domicile

'Domicile', as provided for in the Income Tax Law of Japan, means the principal place of living. Whether or not an individual has their domicile in Japan is determined on the basis of objective facts, such as the fact that the person has an occupation in Japan, that the person's spouse or other relatives make up the person's household in Japan, or that the 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 the person is a Japanese national or a foreign national, has come to reside in Japan to engage in business or an occupation, the person is presumed to have a domicile in Japan, unless it is made clear from the employment contract, etc. based on which the person has come to Japan, that the period of the person's stay in Japan is not 1 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.

3.2.3 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.
- None of the salary is borne by a permanent establishment in Japan.

3.3 Tax Rates

3.3.1 Tax Rates on Ordinary Income

The following progressive tax rates are applied to the net of assessable ordinary income minus allowable deductions and personal reliefs.

(1) National 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	40,000,000	40%	2,796,000
40,000,000	-	45%	4,796,000

(2) Inhabitant Tax Rates

Inhabitant tax consists of 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 percent regardless of the amount of taxable income.

3.3.2 Tax Rates on Capital Gains from Sales of Real Estate

Capital gains from sales of real estate are taxed separately from ordinary income as follows:

- short-term capital gains (the period of possession is 5 years or less as of 1 January of the sale year) – 30 percent income tax and 9 percent inhabitant tax

- long-term capital gains (the period of possession is more than 5 years as of 1 January of the sale year) – 15 percent income tax and 5 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 if land in Japan was acquired in 2009 and 2010, a capital gains rollover relief or a special deduction for long-term capital gains may be available, which is discussed in 1.6.

3.3.3 Tax Rates on Investment Income until 2015

(1) Investment Income derived from Listed Shares

Dividend income from listed shares, in principle, is required to be added to ordinary income; however, a taxpayer has the following options to settle their tax liability on the dividends from listed shares unless the taxpayer holds 3 percent or more of the outstanding shares of a Japanese dividend paying company:

- No-declaration in an income tax return
  This is applied to dividends from a Japanese company. Tax liabilities on dividends are settled by withholding tax.

- Declaration separately from ordinary income
  Dividend income is taxed at a flat rate of 20 percent (15 percent national tax and 5 percent inhabitant tax).

Capital gains from sales of listed shares are basically taxed at 20 percent (15 percent national tax and 5 percent inhabitant tax) separately from ordinary income. When calculating such capital gains, any gains/losses from sales of shares including non-listed shares are aggregated.

Note that if a taxpayer suffers capital losses from certain sales of listed shares in a given year, such capital losses can be offset against dividend income from listed shares declared separately from ordinary income.

Moreover, it is possible to carry over capital losses incurred from certain sales of listed shares for 3 years to set off against the following income:

- dividend income from listed shares declared separately from ordinary income
- capital gains from listed and non-listed shares

Note that dividends and capital gains from publicly-offered stock investment trusts are basically treated in the same way as those

from listed shares.

(2) Investment Income derived from Non-Listed Shares

Dividend income from non-listed shares is generally taxed as ordinary income; however, a taxpayer can settle their tax liability by withholding tax without declaration in their tax return if the amount of the dividend from a Japanese company does not exceed JPY100,000 per annum (where the calculation period of the dividend is less than 1 year, instead of JPY100,000, the amount calculated by multiplying JPY100,000 by the number of the months of the calculation period of the dividend and divided by 12.). Note that such dividends are still required to be declared for inhabitant tax purposes.

Capital gains from the sale of non-listed shares are basically taxed at 20 percent (15 percent national tax and 5 percent inhabitant tax) separately from ordinary income. When calculating the capital gains, any gains/losses from sales of shares including listed shares are aggregated.

Note that dividends and capital gains from privately-offered stock investment trusts are basically treated in the same way as those from non-listed shares.

(3) Investment Income derived from Bonds/Bond Investment Trusts/Bank Deposits

Interest from bonds, bond investment trusts and bank deposits is generally taxed only through withholding tax and declaration in an income tax return is not required provided that the interest is paid in Japan. Capital gains from sales of bonds are generally not taxable.

3.3.4 Tax Rates on Investment Income from 2016

(1) Investment Income derived from Listed Shares/Specified Bonds

Dividend income from listed shares, in principle, is required to be added to ordinary income; however, a taxpayer has the following

options to settle their tax liability on the dividends from listed shares unless the taxpayer holds 3 percent or more of the outstanding shares of a Japanese dividend paying company:

- No-declaration in an income tax return
  This is applied to dividends from a Japanese company. Tax liabilities on dividends are settled by withholding tax.

- Declaration separately from ordinary income
  Dividend income is taxed at a flat rate of 20 percent (15 percent national tax and 5 percent inhabitant tax).

Interest from specified bonds is also subject to the above separate declaration.

'Specified bonds' include the following:

- Japanese government bonds, local government bonds, foreign national government bonds, foreign local government bonds
- publicly-offered bonds, listed bonds
- bonds issued on or before 31 December 2015 (except for discount bonds where tax is withheld at the time of issuance)

Capital gains from sales of listed shares and specified bonds are basically taxed at 20 percent (15 percent national tax and 5 percent inhabitant tax) separately from ordinary income. When calculating the capital gains, any gains/losses from sales of listed shares and specified bonds are aggregated.

Note that when a taxpayer suffers capital losses from certain sales of listed shares and specified bonds in a given year, such losses can be offset against dividend income from listed shares declared separately from ordinary income and interest income from specified bonds.

Moreover, it is possible to carry over capital losses incurred from certain sales of listed shares and specified bonds for 3 years to set off against the following income:

- dividend income from listed shares declared separately from ordinary income
- interest income from specified bonds
- capital gains from listed shares and specified bonds

Note that dividends and capital gains from publicly-offered stock investment trusts are basically treated in the same way as those from listed shares. Also, interest and capital gains from publicly-offered bond investment trusts are treated in the same way as those from specified bonds.

(2) Investment Income derived from Non-Listed Shares/Ordinary Bonds

Dividend income from non-listed shares is generally taxed as ordinary income; however, a taxpayer can settle their tax liability by withholding tax without declaration in their tax return if the amount of the dividend from a Japanese company does not exceed JPY100,000 per annum (where the calculation period of the dividend is less than 1 year, instead of JPY100,000, the amount calculated by multiplying JPY100,000 by the number of the months of the calculation period of the dividend and divided by 12.). Note that such dividends are still required to be declared for inhabitant tax purposes.

Interest from ordinary bonds (i.e. bonds other than specified bonds) is generally taxed only through withholding tax and declaration in an income tax return is not required provided that the interest is paid in Japan.

Capital gains from sales of non-listed shares and ordinary bonds are basically taxed at 20 percent (15 percent national tax and 5 percent inhabitant tax) separately from ordinary income. When calculating the capital gains, any gains/losses from sales of non-listed shares and ordinary bonds are aggregated.

Note that dividends and capital gains from privately-offered stock investment trusts are basically treated in the same way as those from non-listed shares. Also, interest and capital gains from

privately-offered bond investment trusts are treated in the same way as those from ordinary bonds.

(3) Investment Income derived from Bank Deposits

Interest from bank deposits is generally taxed only through withholding tax and declaration in an income tax return is not required provided that the interest is paid in Japan.

3.3.5 Withholding Tax Rates on Investment Income

Withholding tax rates on interest/dividends paid to individuals in Japan are as follows:

Investment income	National income tax	Inhabitant tax
Dividends from listed shares(*)/publicly-offered stock investment trusts	15%	5%
Dividends from non-listed shares/ privately-offered stock investment trusts	20%	-
Interest on bonds/bond investment trusts/bank deposits	15%	5%

(*) If an individual holds 3 percent or more of the outstanding shares of a Japanese dividend paying company, the tax rate for dividends from non-listed shares is applied.

Please see 4.8.2 for details of withholding tax imposed on investment income earned by non-residents.

3.3.6 Tax Rates Imposed on Non-Residents

In general, a non-resident is liable for Japanese income tax at the flat rate of 20 percent of the gross amount of their Japanese source income except for certain income such as Japanese source real estate income which is taxed at progressive tax rates on a net basis. A non-resident is generally not liable for inhabitant tax. Where a

non-resident is registered in the relevant municipal government under the Basic Resident Registration system, the individual may be liable for inhabitant tax.

3.3.7 Special Reconstruction Income Tax

In addition to the above, special reconstruction income tax will be imposed at 2.1 percent on the national income tax liability from 2013 to 2037 in order to increase tax revenue to finance post-earthquake reconstruction. If a taxpayer takes foreign tax credits (discussed in 3.7.3), special reconstruction income tax will be calculated based on the national income tax liability before the foreign tax credits.

Note that special reconstruction income tax will be imposed not only on national income tax declared in an income tax return but also on withholding tax.

Also, inhabitant tax (per capita levy) is increased by JPY1,000 (JPY500 for municipal inhabitant tax and JPY500 for prefectural inhabitant tax) from 2014 to 2023 for reconstruction funding.

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
- miscellaneous income

3.4.1 Remuneration

When considering the tax position of expatriates assigned to work in Japan, the most significant 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
- maid allowance
- utility allowance
- children's tuition allowance
- foreign exchange allowance
- tax equalization
- medical allowance
- 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

(1) Company Housing

Rent paid by an employer is not entirely 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 5 to 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).

(2) 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 benefits 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 1.8.10, 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.

(3) Company Car

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

(4) 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.

(5) Moving Expenses

Moving expenses are generally treated as non-taxable income.

(6) Tax Reimbursements

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

(7) 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.

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 between the second anniversary of the date of the resolution of the shareholders meeting for the option grant and the tenth anniversary.

- The total exercise price of all options exercised in a year must

not exceed JPY12 million.

- 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 securities 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 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 allowances not exceeding the lesser of JPY100,000 or actual monthly commutation costs

- reasonable costs of presents, etc. for the commendation of officers or employees for their long-service with the employer company

- costs 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 JPY10,000.)

- 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 JPY5,000 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

- insurance premiums, provided the amount borne by the employer shall not exceed JPY300 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 their fault

- golf club or social club membership fees, etc. provided that they are connected with the business of the employer

- dividends and capital gains from listed shares held in an individual savings account, in which an individual can make investments in listed shares up to JPY1 million per year for 2014 and 2015 (JPY1.2 million per year from 2016 to 2023) and hold them for a maximum of 5 years

3.5 Allowable Deductions

3.5.1 Standard Deductions

The following standard deductions are allowable to a resident taxpayer.

(1) Employment Income:

(JPY)

Amount of compensation		Standard deduction
Up to	1,800,000	40% of compensation (subject to 650,000 minimum)
Excess over Up to	1,800,000 3,600,000	30% of compensation + 180,000
Excess over Up to	3,600,000 6,600,000	20% of compensation + 540,000
Excess over Up to	6,600,000 10,000,000	10% of compensation + 1,200,000
Excess over Up to	10,000,000 15,000,000	5% of compensation + 1,700,000
Excess over	15,000,000	2,450,000

The maximum standard deduction (currently JPY2,450,000) will be reduced to JPY2,300,000 (for compensation over JPY12,000,000) in 2016 and JPY2,200,000 (for compensation over JPY10,000,000) from 2017 onwards.

When a resident taxpayer having employment income has borne specified expenditure in a given year, the following amounts can be deducted from gross compensation in addition to the standard deduction:

Amount of compensation	Deductible amount
Up to JPY15,000,000	Specified expenditure – (standard deduction x 1/2)
Over JPY15,000,000	Specified expenditure – JPY1,250,000

Note that the deductible amount will be calculated by the specified expenditure less 50 percent of the standard deduction regardless of the compensation amount from 2016 onwards.

Specified expenditure includes expenditure for commuting, relocation and professional qualifications. Expenses for books, clothing and entertainment directly required to perform duties are also treated as specified expenditure, up to JPY650,000 a year.

(2) 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.

The 50 percent reduction will not apply to retirement allowances that a director whose service period is 5 years or shorter receives for the service period.

3.5.2 Specific Deductions

The following deductions are applicable to a resident taxpayer. Note that a non-resident taxpayer subject to progressive tax rates may also enjoy special deductions for casualty losses incurred on the assets in Japan and donations.

(1) 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 JPY50,000 or 10 percent of assessable income.

(2) 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 JPY100,000 or 5 percent of assessable income. The maximum deduction is limited to JPY2,000,000.

(3) 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.

(4) Life Insurance Premiums

The maximum deductible amount for each type of qualified life insurance premiums is as follows:

[For insurance policies entered into before 31 December 2011]

(JPY)

Life insurance premiums	National income tax	Inhabitant tax
Life insurance premiums	50,000	35,000
Personal pension insurance premiums	50,000	35,000

[For insurance policies entered into on or after 1 January 2012]

(JPY)

Life insurance premiums	National income tax	Inhabitant tax
Life insurance premiums	40,000	28,000
Personal pension insurance premiums	40,000	28,000
Medical care insurance premiums	40,000	28,000

The total annual caps of the deductible amount for the above insurance premiums are JPY120,000 and JPY70,000 for national income tax purposes and for inhabitant tax purposes respectively.

Note that insurance premiums paid on policies concluded abroad by foreign insurance companies are not qualified for the life insurance deduction.

(5) Fire and Other Household Casualty Insurance Premiums

The income deduction for casualty insurance premiums has basically been abolished. However, the deduction for long-term casualty insurance premiums remains available provided that the policies were entered into before 1 January 2007. The maximum

deduction for long-term casualty insurance premiums is JPY15,000 and JPY10,000 for national 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 JPY50,000 for national income tax purposes and JPY25,000 for inhabitant tax purposes.

(6) Earthquake Insurance Premiums

Certain earthquake insurance premiums up to the value of JPY50,000 can be deducted from income for national income tax purposes, and a half of the premiums for inhabitant tax purposes (up to JPY25,000).

(7) Donations

Donations qualifying as a deduction do not mean charitable contributions or donations in general but those to the following:

(i) the national government
(ii) local governments
(iii) institutions for educational, scientific or other public purposes as designated by the Minister of Finance
(iv) institutions for scientific study or research specifically provided for in the regulations
(v) public interest incorporated associations/foundations, educational institutions and social welfare institutions, etc.
(vi) political parties or organizations (where the donations are qualified under certain conditions and made by 2019)
(vii) authorized Non-Profit Organizations (NPOs) (where donations are qualified under certain conditions)

The deductible amount is equivalent to the amount of the donations paid during the year (subject to a ceiling of 40 percent of the total assessable income) in excess of JPY2,000. Receipts are required as evidence to support the deduction.

In order to support people and areas affected by the Great East Japan earthquake, special measures have been established in connection with earthquake-related donations. When earthquake-related donations are made, the ceiling for the total eligible donations deductible amount for earthquake-related donations and other tax qualified donations is expanded from 40 percent to 80 percent of the total assessable income, although the ceiling for the donations other than earthquake-related donations remains 40 percent.

Tax credits are also available for certain donations in lieu of deductions. Please see 3.7.4 for details.

For inhabitant tax purposes, only tax credits for donations are available. Please see 3.7.4 for details.

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 subject to progressive tax rates is only entitled to the basic deduction.

(JPY)

Relief	National income tax	Inhabitant tax
Basic deduction for taxpayer	380,000	330,000
Spouse – younger than 70 years	380,000	330,000
Spouse - 70 years or older	480,000	380,000
Dependent - 16-18 years of age	380,000	330,000
Dependent – 19-22 years of age	630,000	450,000
Dependent – 23-69 years of age	380,000	330,000
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

[Additional reliefs for specific cases]

(JPY)

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

When a resident taxpayer applies personal reliefs for non resident family members, submission or presentation of documents proving the family members and documents for money transfers will be required from 2016.

3.7 Tax Credits

The following tax credits can, where applicable, be claimed by a resident filing a final tax return. Note that a non-resident subject to progressive tax rates is also entitled to credits for withholding income tax and donations.

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	National income tax purposes	Inhabitant tax purposes
Up to JPY10,000,000 • Dividends from shares	10%	2.8%

• Distribution from stock investment trusts	5%	1.4%
Over JPY10,000,000 • Dividends from shares	5%	1.4%
• Distribution from stock investment trusts	2.5%	0.7%

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 Credit for Withholding Income Tax

Income tax withheld from employment income, from dividends not subject to separate taxation and from other income reportable in a final tax return should be credited against income tax due on the final tax return. Special reconstruction income tax imposed on such withholding tax is also creditable against special reconstruction income tax due on the final tax return.

3.7.3 Credit for Foreign Taxes

Where a resident pays foreign taxes in a year, such foreign taxes are creditable against their Japanese income tax payable to the extent of the limit calculated by the following formula:

$$\text{Creditable limit} = \text{Japanese income tax} \times \frac{\text{Foreign source income}}{\text{Entire income taxable in Japan}}$$

Any excess foreign tax can be credited against special reconstruction income tax to the extent of the creditable limit for special reconstruction income tax purposes calculated using a similar formula to the above. If there is still excess foreign tax, such amount 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 3 succeeding years. Similarly, any unused element of the tax credit limitation for income tax and inhabitant tax purposes can be carried forward for up to 3 years.

3.7.4 Credit for Donations

(1) National Income Tax

If a taxpayer pays donations to the following organizations, the taxpayer is able to choose to claim a tax credit instead of taking an income deduction for income tax purposes.

<table>
<tr><td colspan="2">Creditable amount = (a) + (b)</td></tr>
<tr><td rowspan="2">(a) Tax credits for donations to political parties
(The smaller of either (i) or (ii))</td><td>(i) (Donations to political parties[1] - JPY2,000) x 30%</td></tr>
<tr><td>(ii) Income tax before tax credits x 25%</td></tr>
<tr><td rowspan="2">(b) Tax credits for donations to authorized NPOs/public interest entities
(The smaller of either (i) or (ii))</td><td>(i) Total of the following:
・(Donations to designated NPOs[2] - JPY2,000) x 40%
・(Donations to certain public interest entities[3] - JPY2,000) x 40%</td></tr>
<tr><td>(ii) Income tax before tax credits x 25%</td></tr>
</table>

[1] Donations to political parties or organizations (where the donations are qualified under certain conditions and made by 2019)
[2] Donations to authorized NPOs (where donations are qualified under certain conditions)
[3] Donations to public interest incorporated associations/ foundations, educational institutions and social welfare institutions, etc. (where donations are qualified under certain conditions)

In principle, the total of the creditable donations and deductible donations is subject to a ceiling of 40 percent of the total assessable income.

(2) Inhabitant Tax

For inhabitant tax purposes, the following tax credits are available:

<table>
<tr><td colspan="2">Creditable amount = (a) + (b)</td></tr>
<tr><td>(a) Basic tax credit</td><td>(Total amount[1] of eligible donations[2] – JPY2,000) x 10%</td></tr>
<tr><td rowspan="2">(b) Additional tax credit
(The smaller of either (i) or (ii))</td><td>(i) (Total amount of donations to local governments – JPY2,000) x (90% - marginal income tax rate for the individual x 102.1%[3])</td></tr>
<tr><td>(ii) Inhabitant tax before tax credits x 20%[4]</td></tr>
</table>

[1] Subject to a ceiling of 30 percent of the total assessable income
[2] The eligible donations are donations to local governments and donations designated by the Minister of Internal Affairs and Communications and local governments.
[3] 2.1 percent is an equivalent of the special reconstruction income tax.
[4] 10 percent is applied until the 2015 local income tax year (tax on 2014 income).

3.8 Remuneration Paid Outside Japan

As discussed at section 3.2 above, expatriates with not more than 5 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 5 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 is 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 5 years in the last 10 years, the expatriate employee will become a 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 discussed in 3.10.

3.9 Exit Tax Regime

In order to prevent wealthy individuals from avoiding tax on capital gains in Japan by moving out of Japan with appreciated financial assets and subsequently selling those assets, a special measure to impose income tax on unrealized capital gains on financial assets at the time of departure (exit tax regime) has been introduced under the 2015 tax reform. The exit tax regime is applicable from 1 July 2015.

(1) Eligible Person

A resident individual departing from Japan and satisfying both of the following conditions:

(i) Total value of eligible assets held by the person as of departure from Japan is JPY100 million or more.
(ii) The person has lived in Japan(*) for more than 5 years in the last 10 years before departure.

(*) The period of living in Japan includes the grace period described in (3) below, but excludes the period of staying in Japan with a status of residence under Table 1 of the Immigration Control and Refugee Recognition Act (e.g. engineer/specialist in humanities/international services, intra-company transferee). Furthermore, the period of staying in Japan before 1 July 2015 with a status of residence under Table 2 of the above Act (e.g. permanent resident, spouse or child of Japanese national) is also excluded from the period of living in Japan as a transitional measure.

(2) Eligible Assets

- securities stipulated in the Income Tax Law
- contributions under a Tokumei-Kumiai agreement
- unsettled derivatives transactions
- unsettled margin transactions
- unsettled when-issued transactions (e.g. trading transactions in advance of shares being issued)

(3) Grace Period for Tax Payments

An individual subject to the exit tax will be allowed to enjoy a tax payment grace period for 5 years (subject to extension upon an application to 10 years) when collateral equivalent to the amount of the exit tax is provided and a notification for appointment of a tax agent is submitted.

(4) Tax Reliefs

(i) Reversal of taxation

Where an individual who was subject to exit tax returns to Japan within 5 years (10 years for an individual who enjoys a 10-year grace period) from the departure, the exit tax on unsold eligible assets will be reversed by filing a request for correction.

(ii) Reduction of income tax

An individual enjoying the grace period may file a request for correction in order to reduce their exit tax under the following circumstances:

(a) In the case where the eligible assets are sold prior to the expiration of the grace period and the selling price of the assets falls below the value of the assets as of the departure

(b) In the case where the grace period is terminated and the value of the eligible assets at the date of the termination falls below the value of the assets as of departure

(5) Exit Tax in the case of Gift, Inheritance or Bequest

The exit tax will also be imposed when eligible persons’ eligible assets are transferred to non-resident individuals upon a gift, inheritance or bequest.

3.10 Filing Tax Returns and Tax Payments

3.10.1 National Income Taxes

(1) Final Tax Returns and Tax Payments Therefor

For individuals, the tax year is the calendar year and a final income tax return must be filed by 15 March of the following year in principle. Extensions of the filing deadline are not available. The final tax due needs to be paid by the same day, which may be extended for about 1 month if the automatic bank transfer system is elected. A tax return for special reconstruction income tax should be filed together with the final income tax return.

If the remuneration subject to withholding tax does not exceed JPY20 million and the amount of other income is less than JPY200,000, the person is not required to file a tax return since the tax liabilities are settled through a year-end adjustment of income tax on the salaries made by the employer and the amount of the other income is minor. If such person has claimable deductions such as for casualty losses, medical expenses and donations that are not deductible through the year-end adjustment procedures, a tax return should be filed to declare such deductions.

(2) Estimated Tax Payments

Those who have filed a final income tax return for the previous year will be required to make estimated tax payments for the current year in July and November. The estimated tax payments are generally equal to one-third of the net of the income tax amount for the previous year less withholding tax declared in such tax return. Note that special reconstruction income tax is also imposed on the estimated tax at 2.1 percent from 2013 to 2037. If the total of the net amount and special reconstruction income tax thereon is less than JPY150,000, prepayments are not required.

(3) Reporting Requirement for Assets/Liabilities

If an individual has an obligation to lodge their income tax return and meets the following two criteria, the individual must submit a 'Statement of Assets/Liabilities' together with their income tax return to report necessary information on assets/liabilities such as type, number, location, value of assets and amount of liabilities as of the end of the calendar year:

(i) Total income exceeds JPY20 million for a calendar year
(ii) Total value of assets as of the end of a calendar year is JPY300 million or more

or

Total value of the eligible assets for exit tax (discussed in 3.9) as of the end of a calendar year is JPY100 million or more

Proper reporting of assets/liabilities may bring the individual taxpayer reduction in penalties when understatements of tax are found in a tax audit, whereas improper reporting may bring them additional penalties.

(4) Reporting Requirement for Overseas Assets

Permanent residents who own overseas assets valued at over JPY50 million as of the end of a calendar year must submit 'Statement of Overseas Assets' to report their overseas assets by 15 March of the following year. Proper reporting of overseas assets may bring the individual taxpayer reduction in penalties when understatements of tax are found in a tax audit, whereas improper reporting may bring them additional penalties.

3.10.2 Inhabitant Taxes

Generally, an inhabitant tax return is not required to be filed since the information necessary for assessment is either submitted by employers or included in the final income tax return filed with a national tax office.

If remuneration is paid through an employer in Japan, inhabitant tax

on such income is paid to a municipal office through the employer as discussed in 3.11.2. Inhabitant taxes on other income including remuneration paid outside Japan for the previous year are generally paid directly by the taxpayer in four installments, whose payment due dates are 30 June, 31 August and 31 October of the current year, and 31 January of the following year.

3.11 Employers' Obligations

3.11.1 National Income Taxes

(1) Withholding Tax on Remuneration

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 JPY20 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 so that the total tax withheld from each payment should be the national income tax to be imposed on the annual compensation.

Note that withholding tax is also subject to special reconstruction income tax at 2.1 percent from 2013 to 2037.

(2) Reporting Requirement for Foreign Stock-based Compensation

If directors/employees of a Japanese subsidiary of a foreign company (only where 50 percent or more of the outstanding shares in the Japanese subsidiary are directly or indirectly held by the foreign company) or a Japan branch of a foreign company earn stock-based compensation, the Japanese subsidiary or the Japan branch is required to prepare and submit a report including names/addresses of the directors/employees and details of the stock-based compensation to the competent tax office by 31 March of the following year.

3.11.2 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 1 January 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

4.1.1 Tax Treatment of Dividends from Foreign Subsidiaries

A Japanese company holding a Foreign Subsidiary is generally entitled to the foreign dividend exclusion (FDE).

(1) Before the 2015 Tax Reform

Under the FDE rules dividends from Foreign Subsidiaries and foreign withholding tax thereon are treated as follows:

Dividends from Foreign Subsidiaries	Foreign withholding tax on the dividends
95% tax exempt (*)	Non-deductible and non-creditable

(*) 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.

Even if the whole amount or part of the dividends is deductible in the country where the head office of the Foreign Subsidiary is located (deductible dividends), the dividends are also subject to the FDE.

(2) After the 2015 Tax Reform

The tax treatment of deductible dividends from Foreign Subsidiaries and foreign withholding tax thereon under the FDE rules was amended by virtue of the 2015 tax reform based on the recommendation of 'Action 2 - Neutralising the Effects of Hybrid Mismatch Arrangements' included in the first deliverables released

in September 2014 under the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.

After the 2015 tax reform, dividends from Foreign Subsidiaries and foreign withholding tax thereon will be treated as follows:

- Dividends other than deductible dividends

The same as the tax treatment before the 2015 tax reform

- Deductible dividends

[In principle]

Deductible dividends from Foreign Subsidiaries	Foreign withholding tax on the dividends
Fully taxable	Deductible or creditable

[Exceptional rule]

When only part of the dividends paid by a Foreign Subsidiary is deducted in the country of the Foreign Subsidiary, only such portion is treated fully taxable as indicated below:

Deductible dividends from Foreign Subsidiaries		Foreign withholding tax on the dividends
Deductible portion	Fully taxable	Deductible or creditable
Non deductible portion	95% tax exempt	Non-deductible and non-creditable

The above amendments will be applied to dividends to be received from Foreign Subsidiaries in fiscal years of a Japanese parent company beginning on or after 1 April 2016 in principle. Note that the pre-amendment rules will be applied if dividends are derived from shares held as of 1 April 2016 and are received from Foreign Subsidiaries in fiscal years of a Japanese company beginning from 1 April 2016 to 31 March 31 2018.

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 foreign tax credits (FTC) or FDE, 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 US (in terms of shares with voting rights only), Australia and the Netherlands, 15 percent for France).

For Japanese companies applying the tax consolidation system, the holding ratio can be 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

4.2.1 Basic Rules

Under the FTC system, 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 Japanese company.

For fiscal years beginning on or after 1 April 2016, a foreign company having a PE in Japan will also be entitled to take a foreign tax credit.

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, certain foreign taxes such as those imposed at a high rate (generally a rate in excess of 35 percent) must be excluded from the creditable foreign tax.

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

[Japanese company]

$$\text{Japanese corporation tax} \times \frac{\text{Foreign source income}}{\text{Total taxable income}}$$

[Foreign company having a PE]

$$\text{Japanese corporation tax on income attributable to the PE} \times \frac{\text{Foreign source income included in income attributable to the PE}}{\text{Income attributable to the PE}}$$

The following points should be noted in relation to the formula above:

- Japan utilizes an overall limitation system rather than a country limitation system or a separate basket limitation system.

- Foreign source income does not include income which is exempted from foreign taxation.

- The ratio of foreign source income to total taxable income (income attributable to the PE for a foreign company) for the purposes of the calculation is limited to a maximum of 90 percent.

- Any allocation of expenses between domestic source and foreign source income should be done on a reasonable basis.

- If the amount of the adjusted creditable foreign tax is over the creditable limit for corporation tax purposes, such excess amount is creditable against special reconstruction corporation tax and local corporation tax to the extent of the creditable limit for special reconstruction corporation tax purposes and local corporation tax purposes, respectively, which is calculated in a similar way as discussed above.

- 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 fiscal year, this amount may be carried forward for up to 3 years to enjoy as a credit in future fiscal years.

Conversely, where there have been insufficient eligible foreign taxes in a fiscal year to make full use of the creditable limit for that year, the residual amount of the creditable limit can be carried forward for up to 3 years to increase the creditable limit applicable in subsequent fiscal years.

4.2.4 Tax Sparing Credits

A 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.

4.3 Transfer Pricing

The transfer pricing legislation is set out under the Special Taxation Measures Law for the purposes 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 Japanese company:

(i) Shareholding relationship

- a relationship between two companies in which one company owns directly or indirectly 50 percent or more of the total issued shares of the other company

- a relationship between two companies in which the same person owns directly or indirectly 50 percent or more of the total issued shares in both companies

(ii) Substantial control relationship

- a relationship between two companies in which one company can, in substance, engage in decision making regarding the other company's business affairs due to shared directors, substantial business transactions, financing, etc.

- a relationship between two companies in which the same person can, in substance, engage in decision making regarding both companies' business affairs due to shared directors, substantial business transactions, financing, etc.

(iii) Combination of shareholding relationship and substantial control relationship

4.3.3 Arm's-Length Price

The transfer pricing legislation provides for five methods to reach an arm's length price: (1) comparable uncontrolled price method, (2)

resale price method, (3) cost-plus method, (4) profit split method and (5) transactional net margin method.

(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: (i) transactions made by one of the related companies with an unrelated company, and (ii) 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) Profit Split Method

Under this method the price is calculated based on allocating the total profit arising from the overall transactions using the respective amount of expenses, fixed assets or other reasonable factors.

(5) Transactional Net Margin Method

Under this method the price is determined by reference to net profit on comparable uncontrolled transactions expressed as a percentage of a base factor (e.g. cost, sales).

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 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 stated 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 purposes 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 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.

- The statute of limitations in relation to tax investigations of transfer pricing issues is 6 years, while the statute of limitations for non-transfer pricing issues is normally 5 years.

- 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 in certain circumstances.

- 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 Rules

4.4.1 Safe Harbor of Debt-Equity Ratio

The thin capitalization rules are applicable if the debt-equity ratios in (i) and (ii) below for a Japanese company are both more than 3:1.

	Debt	Equity
(i)	Interest-Bearing Debts due to Overseas Controlling Shareholders and Specified Third Parties	Net Equity owned by Overseas Controlling Shareholders
(ii)	Total Interest-Bearing Debts	Net Equity of the Japanese company

Alternatively, a Japanese 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.

4.4.2 Definitions of Keywords

The definitions of the keywords under the thin capitalization rules are as follows:

(1) Overseas Controlling Shareholders

If a non-resident individual or a foreign company has a specified relationship with a Japanese company, that person is treated as an Overseas Controlling Shareholder of the Japanese company. The criteria for determining whether there is a specified relationship for both individuals and companies are very similar. Where the person is a foreign company, a specified relationship is defined as follows:

- a relationship between a Japanese company and a foreign

company in which the foreign company owns directly or indirectly 50 percent or more of the total outstanding shares in the Japanese company

- a relationship between a Japanese company and a foreign company in which the same person owns directly or indirectly 50 percent or more of the total outstanding shares in both companies

- a relationship between a Japanese company and a foreign company in which the foreign company can, in substance, engage in decision making regarding the Japanese company's business affairs due to shared directors, substantial business transactions, financing, etc.

(2) Specified Third Parties

If a person falls under either of the following, that person is treated as a Specified Third Party:

- a third party who provides a loan to a Japanese company under a back-to-back loan arrangement with an Overseas Controlling Shareholder of the Japanese company

- a third party who provides a loan to a Japanese company guaranteed by an Overseas Controlling Shareholder of the Japanese company

- a third party who provides a loan to a Japanese company by taking bonds the Japanese company has borrowed from an Overseas Controlling Shareholder of the Japanese company as collateral

- a third party (A) who lends bonds to a Japanese company which are guaranteed by an Overseas Controlling Shareholder of the Japanese company, and a third party (B) who provides a loan to the Japanese company by taking the above bonds as collateral

(3) Interest-Bearing Debts

Interest-Bearing Debts means the average balance (daily, monthly or quarterly average) of interest-bearing 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 stated capital and capital surplus (for tax purposes), the latter is treated as net equity for the purposes of this rule.

4.4.3 Amount to be Disallowed

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

Cases	Disallowed amount
$\{ (A) + (B) \} \leq (D)$	$(c)' \times \dfrac{\{ (A) + (B) + (C) - (D) \}}{(C)}$
$\{ (A) + (B) \} > (D)$	$(c)' + \{ (a) + (b) + (b)' \} \times \dfrac{\{ (A) + (B) - (D) \}}{\{ (A) + (B) \}}$

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

(A)	Interest-Bearing Debt due to Overseas Controlling Shareholders (where interest is _not_ subject to income tax/corporation tax in Japan)
(B)	Interest-Bearing Debt due to Specified Third Parties (where interest is _not_ subject to income tax/corporation tax in Japan)
(C)	Interest-Bearing Debt due to Specified Third Parties (where interest is subject to income tax/corporation tax in Japan)
(D)	Net Equity owned by Overseas Controlling Shareholders x 3

	(or comparable ratio)
(a)	Interest on (A)
(b)	Interest on (B)
(b)'	Guarantee fees/bond borrowing fees relating to (B) (where they are *not* subject to income tax/corporation tax in Japan)
(c)'	Guarantee fees/bond borrowing fees relating to (C) (where they are *not* subject to income tax/corporation tax in Japan)

- 'Subject to income tax/corporation tax in Japan' broadly means declared as taxable income in a Japanese tax return. Thus, interest paid to a non-resident individual/foreign company not having a permanent establishment in Japan should be '*not* subject to income tax/corporation tax in Japan', regardless of whether Japanese withholding tax is imposed on the interest.

- Interest includes discounts on bills/notes, redemption losses on bonds and other payments whose economic characteristics are equivalent to interest.

4.4.4 Miscellaneous

- The amount to be disallowed for corporation tax purposes is not treated as a dividend for withholding income tax purposes.

- Where bonds borrowed under a cash-secured bond lending transaction (genkin-tanpotsuki-saiken-taishaku-torihiki) or purchased under a bond gensaki transaction (saiken-gensaki-torihiki) are lent under another cash-secured bond lending transaction or sold under another bond gensaki transaction to Overseas Controlling Shareholders or Specified Third Parties, the 2:1 threshold with exclusion of the debts related to such transactions is applicable instead of the 3:1 threshold.

- Although a foreign company carrying on business in Japan through a PE is also subject to the thin capitalization rules, this section covers only the tax treatment for a Japanese company.

By virtue of the 2014 tax reform, the interest deduction for a foreign company having a PE will be restricted by another new rule, not by the thin capitalization rules, for fiscal years beginning on or after 1 April 2016. Under the new rule, when the amount of capital of a PE is smaller than the capital attributable to the PE (capital to be attributable to the PE if the PE were a distinct and separate enterprise from its head office), interest expenses corresponding to such deficient portion will not be allowed in calculating income attributable to the PE.

4.5 Earnings Stripping Rules

4.5.1 Limitation on Deductions for Excessive Interest Payments

When a Japanese company's Net Interest Payments to Related Persons exceed 50 percent of Adjusted Taxable Income in a fiscal year, the excess portion (i.e. the following amount) is disallowed:

Net Interest Payments to Related Persons(*)	-	Adjusted Taxable Income x 50%

(*) 'Net Interest Payments to Related Persons' means Interest Payments to Related Persons less Eligible Interest Income.

4.5.2 Definitions of Keywords

The definitions of the keywords under the Japanese earnings stripping rules are as follows:

(1) Adjusted Taxable Income

Adjusted Taxable Income means taxable income (calculated by not applying the provisions described in (i) below and treating all donations paid as tax deductible expenses) with an add back of items described in (ii) below. Note that while 'taxable income' can be negative, 'Adjusted Taxable Income' cannot.

(i) Main provisions not applied in calculating Adjusted Taxable Income

- deduction for domestic dividends received
- foreign dividends exclusion
- certain valuation losses
- disallowance of deductions for income tax/foreign tax credited against corporation tax
- deduction of carried-forward tax losses
- deduction of dividends paid by tax qualified special purpose companies
- thin capitalization rules
- earnings stripping rules

(ii) Items to be added back in calculating Adjusted Taxable Income

- Net Interest Payments to Related Persons
- tax deductible depreciation
- tax deductible bad debt losses

(2) Related Persons

Related Person means any person described in (i) and (ii) below:

(i) Any person with a specified relationship

If a person (both an individual and a company) has a specified relationship with a Japanese company, that person is treated as a Related Person of the Japanese company. The criteria for determining whether there is a specified relationship for both individuals and companies are very similar. Where the person is a company, a specified relationship is defined as follows:

- a relationship between two companies in which one company owns directly or indirectly 50 percent or more of the total outstanding shares in the other company

- a relationship between two companies in which the same person owns directly or indirectly 50 percent or more of the total

outstanding shares in both companies

- a relationship between two companies in which one company can, in substance, engage in decision making regarding the other company's business affairs due to shared directors, substantial business transactions, financing, etc.

(ii) Certain third parties

- a third party who provides a loan to a Japanese company under a back-to-back loan arrangement with a Related Person of the Japanese company as described in (i)

- a third party who provides a loan to a Japanese company guaranteed by a Related Person of the Japanese company as described in (i)

- a third party who provides a loan to a Japanese company by taking bonds the Japanese company has borrowed from a Related Person of the Japanese company as described in (i) as collateral

- a third party (A) who lends bonds to a Japanese company which are guaranteed by a Related Person of the Japanese company as described in (i), and a third party (B) who provides a loan to the Japanese company by taking the above bonds as collateral

(3) Interest Payments to Related Persons

Interest Payments to Related Persons means interest paid by a Japanese company to its Related Persons, excluding payments subject to income tax/corporation tax in Japan. Note that 'subject to income tax/corporation tax' broadly means declared as taxable income in a Japanese tax return, and thus interest paid to a Related Person who is a non-resident individual/foreign company not having a permanent establishment in Japan is included in Interest Payments to Related Persons, regardless of whether Japanese withholding tax is imposed on the interest.

(4) Eligible Interest Income

Eligible Interest Income for a fiscal year is calculated as follows:

$$\text{Total Interest Income} \times \frac{\text{Total Interest Payments to Related Persons}}{\text{Total Interest Payments}}$$

If a Japanese company receives interest from a Domestic Related Person (a Related Person who is a Japanese resident individual/Japanese company or a non-resident individual/foreign company having a permanent establishment in Japan), the lower of the following is deemed to be the interest received from that Domestic Related Person and included in the Total Interest Income in the above formula:

- Interest Income of the Japanese company from that Domestic Related Person

- Interest Income of that Domestic Related Person from a person who is neither the Japanese company nor another Domestic Related Person

The purpose of this rule is to close a loophole whereby a Japanese company provides a loan to a Domestic Related Person for the purposes of: (i) reducing its Net Interest Payments to Related Persons amount; and (ii) reducing taxable income for the Domestic Related Person.

(5) Interest Payments and Interest Income

The scope of Interest Payments and Interest Income for the purposes of the earnings stripping rules is as follows:

(i) Interest Payments

- interest payments
- discounts on bills/notes
- the interest portion of finance lease payments (where total lease

payments under the arrangement are JPY10 million or more)

- redemption losses on bonds
- guarantee fees and bond borrowing fees paid to Related Persons in the cases described in (2)(ii) above
- amortization of premiums on securities having a maturity date or a fixed redemption price
- other payments whose economic characteristics are equivalent to interest

(ii) Interest Income

- interest income
- discounts on bills/notes
- the interest portion of finance lease income
- accumulation of discounts on securities having a maturity date or a fixed redemption price
- other income whose economic characteristics are equivalent to interest

4.5.3 De Minimis Rules

A Japanese company falling under either of the following cases in a given fiscal year will not have disallowed interest pursuant to the Japanese earnings stripping rules in such fiscal year provided the relevant schedules are attached to its tax returns and documents relating to the calculation of excess interest are retained.

(i)	Net Interest Payments to Related Persons	≤	JPY10 million
(ii)	Interest Payments to Related Persons	≤	Total Interest Payments(*) x 50%

(*) Excluding interest paid to Related Persons where the interest is subject to Japanese income tax/corporation tax.

4.5.4 Deductions of Disallowed Interest Payments

When a Japanese company's Net Interest Payments to Related Persons are less than 50 percent of Adjusted Taxable Income for a given fiscal year, disallowed interest payments incurred in the past 7 years are deductible in such fiscal year up to the 50 percent threshold provided certain conditions are satisfied, e.g. relevant schedules are attached to the tax returns for all fiscal years from the fiscal year in which the oldest disallowed interest payments were incurred.

4.5.5 Miscellaneous

- If both the earnings stripping rules and the thin capitalization rules described in 4.4 are applicable in a fiscal year, only the larger of the disallowed amounts (after applying the de mininis rule discussed in 4.5.3) under either will be applied. As there is no carry forward of the disallowed amount under the thin capitalization rules, recognizing disallowed interest under the earnings stripping rules may be preferential for taxpayers, as they may be eligible to take a deduction for the disallowed amounts in the future.

- Where bonds borrowed under a cash-secured bond lending transaction (genkin-tanpotsuki-saiken-taishaku-torihiki) or purchased under a bond gensaki transaction (saiken-gensaki-torihiki) are lent under another cash-secured bond lending transaction or sold under another bond gensaki transaction to a Related Person, interest income and interest payments through these transactions will be excluded in calculating the extent of deductible interest payments.

- Although a foreign company carrying on business in Japan through a PE is also subject to the Japanese earnings stripping rules, this section covers only the tax treatment for Japanese companies.

4.6 Anti-Tax Haven (CFC) Rules

Although the anti-tax haven rules can be applied to Japanese individual residents, this section covers only the tax treatment for Japanese companies.

4.6.1 Outline of Aggregate Tax Rules

Where a Japanese company holds an interest of at least 10 percent in a Specified Foreign Subsidiary (SFS), either of the following rules may be applied:

(1) Aggregate Tax Rule on an Entity Basis

If the SFS does not satisfy the Exception Conditions, the Japanese company is required to report, as taxable income, its proportionate share of the taxable income of the SFS.

(2) Passive Income Aggregation Tax Rule

If the SFS satisfies the Exception Conditions, the Japanese company needs to report, as taxable income, its proportionate share of the Passive Income of the SFS, if any.

***

Under the Aggregate Tax Rules, income of an SFS for a fiscal year should be taxable for the fiscal year of its Japanese shareholder company which includes the day 2 months after the end of the fiscal year of the SFS.

4.6.2 Scope of Specified Foreign Subsidiary (SFS)

An SFS is a foreign related company which either:

- has its main or head office in a country which does not impose tax on income; or
- has an effective income tax rate of 20 percent or less (less than 20 percent for fiscal years of a foreign related company beginning on or after 1 April 2015).

(A foreign related company means a foreign company more than 50 percent of which is directly or indirectly owned by Japanese companies, Japanese resident individuals and non-resident individuals having a special relationship with the Japanese companies or the Japanese resident individuals.)

The effective income tax rate for a foreign related company is calculated by (A)/(B) where:

(A) = (i) + (ii):

(i) foreign corporate taxes paid on income in the country in which the foreign related company's head office is located and other countries

(ii) foreign corporate taxes deemed to be paid using tax sparing credits

(B) = (i) + (ii) ± (iii):

(i) taxable income calculated in accordance with the tax laws of the country where the foreign related company's head office is located

(ii) non-taxable income calculated in accordance with the tax laws of the country where the foreign related company's head office is located

(iii) other adjustments

In calculating (ii), it is not necessary to add back the following items even if these are not taxed in the country where the foreign related company's head office is located:

- domestic dividends
- foreign dividends

4.6.3 Scope of Taxpayers

The scope of taxpayers subject to the Aggregate Tax Rules is a Japanese company, or a Japanese company belonging to a family company group, holding directly or indirectly at least 10 percent of an SFS.

4.6.4 Taxable Income under Aggregate Tax Rule on an Entity Basis

In calculating taxable income of an SFS of a Japanese company under the Aggregate Tax Rule on an entity basis, the following items are excludable:

- the following dividends that the SFS receives:
  - dividends from another SFS (but not a subsidiary defined below) of the Japanese company
  - dividends received from a subsidiary, 25 percent or more of whose outstanding shares are held by the SFS continuously for 6 months or longer as at the date on which the obligation to pay the dividends is determined

    (If the whole amount or part of the dividends is deductible in the country where the head office of the subsidiary is located, such dividends will not be excludable in calculating taxable income unless the subsidiary is another SFS of the Japanese company. When the subsidiary is another SFS of the Japanese company and the whole amount or part of the dividends is deductible in the country where the head office of the subsidiary is located, such dividends will be excludable only to the extent of the taxable income of the subsidiary that has already been aggregated to the Japanese company. These rules will be applied to taxable income to be aggregated to a Japanese company for fiscal years of the SFS beginning on or after 1 April 2016.)
- tax losses incurred in the previous 7 years

- foreign corporate taxes paid on income in the country in which the foreign related company's head office is located and other countries

4.6.5 Exception Conditions

If an SFS satisfies all of the following four conditions for a fiscal year, the Aggregate Tax Rule on an entity basis is not applied to the SFS for that fiscal year:

(1) Business Purpose Test

The primary business of the SFS is not any of the following businesses:

- holding of share certificates or bonds
- licensing of industrial rights or copyrights
- leasing of vessels or aircraft

(2) Substance Test

The SFS maintains an office, store, factory, or other fixed place of business necessary to conduct its primary business in the country where the head office of the SFS is located.

(3) Administration and Control Test

The SFS functions with its own administration, control, and management in the country where the head office of the SFS is located.

(4) Unrelated Party Test/Country of Location Test

Depending on the primary business of the SFS, either of the following is applied:

(i) Unrelated party test

(businesses subject to this test: wholesale business, banking business, trust business, financial instruments business, insurance business, ocean transport or air transport business)

The business of the SFS is conducted primarily (more than 50 percent) with unrelated parties.

(ii) Country of location test

(businesses subject to this test: other than businesses listed in (i))

The business of the SFS is conducted primarily in the country where the head office of the SFS is located.

4.6.6 Exception Conditions for Regional Headquarters Companies

The Exception Conditions are relaxed when an SFS is a Regional Headquarters Company (RHQ). If an SFS satisfies the Exception Conditions as an RHQ, a schedule including details of the RHQ and its Controlled Companies (CCs) and a structure diagram showing the equity relationship basically need to be attached to the corporate final tax returns, and certain documents need to be retained.

(1) Regional Holding Company

Even when an RHQ's primary business is holding shares, if the book value of shares in its CCs is more than 50 percent of the total book value of share investments of an RHQ at the end of the RHQ's fiscal year, the RHQ is considered to satisfy the business purpose test.

In addition, either of the following conditions also needs to be met for fiscal years of the RHQ beginning on or after 1 April 2015:

- The book value of shares in its foreign CCs is more than 50 percent of the total book value of shares in its CCs.

- The management service fees received from foreign CCs is more than 50 percent of the total management service fees received from its CCs.

Also, under the substance test and the country of location test, the primary business of such RHQ is treated as providing management services to its CCs.

(2) Regional Logistic Management Company

If an RHQ is primarily engaged in wholesale businesses, transactions between the RHQ and its foreign CCs are treated as transactions with unrelated parties for the purposes of the unrelated party test.

(3) Definitions of Keywords

The definitions of an RHQ, CC and management services are as follows:

■ RHQ (Regional Headquarters Company)

An RHQ is an SFS satisfying the following:

(i) 100 percent of the shares of the SFS are directly or indirectly held by a Japanese company.

(ii) The SFS provides at least two foreign CCs with management services.

(iii) The SFS has a fixed place of business (an office, shop or factory) and employees (those who are mainly involved with the management services, excluding directors of the SFS and family members of the directors) in the country where the head office of the SFS is located.

■ CC (Controlled Company)

A CC is a company satisfying the following:

(i) At least 25 percent (50 percent for a Japanese company) of the shares and the voting rights of the company are directly held by an RHQ.

(ii) The company has employees engaged in the business carried on in the country where its head office is located.

(iii) Either of the following exceeds 50 percent:

(a) total ownership of the company by an RHQ, the Japanese shareholder company of the RHQ and foreign companies interposed between the RHQ and the Japanese shareholder company (Principle Shareholders)

(b) total ownership of the company by its Principle Shareholders and companies falling under (a)

(c) total ownership of the company by its Principle Shareholders and companies falling under (a) or (b)

Note that a Japanese company will be eligible to be a CC for fiscal years of the RHQ beginning on or after 1 April 2015.

■ Management Services

Management services are services provided by an SFS in accordance with a contract between the SFS and its CCs, in connection with decisions or changes of the CCs' business policy, which should be essential to its business. The services need to contribute to the enhancement of the profitability of the CCs by providing such services collectively to the CCs.

4.6.7 Scope of Passive Income

Even if an SFS satisfies the Exception Conditions, its Japanese shareholder company needs to report, as its taxable income, a proportionate share of the Passive Income of the SFS. The Passive Income to be reported is the total revenue of the following items less related expenses:

(i) dividends from shares where the SFS holds less than 10 percent of the shares
(ii) interest on bonds
(iii) difference between the redemption price and the acquisition cost of bonds
(iv) capital gains from sale of shares described in (i) (only when sold through exchange trades or over-the-counter transactions)
(v) capital gains derived from sale of bonds (only when sold through exchange trades or over-the-counter transactions)
(vi) royalties from IP (e.g. patents, excluding certain IP such as that developed by the SFS)
(vii) lease fees of vessels or aircraft

Deductible related expenses are direct expenses related to each item including withholding taxes. For items from (i) to (iii), interest expenses attributable to such items are also deductible.

The Passive Income Aggregation Tax Rule is not applicable for Passive Income falling under items from (i) to (v), if such income is derived from activities that are fundamental and essential to the businesses (except for the three businesses listed in the business purpose test).

If an SFS falls under either of the following cases, the Passive Income Aggregation Tax Rule is not applied to the SFS:

- total revenue of the Passive Income ≤ JPY10 million
- total of the Passive Income ≤ 5 percent of profits before tax

The maximum amount of the Passive Income of an SFS is the amount of the income subject to the Aggregate Tax Rule on an entity basis for the SFS assuming that the SFS did not satisfy the Exception Conditions.

4.6.8 Foreign Tax Credits for Foreign Taxes on Aggregate Income

Foreign taxes levied on an SFS's income that is also taxed in the hands of its Japanese shareholder company under the Aggregate Tax Rules are subject to foreign tax credits in Japan.

4.6.9 Tax Treatment of Dividends Received by a Japanese Company

There are rules to prevent double taxation where an SFS's income taxed under the Aggregate Tax Rules is taxed again when the SFS distributes the income to its Japanese shareholder company.

(1) Dividends from a First Tier Foreign Company

When a Japanese company receives dividends from a foreign company which has the Specified Taxed Amount, such dividends are fully exempt from tax for the Japanese company to the extent of the amount of the Specified Taxed Amount. Foreign withholding taxes imposed on such dividends are deductible.

The Specified Taxed Amount is the amount that has been taxed under the Aggregate Tax Rules in the fiscal year the dividend is received (the dividend receiving year) and the fiscal years beginning within 10 years before the commencement of the dividend receiving year.

(2) Dividends from a Second Tier Foreign Company

When a Japanese company receives dividends from a foreign company (i.e. a first tier foreign company) which has an Indirect Specified Taxed Amount, such dividends (excluding the amount covered by (1)) are fully exempt from tax for the Japanese company to the extent of the amount of the Indirect Specified Taxed Amount. Foreign withholding taxes imposed on such dividends are deductible.

The Indirect Specified Taxed Amount is the smaller of the following:

(i)	Dividends[1] that the first tier foreign company received from the second tier foreign company within the past 3 years[2]	x	The Japanese company's direct holding ratio for the first tier foreign company (on the record date for the latest dividend)
(ii)	The second tier foreign company's income which has been aggregated to the Japanese company's income within the past 3 years	x	The Japanese company's indirect holding ratio for the second tier foreign company (at the end of fiscal year of the second tier foreign company)

[1] Excludes certain dividends, such as those which were received in the years before the year when the aggregated taxable income of the second tier foreign company was derived.

[2] 'Past 3 years' means the fiscal year in which the Japanese company received the dividend from the foreign company (the dividend receiving year) and fiscal years beginning within 2 years before the commencement of the dividend receiving year.

4.7 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.

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 10 percent.

4.8 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 regard to the taxation of a foreign company having a PE in Japan, please see Chapter 1.

4.8.1 Tax Treaties

Japan has concluded tax treaties with the following countries/regions as at the time of writing (1 October 2015):

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

Agreements centered on the exchange of information are not included in the above.

(1) Covers Czech Republic and Slovak Republic

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

(*) Concluded but not yet applicable as at the time of writing (1 October 2015).

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

	Status	Effective dates of the amendments for Japanese taxes
Kuwait	Tax treaty – signed in February 2010	- WHT: 1 January 2014 - Tax other than WHT: Taxable years beginning on or after 1 January 2014
Portugal	Tax treaty – signed in December 2011	- WHT: 1 January 2014 - Tax other than WHT: Taxable years beginning on or after 1 January 2014
New Zealand	Revised tax treaty – signed in December 2012	- WHT: 1 January 2014 - Tax other than WHT: Taxable years beginning on or after 1 January 2014
Oman	Tax treaty – signed in January 2014	- WHT: 1 January 2015 - Tax other than WHT: Taxable years beginning on or after 1 January 2015

UAE	Tax treaty – signed in May 2013	- WHT: 1 January 2015 - Tax other than WHT: Taxable years beginning on or after 1 January 2015
UK	Revised tax treaty – signed in December 2013	- WHT: 1 January 2015 - Tax other than WHT: Taxable years beginning on or after 1 January 2015 - New article on business profits: Taxable years beginning on or after 1 April 2016
Sweden	Revised tax treaty – signed in December 2013	- WHT: paid or credited on or after 1 January 2015 - Tax other than WHT: Taxable years beginning on or after 1 January 2015
US	Revised tax treaty – signed in January 2013	
Qatar	Tax treaty – signed in February 2015	
Germany	Agreement in principle on the revised tax treaty — reached in July 2015	
Chile	Negotiation to conclude a tax treaty —started in October 2015	

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).

In addition, Japan has concluded the Convention on Mutual Administrative Assistance in Tax Matters (effective on 1 October 2013) and agreements centered on the exchange of information which generally include provisions on the allocation of taking rights with respect to certain income of individuals with the following countries/regions:

- The Bahamas
- Bermuda
- The Cayman Islands
- Guernsey
- The Isle of Man
- Jersey
- Macao
- Principality of Liechtenstein
- Samoa
- The British Virgin Islands

4.8.2 Dividends, Interest and Royalties

Japanese withholding income tax is ordinarily imposed on dividend, interest and royalty payments to foreign companies and non-resident individuals. The normal withholding rate is 20.42 percent including special reconstruction income tax that is imposed on withholding tax at 2.1 percent from 2013 to 2037 (in certain limited cases for interest, 15.315 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 foreign investor or the investor's 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 applied in Japan 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.

Where a reduced withholding tax rate or exemption is applied under a tax treaty, the special reconstruction income tax will not be imposed.

Name of country	Dividends			Interest	Royalties
	Between Parent and Subsidiary		Other		
Australia	0% 5%	(80%) (10%)	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%	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% 5%	(15% directly or- 25% directly or indirectly) (10%)	10%	0-10%	0%
Germany	10%	(25%)	15%	10%	10%
Hong Kong	5%	(10%)	10%	10%	5%
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%	10%	5%
Kuwait	5%	(10%)	10%	10%	10%
Luxembourg	5%	(25%)	15%	10%	10%
Malaysia	5%	(25%)	15%	10%	10%
Mexico	0-5%	(25%)	15%	10-15%	10%
Netherlands	0% 5%	(50%) (10%)	10%	0-10%	0%
New Zealand	0%	(10%)	15%	0-10%	5%
Norway	5%	(25%)	15%	10%	10%
Oman	5%	(10%)	10%	10%	10%
Pakistan	5% 7.5%	(50%) (25%)	10%	10%	10%
Philippines	10%	(10%)	15%	10%	10-15%
Poland	10%		10%	10%	0-10% [5]
Portugal	5%	(10%)	10%	5-10%	5%
Qatar	5%	(10%)	10%	0-10%	5%
Romania	10%		10%	10%	10-15%
Saudi Arabia	5%	(10%)	10%	10%	5-10%
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	(10%)	10%	0%	0%
Switzerland	0% 5%	(50%) (10%)	10%	0-10%	0%
Thailand	15-20%	(25%)	-	10-25%	15%
Turkey	10%	(25%)	15%	10-15%	10%
UAE	5%	(10%)	10%	10%	10%
UK	0%	(10%)	10%	0%	0%
US (current)	0% 5%	(50%) (10%)	10%	0-10%	0%
US (revised)	0% 5%	(50%) (10%)	10%	0%	0%
USSR [3]	15%		15%	10%	0-10% [5]
Vietnam	10%		10%	10%	10%
Zambia	0%		0%	10%	10%

[1] Covers Czech Republic and Slovak Republic

[2] The original tax treaty with the UK 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 percent of certain royalties are exempt and royalties for copyright or cinema films are fully exempt.

[5] Cultural royalties are exempt.

4.8.3 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 (and local corporation tax for fiscal years beginning on or after 1 October 2014), 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 31 March 2017.

Withholding tax at 10 percent (10.21 percent from 2013 to 2037 including a 2.1-percent special reconstruction income tax) 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.

4.8.4 Shares in a Real Estate Holding Company

(1) Taxation under Japanese Domestic Tax Law

Capital gains from a disposition of shares in real estate holding companies by a non-resident individual or a foreign company are subject to income tax or national corporation tax (and local corporation tax for fiscal years beginning on or after 1 October 2014), respectively.

- 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 Japanese companies or foreign companies can be real estate holding companies.

(i) land, buildings, attachments to buildings and structures situated in Japan
(ii) shares in other real estate holding companies

- Safe harbor rule

There is a safe harbor rule, which excludes minority shareholders from this taxation system. Where the aggregate shareholding in the real estate holding company of a foreign investor and its related persons as of the day prior to the beginning of the fiscal year including the disposal day was 5 percent or less (2 percent or less for unlisted companies) of the total issued shares of the company, the foreign investor is not taxed on capital gains on a disposal of shares in real estate holding companies.

- Related persons

'Related persons' of a foreign investor in the above are as follows:

(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

Where a foreign investor holds shares in a real estate holding company through an NK-type partnership[2], any other partners of the partnership are treated as related persons of the foreign investor.

[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.

(2) 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	Romania
Brazil	Indonesia	Spain
Czechoslovakia	Ireland	Zambia
Finland	Italy	
Germany	Poland	

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

Bulgaria	Korea	US (*)
India	USSR	

(*) Under the revised tax treaty that was signed in January 2013, Japan is given the right to impose Japanese tax on capital gains from sales of shares in a real estate holding company that is either a Japanese company or a foreign company.

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 4.8.5. and the real estate holding company is a Japanese company.

Austria	Denmark

4.8.5 Shares in a Japanese Company

(1) Taxation under Japanese Domestic Tax Law

Capital gains from the sale of shares in a Japanese company by a non-resident individual or a foreign company are subject to income tax or national corporation tax (and local corporation tax for fiscal years beginning on or after 1 October 2014), respectively in the circumstances described below:

(i) gains arising from the sale of forestalled shares (shares acquired for the purposes of a takeover of a company or a demand sale of such shares) in a Japanese company

(ii) gains arising from the sale of a substantial interest in a Japanese company, being a sale made by a foreign investor of 5 percent or more of the outstanding shares of a Japanese company within 1 fiscal year, where the seller investor has held 25 percent or more of such outstanding shares at any time during the fiscal year of

sale or during the 2 preceding fiscal years

When judging the threshold of 25 percent and 5 percent in (ii) above, the judgment should be made by looking at the aggregate shareholding in the Japanese company of the foreign shareholder and related persons of the foreign shareholder.

'Related persons' of the foreign investor in the above are as follows:

(i) family relatives of a 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

Where a foreign shareholder holds shares in a Japanese company through an NK-type partnership[2], any other partners of the partnership are treated as related persons of the foreign investor.

[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.

However, 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 1 year, or where shares in a bankrupt financial institution are transferred:

(i) disposals of shares by a Specified Foreign Partner(*) through an Investment Fund(*)

(ii) disposals of shares by a foreign partner of an Investment Fund(*) through the Investment Fund, provided that the foreign partner 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 3 years

(*) Please see Chapter 2 (2.1.2) for the definition of the 'Specified Foreign Partner' and 'Investment Fund.'

(2) 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 Japanese 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	Poland
Belgium	Ireland	Portugal (2)
Brazil	Italy	Romania
Czechoslovakia	Kuwait (2)	Spain
Finland	Netherlands (2)	Switzerland (2)
Germany	New Zealand (2)	UK (2)
Hong Kong (2)	Oman (2)	US (2)
Hungary	Philippines (2)	Zambia

[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.

[2] Exemption is not applicable in relation to real estate holding companies.

The tax treaty with Qatar that is not yet applicable also provides for exemption unless the Japanese company is a real estate holding company.

Furthermore, some tax treaties such as those with the US, Hong Kong, the Netherlands and Switzerland include a clause to give a source country the taxing right on capital gains from shares of distressed financial institutions.

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.

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 a company:

(i) the sale or lease of an asset located in Japan
(ii) the supply of services (excluding digital services) provided in Japan
(iii) the supply of digital services provided to individual residents of Japan or Japanese companies

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 as follows:

- 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 Digital Services

Under the 2015 tax reform, new rules on digital services were introduced and became effective on 1 October 2015.

(1) Digital Services and Place of Taxation Therefor

Digital services are defined as 'services supplied through telecommunications lines such as supplies of copyrighted works through telecommunications lines' and include neither 'services that merely enable customers to use communication lines (e.g. telephone)' nor 'supplemental services incidental to non-digital services.'

Examples of digital services indicated by the Japanese tax authorities are as follows:

- provision of e-books, digital newspapers, music, videos, and software (including various applications such as games) via the internet
- services that allow customers to use software and databases in the cloud
- services that provide customers with storage space to save their electronic data in the cloud
- distribution of advertisements via the internet
- services that allow customers to access shopping and auction sites on the internet (e.g., charges for posting goods for sale, etc.)
- services that allow customers to access places to sell game software and other products on the internet
- provision via the internet of reservation website for accommodation and restaurants (those who charge for posting on the website from the businesses that provide accommodation and operate restaurants)
- English lessons provided via the internet consulting services provided continuously via telephone and emails

As the place of taxation for digital services is to be determined by the place of the service recipient, digital services provided to individual residents of Japan or Japanese companies are treated as domestic transactions, which are generally taxable for consumption tax purposes.

(2) Classification of Digital Services Provided by Foreign Suppliers

As Japan has not adopted a VAT identification number system, unlike EU countries, digital services provided by foreign suppliers (non-resident individuals or foreign companies) are classified into B2B (business to business) digital services and B2C (business to consumers) digital services based on the characteristics of the services or the terms and conditions of the transactions as indicated below:

B2B digital services	Digital services supplied by foreign suppliers where the recipients of the services are normally limited to business customers based on the characteristics of the services or the terms and conditions of the transactions
B2C digital services	Digital services supplied by foreign suppliers not falling under the above B2B digital services

(3) Tax Treatment of B2B Digital Services (Reverse Charge Mechanism)

Where a foreign supplier provides B2B digital services to a domestic business customer, the obligation to declare/pay consumption tax on the services is imposed on the domestic business customer under the reverse charge mechanism. Thus, consideration of such supplies paid by the domestic business customer does not include consumption tax.

If the taxable sales ratio (see 5.1.8) for a taxable period of a business customer is greater than or equal to 95 percent or if the simplified calculation method is elected for a taxable period of a business customer, reverse charge purchases[*] will be ignored for the taxable period for the time being. This is a transitional measure to take into account the administrative burden for domestic business customers.

[*] Reverse charge sales/purchases means sales/purchases subject to the reverse charge mechanism. In addition to B2B digital services, specific entertainment services will also be subject to

the reverse charge mechanism from 1 April 2016. When a foreign supplier provides business customers with services performed by entertainers or professional athletes in Japan, such services are treated as specific entertainment services.

(4) Tax Treatment of B2C Digital Services

A foreign supplier has an obligation to file a consumption tax return and pay consumption tax to the Japanese government with respect to B2C digital services in the same way as that for ordinary domestic taxable transactions.

As discussed in (2), digital services provided by foreign suppliers are classified into B2B or B2C based on the characteristics of the services or the terms and conditions of the transactions. Thus, there could be cases where a domestic business customer receives B2C digital services from foreign suppliers. A special rule whereby a domestic business customer receiving B2C digital services is able to take a credit for the consumption tax on the B2C digital services only when it is provided from a registered foreign supplier (see details in (5) below) was introduced. This is because it is uncertain that the Japanese government is able to collect consumption tax on B2C digital services from non-registered foreign suppliers.

(5) Registration of Foreign Suppliers

A foreign supplier having consumption taxpayer status is able to become a registered foreign supplier by submitting an application form together with certain documents to the National Tax Agency (NTA) through the competent tax office. The NTA makes public basic information (e.g. name, address, registration number and date of registration) of registered foreign suppliers on its website once registered so that domestic business customers of B2C digital services can confirm if their counterparties are registered or not.

A registered foreign supplier is required to issue invoices including relevant information (e.g. the registration number) upon customers' requests and preserve such invoices for 7 years.

Moreover, a registered foreign supplier will not be able to have tax

exempt status after obtaining approval for the registration unless its registration is canceled.

5.1.4 Taxpayers Required to File a Consumption Tax Return

Whilst broadly anyone, whether a consumer or a business operator, 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.

(1) Principle Rules for Taxpayer Status

In principle, a business operator's taxpayer status is determined depending on the amount of taxable sales (domestic taxable sales (excluding reverse charge sales) and export exempt sales) in the past as follows:

Taxable sales in the base period[(1)]	Taxable sales in the specified period[(2)]	Taxpayer status
over JPY10 million	-	Taxpayer
JPY10 million or less	over JPY10 million	Taxpayer
	JPY10 million or less	Not taxpayer

[(1)] The base period generally means the fiscal year 2 years prior to the current fiscal year for a corporate taxpayer. Where the base period is not 1 year, the annualized value of the taxable sales in the base period is used. For an individual taxpayer, the base period means the calendar year 2 years prior to the current year.

[(2)] The specified period generally means the first 6 months of the previous fiscal year for a corporate taxpayer. For an individual taxpayer, it means the period from January to June of the previous year.

When determining taxpayer status for taxable periods including 1

October 2015 or beginning on or after 1 October 2015, taxable sales in the base period or the specified period should be calculated on the assumption that the amendments discussed in 5.1.3 were applied from the first day of the base period or the specified period. If it is difficult to calculate this, taxable sales in the base period or the specified period can be calculated based on the taxable sales for the period from 1 April to 30 June 2015 on the assumption that the amendments discussed in 5.1.3 were applied for that period.

(2) Election for Taxpayer Status

Regardless of the rules described in (1), a business operator is able to become a taxpayer by an election for consumption taxpayer status.

An application must ordinarily be submitted prior to the commencement of the first taxable period for which it will apply. However, in the first taxable period of a business operator, the election can apply from the commencement of business where the election is made prior to the end of that taxable period. An election is irrevocable generally for a period of 2 years.

If a taxpayer who made an election for taxpayer status acquires certain fixed assets (the acquisition cost of which is JPY1 million or more) within this 2-year period (excluding taxable periods in which the simplified tax credit system has been applied), the taxpayer status must continue for 3 years beginning from the taxable period in which the fixed assets are acquired.

(3) Newly Established Companies

Even if a business operator is not treated as a consumption taxpayer under the rules described in (1) or (2), if it is a newly established company falling under either of the following tests, the company will have mandatory taxpayer status in fiscal years with no base period (generally, for the first 2 fiscal years).

(i) The newly established company's stated capital at the beginning of the fiscal year is JPY10 million or more.

(ii) The newly established company meets both of the following:

- The newly established company is controlled (e.g. the majority of the outstanding shares of which are directly or indirectly held) by a person (including individuals and companies) as of the beginning of the fiscal year.

- The amount of the taxable sales for the person who is treated as controlling the newly established company or the amount of the taxable sales for a company related to that person exceeds JPY500 million in the period corresponding to the theoretical base period of the fiscal year of the newly established company.

If a company having mandatory taxpayer status under the above tests acquires certain fixed assets (the acquisition cost of which is JPY1 million or more) in fiscal years with no base period (excluding taxable periods in which the simplified tax credit system has been applied), the company must continue to be taxpayer for 3 years beginning from the taxable period in which the fixed assets are acquired.

5.1.5 Taxpayers as an 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.

5.1.6 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.

5.1.7 Tax Rate

The current consumption tax rate is 8 percent that was increased from 5 percent on 1 April 2014. Furthermore, the rate will increase to 10 percent on 1 April 2017. Although the increase was originally planned to be effective on 1 October 2015, it was postponed for 18 months.

5.1.8 Computation of Consumption Tax to be Paid

Unless a taxpayer elects for the simplified calculation method (discussed in 5.1.9), consumption tax to be declared in a consumption tax return and to be paid over to the government by a consumption taxpayer should be calculated based on the net of (i) consumption tax received on domestic taxable sales transactions for the taxable period (output tax) minus (ii) 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 the creditable input tax suffered in a taxable period exceeds the output tax in the same period, a refund of the difference will be made.

Note that if a taxpayer receives services subject to the reverse charge mechanism in a taxable period, the consumption tax on the reverse charge purchases will be added to both (i) output tax and (ii) input tax, unless the taxable sales ratio for the taxable period is greater than or equal to 95 percent.

The creditable input tax is calculated depending on the taxable sales

ratio and the taxable sales as follows:

Taxable sales ratio	Taxable sales for the taxable period	Creditable input tax
95% or more	JPY500 million or less	Total input tax (i.e. fully creditable)
	over JPY500 million	Creditable input tax is calculated by [1] Individual method, or [2] Pro-rata method
less than 95%	-	

- Taxable sales ratio

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

Domestic taxable sales do not include reverse charge sales and the amounts of sales do not include output tax.

(*) As for sales proceeds of certain securities/monetary claims, only 5 percent of the proceeds should be included.

- Taxable sales for the taxable period

Taxable sales means domestic taxable sales (excluding reverse charge sales) and export exempt sales. Where the taxable period is shorter than 1 year, the annualized value of the amount of the taxable sales will be used.

- Total input tax

$$\text{Total gross value of domestic taxable purchase transactions (including input tax)} \times 8/108^{(*)} + \text{Input tax on import transactions}$$

(*) 10/110 will be applied to transactions carried out on or after 1 April 2017 except for those covered by the transitional measures.

When a taxpayer receives services subject to the reverse charge mechanism, total input tax should include consumption tax on such reverse charge purchases (i.e. total gross value of reverse charge purchases x 8/100 (10/100 from 1 April 2017).

- Individual method

(a) + (c) x Taxable sales ratio(*)

(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

Total input tax x Taxable sales ratio

If this method is chosen, it should be used at least for 2 years.

5.1.9 Simplified Calculation Method

A simplified calculation method, as described below, is applicable to individual and corporate taxpayers the annualized value of whose taxable sales (domestic taxable sales and export exempt sales) for the base period was JPY50 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 2 years.

Under the simplified calculation method, the tax payable is calculated by using the following formula:

Domestic taxable sales	x	Assumed profit margin	x	Consumption tax rate

The assumed profit margin differs depending on the taxpayer's business as follows:

<table>
<tr><th colspan="2" rowspan="3">Taxpayer's business</th><th colspan="2">Assumed profit margin</th></tr>
<tr><th colspan="2">Taxable period beginning</th></tr>
<tr><th>before 1 April 2015</th><th>on or after 1 April 2015</th></tr>
<tr><td colspan="2">Wholesale</td><td>10%</td><td>10%</td></tr>
<tr><td colspan="2">Retail</td><td>20%</td><td>20%</td></tr>
<tr><td colspan="2">Manufacturing, construction, mining, agriculture and fishing</td><td>30%</td><td>30%</td></tr>
<tr><td rowspan="2">Service, etc.</td><td>Transportation, communication and services</td><td rowspan="2">50%</td><td>50%</td></tr>
<tr><td>Real estate</td><td>60%</td></tr>
<tr><td rowspan="2">Other than above</td><td>Food services, etc.</td><td rowspan="2">40%</td><td>40%</td></tr>
<tr><td>Financial or insurance services</td><td>50%</td></tr>
</table>

5.1.10 Taxable Period

The taxable period is the respective fiscal year for a corporate taxpayer and the calendar year for an individual taxpayer.

However, upon election, the taxable period may be on a quarterly basis rather than on an annual basis (i.e. every 3 months starting from the commencement date of the respective fiscal year for a corporate taxpayer and the periods from January to March, April to

June, July to September, and October to December for an individual taxpayer). A monthly taxable period is also available upon election.

5.1.11 Tax Returns and Tax Payments

(1) Final Tax Return and Tax Payments

A taxpayer is required to file its final consumption tax return and pay tax due within 2 months after the end of the taxable period.

(2) Interim Tax Returns and Tax Payments

A taxpayer who has not elected for a quarterly or monthly taxable period may be required to make interim payments depending on the amount of the consumption tax payable for the previous taxable period (the annualized value if the previous taxable period is shorter than 1 year) described as follows within 2 months after the end of each interim period:

Amount of the consumption tax payable for the previous taxable period	Interim payments
over JPY60,952,300	Monthly basis
over JPY5,079,300 but JPY60,952,300 or less	Quarterly basis
over JPY609,500 but JPY5,079,300 or less	Semi-annual basis

Interim consumption tax payable is calculated on a pro-rata basis (i.e. calculated by dividing the consumption tax payable for the previous taxable period by the number of the months of the previous taxable period and multiplied by the number of the months of the interim period) or on a provisional basis (i.e. calculated based on actual operating results for each interim period).

Interim tax returns should be filed within 2 months after the end of each interim period. However, if interim consumption tax payable is calculated on a pro-rata basis, filing can be skipped.

5.2 Customs Duty

As a World Trade Organization (WTO) signatory country, Japan's customs valuation related laws and practices are generally similar to what are agreed in the WTO Customs Valuation Agreement. Japan also follows WCO positions regarding classification, etc.

5.2.1 Customs Valuation

Japanese customs valuation methodologies incorporate the rules of the WTO Customs Valuation Agreement and its appraisement hierarchy.

(1) First Sale for Export

Japanese Customs Office does not accept First Sale for Export position for customs valuation purposes.

(2) Unbundling

Unbundling various cost factors, which are essentially not dutiable, from the transaction value could be a valid option for customs duty purposes. In such case, the related transaction agreements should be modified to support the non-dutiable nature of the unbundled factors.

(3) Buying Agent Fee

The fee for a Buying Agent is not dutiable

(4) Commissionaire Arrangements

Transaction value is generally not applicable since a commissionaire is recorded as the importer. Either deductive value or computed value would be generally selected as the appropriate valuation methodology.

In a typical commissionaire arrangement, the commissionaire carries out the role of the importer of record from a formalities

standpoint. However, Japan Customs generally refers to the economic substance of the arrangement to treat the 'import' declared by the commissionaire as an intra-company movement of goods by the principal, which is not accompanied with buy-and-sell and therefore deny a valuation based on the transaction value. Japan customs often requires the application of the deductive value in such a case.

(5) Royalty and Valuation

A royalties paid by the buyer in order to import goods is required to be included at transaction value. Determination of whether the buyer must pay a royalty or license fee as a condition of sale must be made based of the facts and circumstances of each situation surrounding the sale and importation of the goods, including the contractual and legal obligations contained in relevant documents, such as the sales, royalty, and/or license agreements as mentioned in Article 7, Commentary 25.1 of the WCO Technical Committee on Customs Valuation.

(6) Transfer Pricing and Valuation

In a situation where the sales and purchase agreement does not include a price adjustment clause for transfer pricing purposes, how to treat the transfer pricing adjustment from a customs valuation perspective is not prescribed in the Japanese customs laws/regulations. Entering into a blanket value application and obtaining an advance agreement with the customs office regarding the treatment of the transfer pricing adjustment in the customs valuation can resolve uncertainty in such a situation.

5.2.2 Classification

The Customs Tariff Schedules of Japan is based on the HS convention and its Annex. In addition to the six-digit subheadings in the Annex, Japan adopts additional codes of three-digits for statistics purpose. Please see 5.2.5 for advance ruling regarding classification.

5.2.3 Customs clearance by non-resident owner of goods

A non-resident person or a company who does not have a business presence in Japan can be an importer of record under its own name regarding the importation of goods into Japan.

When a non-resident person or a foreign company clears goods through customs, the importer must appoint a customs representative to carry out the work by proxy. The customs representative must be a person who has an address or residency in Japan, or a company which has a business presence in Japan. A notification to the customs office is required in advance of the import.

5.2.4 Measures for Processing Trade

Japanese customs laws provide measures for promoting processing trade.

(1) Duty exemption for re-export

This exemption applies to processing which is relatively simple and therefore it is easy to see the connection between the original import and the export. There are certain procedural requirements upon original entry.

(2) Bonded Factory

A factory can be a Bonded Factory if approved by the chief of customs office subject to fulfillment of various administrative conditions. Use of Bonded Factory may be considered in a case where the processing is not simple or the connection between the input raw materials and the output goods becomes hard to identify.

5.2.5 Advance rulings

(1) Advance Rulings and Informal Inquiries

The advance rulings can be utilized by importers and other related parties to seek advice from customs on tariff classification, origin of imported goods, and valuation methods respectively prior to importation. Although the prior instruction under this system can be provided either orally or in writing, it is generally advisable to seek written clarification for the sake of better assurance. In addition, it is possible to make inquiries by e-mail as a part of oral inquires.

In principle, all the written/issued rulings will become publicly accessible on the customs website as they may serve as references for other interested parties. Any information contained in the ruling that would identify specific parties/individuals is not disclosed. The timeline for issuing a formal response paper varies for each case, but it generally requires months rather than weeks.

In the case of an inquiry made orally or via informal emails, the corresponding response(s) will generally also be provided orally or via informal email. The benefit of an informal oral inquiry approach is that the traders may expect relatively shorter turnaround time compared to a written/formal response.

(2) Value Declaration/Application

There are two categories of value declaration/applications which traders (e.g., importers) may utilize:

- Individual Value Application: The individual value application is valid for single duty-payable import declaration

- Blanket Value Application: The blanket value application covers several duty-payable import declarations for a specific import transaction for a specified period. Blanket value application is valid for a maximum period of two years.

To prepare and submit a blanket value application, it is normally the case that the trader (e.g., importer) would need to go through individual face-to-face consultations with valuation officers at the competent customs office. Since the method of valuation is discussed intensively based on specific fact patterns as well as detailed support documents, once the blanket value application is accepted by customs, in most cases it is likely that customs would respect the position per the original blanket value application in practice, although, technically speaking, it should not be regarded as an official position of customs on the valuation treatment for the imported goods.

5.2.6 Post Entry Customs Audit and related administration

Post entry customs audits are carried out every 3 years to 5 years. Some importers automatically become subject to a post entry customs audit by unusual date input into NACCS (Nippon Automated Cargo and Port Consolidated System).

The customs inspectors visit the office of the chosen company. Usually, the request for any necessary information is made prior to the visit for the customs audit field work. Typically the import/export permissions, invoices, contracts and documents related to the remittance are requested by the customs office. The duration of the post entry customs audit is from two to six months in general.

(1) Statute of Limitations

The basic statute of limitations with regard to customs duties is 5 years from the date of import permission.

(2) Penalties and Interest

Penalty for failure to declare (15 percent) and penalty for failure to pay (10 percent) may be applicable to underpayment of tax resulting from the post entry customs audit. In the case of a voluntary correction of the tax, no penalty tax is levied. Interest on late payments of tax is levied.

5.2.7 FTA/EPA

(1) Current Status

The following free trade agreements (FTA) and Economic Partnership Agreements are in force:

- Japan-Singapore EPA (2002.11 in force)
- Japan-Mexico EPA (2005.04 in force)
- Japan-Malaysia EPA (2006.07 in force)
- Japan-Chile EPA (2007.09 in force)
- Japan-Thailand EPA (2007.11 in force)
- Japan-Indonesia EPA (2008.07 in force)
- Japan-Brunei EPA (2008.07 in force)
- Japan-ASEAN EPA (2008.12 in force)
- Japan-Philippine EPA (2008.12 in force)
- Japan-Switzerland FTA & EPA (2009.09 in force)
- Japan-Vietnam EPA (2009.10 in force)
- Japan-India EPA (2011.08 in force)
- Japan-Peru EPA (2012.03 in force)
- Japan-Australia EPA (2015.01 in force)
- Japan-Mongol EPA (2015.02 singed)

The following FTA and EPA are under discussion:

- Japan-Canada EPA
- Japan-Columbia EPA
- Japan-China-Korea FTA
- Japan-EU EPA
- Regional Comprehensive Economic Partnership (RCEP)
- Trans-Pacific Strategic Economic Partnership Agreement (TPP)
  Note: reached substantial agreement in October 2015
- Japan-Turkey EPA
- Japan-Gulf Cooperation Council FTA
- Japan-Korea EPA

(2) Origin Certification

Almost all FTA/EPAs of Japan provide third-party origin certification. Only a few FTA/EPAs allow self-certification at the moment. Self certification is expected under more FTA/EPAs in the future.

5.2.8 Anti Dumping Duty

General anti-dumping laws and regulations are provided in the Customs and Tariff Law. Until recently however, the Japanese government had been rather passive in dealing with the imposition of anti-dumping duties. The Japanese government has only ever made three final determinations historically to impose an anti-dumping duty. However, in recent years the Japanese government has become more active in the imposition of anti-dumping duties.

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 1 October 2015, as shown below.

(JPY)

	Employee share	Employer share	Maximum premium
Health Insurance[1]			
On salaries[2]	4.985%	4.985%	120,637/month
On bonuses	4.985%	4.985%	538,380/year
Health Insurance[1] (including nursing care premium)			
On salaries[2]	5.775%	5.775%	139,755/month
On bonuses	5.775%	5.775%	623,700/year
Welfare pension insurance			
On salaries[2]	8.914%	8.914%	110,533.60/month
On bonuses	8.914%	8.914%	267,420/month
Labour insurance[3]			
Employment insurance	0.5-0.6%	0.85-1.05%	-
Workman's accident compensation:			
- Non-manufacturing	-	0.25-0.35% (generally)	-
- Manufacturing	-	Variable	-

[1] A variable premium rate in the range of 9.86 percent to 10.21

percent is set in each prefecture depending on the domicile of the employer's office. 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

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), to support elderly residents.

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 JPY600,000.

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

Taxpayers for business occupancy tax purposes are companies or individuals operating a business at a place of business in a designated city.

6.4.2 Taxable Basis and Tax Rate

Taxable basis	Tax rate
Size of premises for business use	JPY600 per square meter (not assessable where the total space is not more than 1,000 square meters)
Gross payroll	0.25% (not assessable where the number of staff members, including officers, is not more than 100)

6.4.3 Method of Collection of Business Occupancy Tax

(1) Companies

A return is required to be filed within 2 months after the end of each fiscal year and the tax paid thereon.

(2) Individuals

A return is required to be filed for each calendar year by 15 March 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 Japanese 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 Japanese company or branch:

- Kabushiki Kaisha – 0.7 percent of stated capital (minimum JPY150,000)

- Godo Kaisha – 0.7 percent of stated capital (minimum JPY60,000)

- Branch of a foreign company – JPY90,000 (or JPY60,000 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 October 2015
Transfer of ownership by sale	1.5% (Land)[1] 2% (Buildings)
Transfer of ownership by merger	0.4%
Entrusting of real estate	0.3% (Land)[2] 0.4% (Buildings)

[1] Applicable for the period through 31 March 2017 (It will be increased to 2 percent from 1 April 2017 onwards.)

[2] Applicable for the period through 31 March 2017 (It will be increased to 0.4 percent from 1 April 2017 onwards.)

On the acquisition of real estate, a local tax, real estate acquisition tax, will also be applied. This tax is levied at 4 percent of the appraised value of the property, however this has been reduced to 3 percent until 31 March 2018 for land and residential buildings. Furthermore, when land is acquired by 31 March 2018, the tax base of such land will be reduced by 50 percent.

6.6 Inheritance and Gift Taxes

Inheritance tax and gift tax are levied on an heir who acquired properties by inheritance and an individual (donee) who acquired properties from another individual (donor) as a gift, respectively. The scope of taxable properties depends on whether the heir/donee holds Japanese nationality and whether the heir/donee or the decedent/donor has or had a domicile in Japan.

<table>
<tr><th colspan="2" rowspan="3">Heir
Donee
Decedent
Donor</th><th rowspan="3">Domicile in Japan</th><th colspan="3">No domicile in Japan</th></tr>
<tr><th colspan="2">Japanese nationality</th><th rowspan="2">No Japanese nationality</th></tr>
<tr><th>Domicile in Japan within past 5 years</th><th>No domicile in Japan within past 5 years</th></tr>
<tr><td colspan="2">Domicile in Japan</td><td>All properties</td><td>All properties</td><td>All properties</td><td>All properties</td></tr>
<tr><td rowspan="2">No domicile in Japan</td><td>Domicile in Japan within past 5 years</td><td>All properties</td><td>All properties</td><td>All properties</td><td>Properties located in Japan</td></tr>
<tr><td>No domicile in Japan within past 5 years</td><td>All properties</td><td>All properties</td><td>Properties located in Japan</td><td>Properties located in Japan</td></tr>
</table>

Rates for both taxes range from 10 percent to 55 percent.

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