

Japan Tax Update

Monthly tax update



July 15, 2004 Issue 1

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Introduction to PwC Japan Tax Update

This is the first edition of our new monthly publication, "Japan Tax Update".

As we all know, the only thing constant is change. And the only way to stay successful is to keep on top of changes — in the economy, the industry, and with regulation.

The "Japan Tax Update" seeks to update you on the latest developments in Japanese tax law that affect Japanese and foreign multinationals having operations in Japan. In addition to providing information on Japanese tax issues, the purpose of this newsletter is to make management aware of changes in the regulatory environment that may have an impact on their business.

Included in this issue are the following articles:

- 1. Recent National Tax Tribunal Decision Regarding Withholding Tax Treatment of Software License Payments**
- 2. Japanese and U.S. Governments Issue Guidance Relating to the New Japan/US Tax Treaty**
- 3. Japan to Renegotiate Netherlands Tax Treaty**
- 4. Calculation of Enterprise Tax Under Size-based Taxation System**
- 5. FSA Permits Foreign Companies to Publish Their Financial Statements in English**

1. Recent National Tax Tribunal Decision Regarding Withholding Tax Treatment of Software License Payments

On 31 March 2004, the National Tax Tribunal ("NTT") handed down another decision regarding the withholding tax ("WHT") treatment of software license payments made by a Japanese resident to a non-resident.

In the judgment, certain criteria were established for software transactions to differentiate transactions subject to Japanese withholding tax and those that are not subject to withholding tax by identifying three types of software transactions. Among the three types of transactions, it was concluded that the payment made by the Japanese distributor to the foreign developer in the Type A transaction is, in principle, not treated as a royalty under the Japanese Income Tax Law.

The three types of transactions and the respective tax treatments are as follows;

Type A: Purchase and Selling

Japanese distributor ("Distributor") purchases software products from the foreign developer ("Developer") and sells to Japanese end-users. The end-user, who purchased and owns the software, is free to copy the software to its hardware to the extent necessary to operate the software pursuant to the Japanese Copyright Law. Accordingly, the payment by the Distributor to the Developer does not constitute the use of the "copyright" right (i.e., the reproduction right). Rather, the payment by the Distributor to the Developer is treated as consideration for the purchase of software products (copyrighted article).

Type B: Lease and Sub-leasing

The Developer leases the software products to the Distributor who in turn leases the software products to the end-user in Japan. Title to the software products remains with the Developer. The end-user, who leases and does not own the software, is not allowed to make copies of the software without permission of the Distributor or Developer. Copying of the software to its hardware for the operation of software is considered to constitute the use of the "copyright" right (i.e., the reproduction right). Accordingly, the payment by the Distributor to the Developer is treated as consideration for the use of the copyright.

Type C: Purchase and Leasing

The Distributor purchases the software products from the Developer and leases to the end-user. The payment by the Distributor to the Developer is treated as a royalty if such payment is equivalent to that made by the end-user for leasing the software as explained in the Type B transaction.

The above categories are classified primarily based on the duration of the licensing terms and the pricing for the license fee. A perpetual license with a lump-sum license fee that is paid in proportion to the number of software products is treated as a purchase/sale of the software product. A time license with a license fee that is paid in accordance with the subscription period is treated as the leasing of the software product. This test is applied based on the substance (fact findings of transactions) regardless of the form of the contract.

In the new Japan-US Tax Treaty effective July 1, 2004 for withholding tax transactions, no withholding tax is imposed for royalties if certain requirements are met. However, in case of software transactions with the resident of a country other than the USA, the distributor should be aware of the above criterion for taxable vs. non-taxable transactions.

2. Japanese and U.S. Governments Issue Guidance Relating to the New Japan/US Tax Treaty

The U.S. Internal Revenue Service and the Japanese National Tax Agency have issued guidance regarding the applicability of the new tax treaty to withholding taxes for dividends, interest, and royalties.

The new Treaty provides for the elimination or reduction of withholding taxes on dividends, interest, and

royalties paid or accrued on or after July 1, 2004. The new Treaty is effective for taxable years beginning on or after January 1, 2005 for other taxes.

With respect to Japanese withholding taxes, Article 30, paragraph 2 of the Treaty states that the Treaty will apply to “amounts taxable” on or after July 1, 2004. Therefore, the Treaty will apply to the amount of investment income that is “due to be received” on or after July 1, 2004.

In the case of US withholding taxes, Article 30, subparagraph 2 states that the Treaty will be applicable to “amounts paid or credited” on or after July 1, 2004

The guidance that was issued by both Governments provides examples regarding the applicability of the above rules to payments. The guidance can be summarized as follows:

	Japan	US
Dividends	Date of the Shareholder’s meeting where the dividends are declared.	The date that the dividend is paid. Where the amount of the dividend is credited, the date on which the dividend is credited.
Interest	Due date as stated in the contract. If no date is specified, the date on which the interest is paid.	The date that the interest is paid. Where the amount of the interest is credited, the date on which the interest is credited.
Royalties	Due date as stated in the contract. If no date is specified, the date on which the royalty is paid.	The date that the royalty is paid. Where the amount of the royalty is credited, the date on which the royalty is credited.

3. Japan to renegotiate Netherlands Tax Treaty

The Japanese finance and foreign affairs ministries have announced that Japan will renegotiate its income tax treaty with the Netherlands. The Japanese government has stated that the negotiation process will take approximately two to three years to complete. According to the Japanese government, one of the objectives of the revised tax treaty is to simplify the tax payment process for Japanese companies operating in the Netherlands and for Dutch companies operating in Japan. In addition, measures to combat tax avoidance will be considered.

PwC comment

It is widely perceived that the current treaty provides opportunities for abusive tax planning techniques, particularly those involving the “other income” article of the treaty under “Tokumei Kumiai” arrangement. We believe that this issue is likely to be addressed during the negotiation process. In addition, it is possible that the revised treaty will follow the recently ratified new tax treaty between Japan and the United States by the inclusion of a “Limitation on Benefits” article to prevent abusive use of the treaty.

4. Calculation of Enterprise Tax Under Size-based Taxation System

For fiscal years commencing on or after April 1, 2004, a company with stated capital of more than JPY 100 million at the end of the fiscal year is subject to the size-based enterprise tax system. Unlike the enterprise tax system that is applicable to companies with stated capital of JPY 100 million or less (calculated based on taxable income only), the calculation of enterprise tax under the size-based system takes into account certain factors, including the aggregate of stated capital and capital surplus of the company (“capital factor”).

Under the Japanese Commercial Code, a company can undertake a reduction of stated capital and offset the decreased amount of capital against its accumulated deficit. However, for tax purposes, the reduced

amount of stated capital is not offset against the accumulated deficit, but rather, is classified as capital surplus. As the calculation of enterprise tax under the size-based system is partly based on the capital factor, the reduction in stated capital will not have any impact.

The size-based enterprise tax system has been modified to eliminate this anomaly between the legal and tax treatment. For reductions of stated capital that occurred on or after April 1, 2001, the reduced amount of capital will be excluded from the capital factor. This treatment will be applicable to fiscal years commencing between April 1, 2004 and March 31, 2006.

5. FSA Permits Foreign Companies to Publish Their Financial Statements in English

Under the current Japanese SEC regulations, foreign corporations who are Japanese SEC registrants are required to file their financial statements in Japanese. However, the Finance System Council of the Financial Service Agency recently announced their decision to allow Exchange-Traded Funds (ETFs) to file their accounts in English beginning fiscal year 2005. Beginning fiscal year 2007, the new rule will be applied to all of the foreign corporations (Japanese SEC registrants).

Even under the new rule, foreign corporations will still be required to provide summarized financial statements in Japanese.

The purpose for the change is to encourage foreign corporations to list their shares on the Japanese Stock Exchanges.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the July issue of Japan Tax Update and appreciate your comments about our current issue or ideas for what you'd like to see covered in future issues

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