

Japan Tax Update

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PwC Japan Tax Newsletter

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The intention of this Japan Tax Update is to provide an outline of the Japanese tax reforms proposed for 2010.

This newsletter is prepared based on the outline of the tax reform proposal released on December 22, 2009. The annual tax reform is usually approved by the Diet by the end of March. The full details of the amended tax laws will not be clarified until Diet approval has been received, and Cabinet Orders or Enforcement Orders enacting the changes issued.

This Newsletter is provided for general guidance only, and does not constitute the provision of advice or professional consulting of any kind. Before making any decision or taking any action, you should consult your usual PwC contact with all the pertinent facts relevant to your particular situation.

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Proposed 2010 Tax Reform

This issue exclusively deals with the draft proposed outline of the 2010 tax reform.

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1. Corporate taxation

1.1 Introduction of group taxation regime

Under the proposal, a new group taxation regime will be introduced, which may be applicable to domestic companies ("group companies") that are wholly owned by either a domestic company, foreign company or individual. The existing tax consolidation system will become a part of the group taxation regime. Although the tax consolidation system is applied upon election by the taxpayer, the group taxation regime will automatically apply to group companies.

The key amendments proposed under the group taxation regime are summarized below.

1.1.1 Deferral of gains or losses from transfer of certain assets

Under the current law, the transfer of assets between companies in a non-consolidated tax group is a taxable event (unless the transfer occurs as part of a qualified or non-taxable corporate reorganization). Under the proposal, the recognition of capital gains or losses from the transfer of certain assets (including the transfer of assets as a result of a non-qualified or taxable merger) between group companies will be deferred until the asset is transferred to a non-group company. The scope of assets will be the same as that under the tax consolidation system i.e. fixed assets, land, securities, monetary receivables and deferred expenses (excluding securities for trading purposes and assets with a book value of less than JPY 10 million).

Under the current law, in the case of a non-qualified share exchange, the company becoming a wholly owned subsidiary is required to recognize built-in gains or losses in respect of its assets. Under the proposal, the recognition of such built-in gains or losses will no longer be required in the case of a non-qualified share exchange.

1.1.2 Donations

Under the current law, a donation between companies in a non-consolidated tax group generally results in a non-deductible donation expense for the donor and taxable donation income for the donee. A donation is defined as the transfer of an asset or provision of a service at greater or less than fair market value, the amount of the donation being the difference. Under the proposal, where a donation occurs between group companies, there will be no tax implications for either the donor or donee.

The proposal is consistent with the current treatment of a donation between members of a consolidated tax group.

1.1.3 Dividends-in-kind

Under the current law, where a company satisfies an obligation to pay a dividend to its shareholder(s) through the transfer of a non-cash asset, this is considered to be a taxable disposal of the asset by the company, thus requiring the recognition of a gain or loss. Under the proposal, where the company and shareholder are group companies, the gain or loss from the transfer of a non-cash asset in satisfaction of a dividend (or deemed dividend) will be deferred for the company. This will be provided for as part of the corporate reorganization tax rules. In addition, the company will not have any withholding tax obligation in respect of a qualified dividend in kind.

1.1.4 Reduction of dividend received deduction by allocable interest expense

Under the current law, a dividend between group companies is initially included in the gross income of the recipient but a "dividend received deduction (or DRD)" is available. In the case where the recipient owns 25% or more of the dividend paying company, the amount of the DRD is equal to the amount of the dividend reduced by allocable interest expense. Under the proposal, a dividend received from a group company can be fully excluded from taxable income without any reduction for allocable interest expense.

The proposal is consistent with the current treatment of dividends between members of a consolidated tax group.

1.1.5 Repurchase of shares

Under the current law, where a company repurchases its shares, a shareholder is required to recognize a deemed dividend and capital gain or loss from the disposal of the shares. In general, the deemed dividend represents the earnings portion of the consideration received for the repurchase, whereas the capital gain or loss component is calculated as the difference between the capital portion of the consideration and the tax basis of the shares. The deemed dividend is eligible for the DRD and any capital gain or loss would be taxable or deductible. Under the proposal, where a repurchase of shares occurs between group companies, the shareholder will not recognize any capital gain or loss. The tax treatment of the deemed dividend would be as discussed in 1.1.4.

1.1.6 Corporate reorganizations without consideration

Under the current law, the tax treatment of a corporate reorganization without consideration (the transferee company does not issue shares to the transferor company) is not provided for. Although no details are provided under the proposal, it is noted that the tax treatment of corporate reorganizations without consideration between group companies will be provided for as part of the FY2010 tax reform.

1.1.7 Special tax measures for small and medium sized entities (“SMEs”)

Under the current law, a company with paid-in capital of JPY 100 million or less is regarded as a SME and is eligible for certain tax benefits eg. reduced corporate tax rate, exemption from special tax rates applicable to specified family corporations, preferable allowable ratios for deductible portion of bad debt provisions, partial deductibility of entertainment expenses, carry back of tax losses, etc. The eligibility for such benefits is determined on a stand-alone company basis. Under the proposal, a group company that would otherwise qualify as a SME on a stand-alone basis will not be eligible for the aforementioned benefits if the parent company of the group has paid-in capital of JPY 500 million or more.

Comparison of group taxation regime and tax consolidation system

	Group Taxation Regime	
		Tax consolidation system
Applicability	Automatically apply	By election of taxpayer
Applicable companies	Domestic company wholly owned by domestic or foreign company or individual	Domestic company wholly owned by domestic company
Tax return filing	Individual company basis	Group consolidation basis
Transfer of assets between group companies	Capital gain or loss from transferred asset is deferred	
Donation taxation within the 100% group company	Not applicable	
Dividend received deduction	Not reduced by allocable interest expense	
Special tax reliefs for SMEs	Not applicable for group company where paid-in capital of ultimate parent is JPY 500 million or more	

1.2 Corresponding amendments to tax consolidation system

Since the introduction of the tax consolidation system in 2002, there have not been any significant changes to this system. As a result of the proposed introduction of the group taxation regime, some corresponding amendments will be made to the tax consolidation system which, in general, are beneficial to taxpayers.

1.2.1 Pre-consolidation tax losses of subsidiaries joining consolidated tax group

Under the current law, in general, pre-consolidation tax losses for national tax purposes of a subsidiary cannot be carried forward into a consolidated tax group (with certain exceptions). Under the proposal, pre-consolidation tax losses of a subsidiary can be carried forward into a consolidated tax group but may only be offset against taxable income of the subsidiary (similar to the US separate return limitation year rules).

This rule will be applicable only if the subsidiary is not subject to the taxation of built-in gains or losses on its assets upon joining the consolidated tax group.

1.2.2 Due date for tax consolidation application filing

Under the current law, an election by a parent company to file consolidated tax returns must be submitted at least six months before the beginning of the fiscal year from which consolidated tax filing will commence. Under the proposal, the due date will be reduced to three months.

1.2.3 Timing of joining consolidated tax group

Under the current law, a company that becomes a wholly owned subsidiary of a member of an existing consolidated tax group during a fiscal year is deemed to have joined the consolidated tax group at the time the wholly owned relationship was established. Under the proposal, the company will be deemed to have joined the consolidated tax group on the day following the first monthly closing date. For example, if a company with a March 31 fiscal year end becomes a wholly owned subsidiary on March 15, it will join the consolidated tax group from April 1.

1.2.4 Realization of built-in gains or losses

Under the current law, at the time of the formation of a consolidated tax group or where a company joins an existing consolidated tax group, it is required to recognize built-in gains or losses on certain assets in the fiscal year immediately preceding the fiscal year in which it will commence consolidated tax filing. Under the proposal, the recognition of built-in gains or losses is not required at the time the consolidated tax group is formed or when the company joins an existing consolidated tax group if the 100% group relationship with the parent company of the consolidated tax group will cease within two months from joining the consolidated tax group.

1.2.5 Dissolution of a company and tax consolidation

Under the current law, when a member of a consolidated tax group is placed into dissolution, it is deemed to no longer be a member of the consolidated tax group. Under the proposal, due to the proposed abolishment of liquidation income taxation (refer 1.3), the dissolution of a subsidiary will no longer be considered an event triggering its leaving the consolidated tax group.

Effective dates

The above proposals (with the exception of 1.1.4 and 1.1.7 will apply on or after October 1, 2010. The effective dates for the proposals discussed in 1.1.4 and 1.1.7 were not specified in the proposal.

1.3 Proposals relating to capital transactions

Commencing from the FY2001 tax reform, various tax laws have been introduced relating to the treatment of certain capital transactions. Due to the increasing use of capital transactions, including share repurchases and corporate reorganizations, the proposal contains certain amendments to the tax treatment of specific capital transactions.

1.3.1 Repurchase of shares

As discussed at 1.1.5, under the current law, where a company repurchases its shares, a shareholder is required to recognize a deemed dividend and capital gain or loss from the disposal of the shares. In general, the deemed dividend is eligible for the DRD and any capital gain or loss would be taxable or deductible. Under the proposal, where a repurchase of shares occurs between group companies, the shareholder will not recognize any capital gain or loss and the deemed dividend can be fully excluded from taxable income without any adjustment for allocable interest expense.

Under the proposal, in the case of a repurchase of shares other than between group companies, if a domestic company acquires shares of another domestic company and at the time of the acquisition, it is expected that the acquiring company will have some or all of its shares repurchased, any deemed dividend arising upon the

repurchase will be fully taxable. However, the capital gain or loss will still be taxable or deductible. If the company whose shares are acquired is a foreign company, the deemed dividend received by the acquiring company would not be eligible for the foreign dividend exemption (which would otherwise exempt 95% of the deemed dividend where certain conditions are satisfied).

1.3.2 Non-qualified corporate reorganizations

Under the current law, where:

- (i) a company that is the surviving company of a merger owns shares in the merged company; or
- (ii) a company that receives shares in a corporate split off owns shares in the transferor company,

and the above reorganizations are treated as non-qualified, the company should recognize a capital gain or loss from the disposal of its shares upon the merger or corporate split off. Under the proposal, the recognitions of gains or losses in such non-qualified reorganizations will not be required.

1.3.3 Abolishment of liquidation income taxation

Under the current tax law, when the shareholders of a company resolve to place the company into liquidation ("dissolution date"), the company is required to file a tax return for the period from the first day of the year to the dissolution date. The taxable income or loss for this period is calculated under normal tax rules. The period from the dissolution date is referred to as the liquidation period and during this period, the company is taxed on its liquidation income, calculated in accordance with special rules. For example, tax losses cannot be utilized by the company as liquidation income is essentially calculated on a balance sheet basis (value of residual assets less capital and retained earnings for tax purposes). Under the proposal, the liquidation income taxation system will be abolished and the ordinary corporate tax rules will apply.

1.3.4 Simplified method for calculation of allocable interest for DRD purposes

As discussed in 1.1.4, a dividend between domestic companies is initially included in the gross income of the recipient but a DRD is available. In the case where the recipient owns 25% or more of the dividend paying company, the amount of the DRD is equal to the amount of the dividend (50% of the dividend in other cases) reduced by allocable interest expense. Under the current tax law, a simplified calculation method is allowed for calculating the allocable interest amount. The proposal states that the base year used in the simplified method will be reviewed.

Effective date

The above proposals (with the exception of 1.3.4) will apply on or after October 1, 2010.

1.4 Proposals relating to corporate reorganization rules

1.4.1 Abolishment of tax-qualified corporate split off similar to merger transaction

The tax rules relating to the treatment of a tax-qualified corporate split off similar to a merger transaction (whereby the transferor company will be liquidated shortly after the split off) will be abolished.

1.4.2 Abolishment of deemed fiscal year of transferor company in corporate split off

Under the current law, if a corporate split off is carried out during the fiscal year, the transferor company should file tax returns for (i) a deemed fiscal period beginning on the first day of the fiscal year to the date before the effective date of the split off, and (ii) for the period from the effective date to the last date of the fiscal year. Under the proposal, a corporate split off will no longer trigger a deemed fiscal period.

1.4.3 Restriction on utilization of tax losses in case of qualified mergers and other reorganizations

Under the current law, restrictions apply to the utilization of tax losses of companies participating in certain qualified reorganizations. The proposal notes that these restrictions will be reviewed and possibly relaxed for certain types of transactions.

1.4.4 Transfer of securities for trading purposes and unsettled derivative contracts by qualified corporate spin off

The proposal notes that the tax treatment of the transfer of securities for trading purposes and unsettled derivative contracts by way of a qualified corporate spin off will be reviewed.

1.5 Proposals relating to special tax incentives

The Ruling Party decided to review the special tax incentives provided in the Special Taxation Measures Law during the next four years. Under the proposal, 41 incentives for national tax purpose will be abolished or reviewed, the major items being summarized in the table below.

Item	Amendment
<ul style="list-style-type: none"> · Tax credit for facilities to reinforce information infrastructure · Special depreciation applicable to facilities for recycling of products 	Abolished after April 1, 2010
<ul style="list-style-type: none"> · Special depreciation or tax credit for qualified assets acquired by SMEs · 100% deduction for depreciable assets with small acquisition cost · Tax credit for R&D expense · Special deduction of entertainment expenses for SMEs 	Applicable period will be extended for two years

2. International taxation

2.1 Anti-tax haven (CFC) rules

Under the current anti-tax haven rules ("CFC rules"), a foreign corporation that is owned more than 50% by Japanese corporations or Japanese resident individuals will be treated as a Specified Foreign Subsidiary Corporation, or "CFC", if such corporation (i) has its main or head office in a country which does not impose income tax, or (ii) pays tax at an effective rate of 25% or less, and (iii) does not meet the conditions for exemption from the application of the CFC rules. A Japanese corporation or Japanese resident individual owning a 5% or more direct or indirect interest in a CFC would be required to include in its gross income for Japanese corporate income tax purposes, its pro-rata share of the taxable retained earnings of the CFC.

2.1.1 Lowering of threshold rate for treatment as CFC

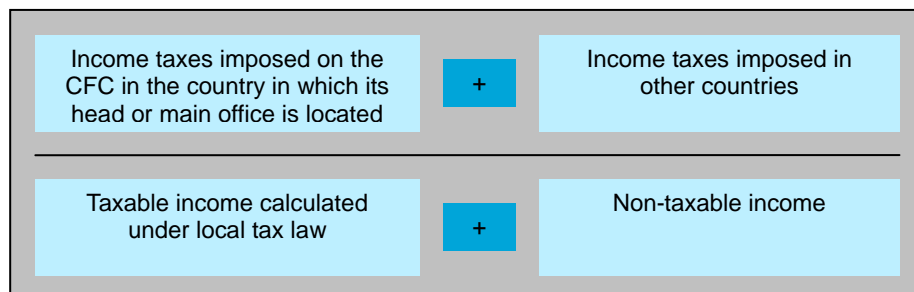
Under the proposal, the minimum effective tax rate will be lowered from 25% to 20%. This is recognition of the fact that since the introduction of the CFC rules from fiscal years commencing on or after April 1, 1978, there has been a reduction in global tax rates. Many Japanese multinational companies have genuine operations in countries where the statutory tax rate is 25% or lower, for example, China (25%), Hong Kong (16.5%), Indonesia (25%), Korea (22%), Malaysia (25%), Singapore (18%), Taiwan (25%) and Vietnam (25%). Maintaining the threshold rate for application of the CFC rules at 25% would be inconsistent with the government's policy of encouraging Japanese companies to invest overseas in view of Japan's mature markets and declining population.

2.1.2 Increase of threshold rate for inclusion of CFC income

Under the proposal, the threshold of stock ownership a taxpayer is required to own (directly or indirectly) in a CFC before it is required to include a pro rata share of the CFC's taxable retained earnings in its taxable income, will be increased from 5% to 10%.

2.1.3 Exclusion of certain dividends from calculation of effective tax rate

The effective tax rate for CFC purposes is computed based on the taxable income for local tax purposes, which is computed based on the net income as determined by a closing of accounts in accordance with the tax law of the country in which the CFC is resident. In computing taxable income, any non-taxable income should be added back and thus, the effective tax rate formula can be represented as follows:



In general, non-taxable income is defined as income that is excluded from the taxable base in the computation of local taxable income. Under the current law, (i) dividends received from a corporation whose head or main office is located in the same country in which the head or main office of the CFC is located, and (ii) foreign dividends exempted from tax under a regime whereby exemption is subject to certain shareholding requirements, are excluded from the definition of "non-taxable income" and are thus, not required to be added back to the denominator of the above formula.

As the scope of exempt dividends excluded from the definition of "non-taxable income" is currently limited to (i) and (ii) above, this could result in a foreign holding corporation located in a country that is not traditionally viewed as a tax haven being treated as a CFC (due to its effective tax rate being diluted by dividends that are currently considered "bad" dividends).

Under the proposal, the scope of exempt dividends that may be excluded from the definition of "non-taxable income" will be expanded, although it is not clearly stated what types of dividends. However, it is possible that dividends exempted under a regime which does not require a minimum shareholding requirement (for example, the UK or German participation exemptions) may be included.

2.1.4 Expansion of active business exemption

Qualification of Regional Headquarters Corporation for active business exemption

Under the current law, a foreign corporation that would otherwise be treated as a CFC is exempted from the application of the CFC rules if it satisfies the following conditions:

- (i) Substance test: The corporation has a place necessary to conduct its main business, such as an office, shop, factory, other fixed facility, etc. in the country where its head office is located.
- (ii) Administration and control test: The corporation manages and controls its main business in the country where its head or main office is located.
- (iii) Business purpose test: The main business of the corporation is other than holding debt or equity securities, licensing of industrial property rights, other technical rights or copyrights or leasing of ships or aircraft.
- (iv) Unrelated party test: In the case of a corporation whose main business is wholesale trade, banking, trust corporation, securities, insurance or marine or air transport, the corporation conducts its business mainly with third parties. The corporation would be considered to conduct its business mainly with third parties if either revenue from sale of inventory to third parties represent more than 50% of its total revenue or the acquisition cost of inventories and services purchased from third parties represents more than 50% of the total acquisition cost of inventories or services.
- (v) Local country test: In the case of a corporation whose main business is real estate, personal property

leasing or any business other than a business included in (iv), the corporation conducts its business mainly in the country where its head or main office is located

Under the proposal, the application of the business purpose test will disregard the holding of equity securities where the CFC qualifies as a Regional Headquarters Corporation ("RHQ"). The conditions that must be satisfied in order for a CFC to qualify as a RHQ are as follows:

- (i) the CFC is wholly-owned, directly or indirectly, by a Japanese corporation;
- (ii) the CFC directly owns 25% or more of the outstanding shares and voting shares of at least two foreign corporations which carry on an active or substantive business in the country in which their head or main office is located ("controlled corporations"); and
- (iii) the CFC solely manages and controls the foreign corporations with a sufficient fixed place and employees in the country where the CFC is located.

If the CFC is a pure holding company, it should be able to qualify for the active business exemption by satisfying the substance test, administration and control test, the proposed new business purpose test and the local country test.

If the CFC conducts a wholesale business in addition to its RHQ activities, it should be able to qualify for the active business exemption by satisfying the substance test, administration and control test, the proposed new business purpose test and the unrelated party test. However, when applying the unrelated party test, transactions between the Regional Headquarters Corporation and its controlled corporations should be disregarded as related party transactions.

Where a Japanese corporation directly or indirectly owns a RHQ, it will be required to attach certain information to its tax return, including details of the RHQ, a group structure chart for the RHQ and its controlled corporations, etc.

Abolishment of payroll deduction

Under the current law, where a CFC satisfies the substance test, administration and control test and the business purpose test but not the unrelated party test or local country test (so that it is treated as a CFC), when calculating its taxable retained earnings, a deduction equal to 10% of its personnel costs is allowed. Under the proposal, this deduction will no longer be available.

2.1.5 Introduction of tainted income rule

Under the current law, where a CFC qualifies for the active business exemption, none of its income is subject to inclusion in the taxable income of its 5% or more Japanese resident shareholders. This allows Japanese taxation on non-operating income (dividends, interest, royalties, etc.) to be deferred or sheltered from Japanese tax by parking such income in a CFC that satisfies the conditions for the active business exemption.

Under the proposal, a tainted income rule will be introduced whereby the following types of income derived by a CFC that qualifies for the active business exemption will be included in the calculation of its taxable retained earnings and included in the taxable income of its 5% or more Japanese resident shareholders:

- (i) dividends from less than 10% shareholdings;
- (ii) gains from the sale of less than 10% shareholdings on the market (exchange trades or over-the-counter transactions);
- (iii) interest on bonds and other debt securities (exchange trades or over-the-counter transactions);
- (iv) gains from the sale of publicly traded debts (exchange trades or over-the-counter transactions);
- (v) royalties (except for royalties generated from intangibles developed by the CFC); and
- (vi) rental income from ocean and air transportation leasing activities.

Income items (i) to (iv) will not be treated as tainted income if they are derived by the CFC in the ordinary and necessary course of its business or through activities that are fundamental or essential to its business. However, this rule will not be applicable to income derived through a business of holding debt or equity

securities, licensing of industrial property rights, other technical rights or copyrights or leasing of ships or aircraft. The proposal does not provide any guidance with respect to how this rule should be interpreted and thus, its impact will be assessed after the draft tax laws are issued.

The amount of tainted income can be reduced by:

- directly attributable expenses; and
- indirectly attributable interest expense but only with respect to dividend and interest income.

As a de minimis rule, the tainted income rule will not apply if the total tainted income of the CFC is less than (i) 5% of the CFC's pre-tax income, or (ii) JPY 10 million. Furthermore, the tainted income inclusion amount will be limited to the amount of the CFC's taxable income.

2.1.6 Avoidance of double taxation of previously taxed CFC income

The FY2009 tax reform introduced a foreign dividend exemption for dividends received by a Japanese corporation in fiscal years commencing on or after April 1, 2009. Under the current law, 95% of a dividend from a foreign corporation in respect of which the Japanese corporation has held a 25% or more shareholding for at least 6 months is exempt from tax i.e. 5% remains subject to tax.

Where the dividend is paid by a CFC from taxable retained earnings that have previously been subject to Japanese tax under the CFC rules as taxable income of the Japanese corporation, double taxation is avoided through the allowance of a deduction for previously taxed earnings, provided such taxable retained earnings were included in the taxable income of the Japanese corporation within the previous ten years up to the end of the fiscal year preceding the year in which the dividend is received. However, where the CFC is a second tier or lower subsidiary of the Japanese corporation and the dividend paid by the first tier holding corporation is sourced from a dividend received paid by a second tier or lower CFC from previously taxed CFC income, no deduction is available for previously taxed earnings and thus, there is an element of double taxation.

Under the proposal, when a Japanese corporation receives a dividend from a foreign corporation, the smaller of the following amounts will be fully exempt:

- (i) the amount of the dividend that the foreign corporation received from a second tier or lower corporation in the year in which the Japanese corporation receives the dividend and the preceding two fiscal years, whose taxable retained earnings have previously been subject to Japanese tax under the CFC rules, proportionate to the Japanese corporation's indirect ownership interest in the second tier or lower corporation; or
- (ii) the amount of the second tier or lower corporation's taxable retained earnings that were included in the taxable income of the Japanese corporation in the year in which the Japanese corporation receives the dividend and the preceding two fiscal years.

Effective dates

The proposals described in 1. to 5. will be effective from a CFC's fiscal year beginning on or after April 1, 2010.

The proposal described in 6. will be effective to dividends received from a foreign corporation in fiscal years of the recipient Japanese corporation commencing on or after April 1, 2010.

2.2 Transfer Pricing Legislation

2.2.1 Provisions for foreign-related companies that are, in substance, not controlled

There are often situations where foreign-related parties are technically "controlled" by the ownership criteria of 50% or more of issued stocks etc. under the current Special Taxation Measures Law, Article 66-4, paragraph 1, however, in substance they are not truly controlled from the economic perspective. In such cases application of the transfer pricing legislation may restrict the operations of the foreign-related party. In fact, in many cases, it may be commercially impossible to implement transfer pricing rules in these circumstances. To respond to

such concerns, it is proposed that the 2010 tax reform will deal specifically with the process of price negotiation between foreign-related parties, and to the calculation and verification of the arm's length price. [This revision would be in addition to the existing paragraph 2-4-(3)-b of the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines) issued by the National Tax Agency of Japan on June 1, 2001.]

When the foreign-related party is a joint venture for example, it would seem reasonable if the price in a transaction with that foreign-related party were considered substantially equivalent to the price in a third party transaction. However, this has not always been the case in practice, and assessments have been issued against joint venture subsidiaries from time to time. The 2010 tax reform is expected to clarify the application of the control test to such cases. Going forward, this should greatly ease the transfer pricing difficulties surrounding investment into countries where a local partner is required in order to set up business (e.g., China).

2.2.2 Clarification of the documents required to be submitted pursuant to paragraph 7 of Article 66-4

Paragraph 7, Article 66-4 of Special Taxation Measures Law permits the tax authorities to apply "taxation by estimation" if a taxpayer fails to submit documents, books or records that are "necessary to calculate the arm's length price"¹. However, the range of documents that may be "necessary" is not specified under the current legislation. The 2010 tax reform will clarify the range of such documents in the following categories.

- (i) Documents containing details of the foreign-related transactions
- (ii) Documents used by the taxpayer for the calculation of arm's length prices in the foreign-related transactions

Based on the proposed tax reform, it is understood that there will be no significant changes to the current transfer pricing legislation. However, it has been disclosed in discussion papers submitted to the Tax Commission that a concrete framework for documents that are "necessary to calculate the arm's length price" under paragraph 7 of Article 66-4, is still not clear. In the process of these discussions, the Tax Commission has apparently considered legislation relating to transfer pricing documentation in the United States, Germany and China, among other countries. In substance, it may be interpreted that certain documentation will also be required in Japan. In addition, from a practical perspective, it is also clear that taxpayers need a reasonable period of time to prepare documentation in response to requests under paragraph 7 of Article 66-4, and thereby avoid application of taxation by estimation.

Bearing in mind these considerations, it would appear that - although it is unlikely a formal documentation requirement will be introduced into the Japanese transfer pricing legislation in 2010 (and thus there will be no introduction of the concept of "penalty protection" that exists in other jurisdictions) - ensuring that a taxpayer has transfer pricing documentation on hand may significantly mitigate the risk of the tax authorities applying taxation by estimation.

3. Finance industry related amendments

3.1 Taxation of corporate securities

3.1.1 Certain interest and redemption gains exempted from taxation

Currently, foreign investors in bonds issued by Japanese issuers (other than Eurobonds, JGBs and local government bonds) are subject to Japanese tax on interest and redemption proceeds in excess of their acquisition or subscription price. Under the 2010 Tax Reform Proposal, qualified investors (primarily, foreign corporations, foreign individuals and certain qualified foreign securities investment trusts (QFSIT*), excluding parties related to the issuer) will be exempt from Japanese tax on interest and redemption gains if the bond is a book-entry corporate bond (Furikae Shasai), other than a profit-linked bond. For interest, this new rule is expected to apply to interest calculation periods starting on or after June 1, 2010 provided the bond has been issued on or before March 31, 2013. The effective date for redemption gain on short-term bonds is for bonds issued on or after June 1, 2010 and on or before March 31, 2013.

¹ Under this approach, the tax examiners may estimate transfer prices (including based on transactions between related parties, so not at arm's length) without reference to the taxpayer's own transfer pricing method, and without providing as many details of how that price was calculated as in the typical assessment.

*Under the 2010 Tax Reform Proposal, the existing definition of a QFSIT for JGBs in book-entry form (Furikae Kokusai), will be expanded to include foreign investment trusts satisfying either of the following conditions (limited to securities investment trusts or publicly offered bond investment trusts):

- (i) (a) The foreign investment trust has been established outside of Japan ; (b) the offering of units has been made both in and out of Japan only by way of a public offering, and (c) the distribution of profits in relation to the units offered in Japan is made only via a Japanese entity responsible for handling payments (paying agent); or
- (ii) The units of such foreign investment trust have only been offered to QFSITs (including a foreign investment trust falling under the category of (i) above).

3.1.2 Eurobonds

The existing concessionary tax exemption rule for Eurobonds (Minkan Kokugai Sai), which has typically been extended in two years increments, was set to expire on March 31, 2010, but is now proposed to be made permanent. Furthermore, the following changes to the existing regime are being proposed: (i) special concessions currently enjoyed by Eurobonds issued in Switzerland will be abolished (after a transitional period of two years); (ii) profit-linked bonds will be excluded from the scope of the Eurobonds exemption; and (iii) related parties of the Eurobond issuer may not enjoy the exemption.

TMKs

A special purpose investment structure often used to invest in Japanese real estate and certain securities, a TMK may be subject to only a small amount of tax by deducting dividends declared to its shareholders. In order for a TMK to deduct its dividends, certain specific tests must be satisfied, including that the TMK's preferred shares are offered primarily in Japan. Under the 2010 Tax Reform Proposal, a TMK will also have to offer its common shares primarily in Japan to maintain the deductibility of its dividends.

Furthermore, current law also requires a TMK's specified bonds to be offered primarily in Japan. The 2010 Tax Reform Proposal proposed to abolish this requirement.

Taxation of overseas investors in certain investment funds

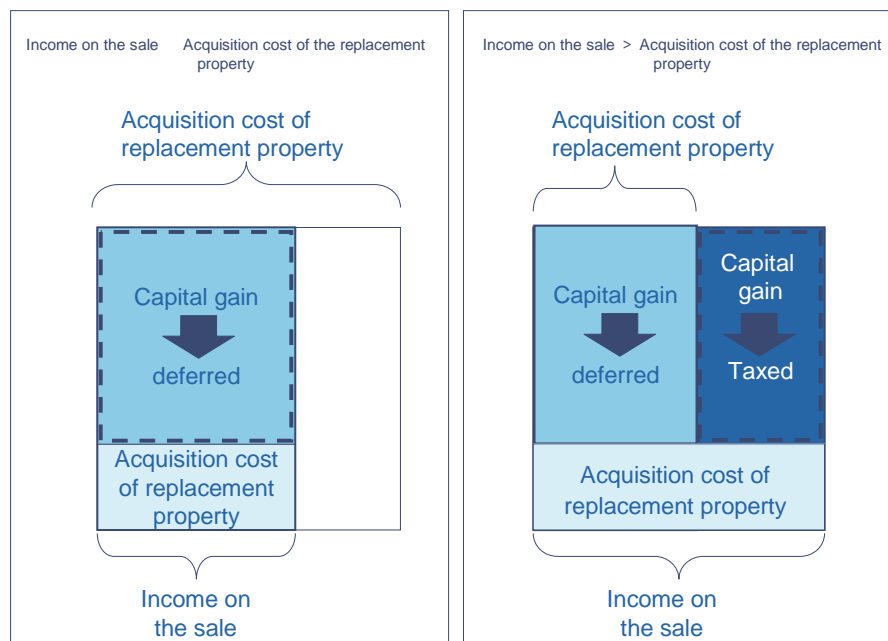
Under tax reforms enacted from April 1, 2009, overseas investors in certain investment funds may be exempt from Japanese permanent establishment (PE) taxation if certain conditions are met (please see our April 2009 Financial Newsletter for details). One required condition is that the investor must not be involved in the management or operation of the fund. The 2010 Tax Reform Proposal provides that an investor will not be considered to be involved in the management or operation of the fund merely by exercising limited rights with regard to certain conflict of interest transactions regulated in the Financial Instruments and Exchange Law.

4. Taxes on property

4.1 Individual Income tax and Individual Inheritance tax

4.1.1 Deferral of gain on sale of certain residential property and a replacement residence is acquired.

If a taxpayer sells certain residential property and purchases replacement residential property within a certain period, gain on the transfer of the residential property may be deferred until the replacement property is transferred in a taxable transaction.



The applicability of this deferral treatment will be extended an additional two years with the additional condition that the income received on the sale of the property is equal to or less than 200 million yen.

4.1.2 Other

- 1) The rule that permits a taxpayer to carryforward a long-term capital loss on the sale of the replacement residential property will be extended an additional two years.
- 2) The rule that permits a taxpayer to carryforward a capital loss on the sale of residential property with a mortgage will be extended an additional two years.

4.2 Inheritance tax and Gift tax

4.2.1 Revision of gift tax exemption on funds received from parents or grandparents for the purchase of a residence

Before 2010 Tax Reform

If a taxpayer is gifted funds from his/her parents or grandparents for the purchase of a residence between January 1, 2009 and December 31, 2010, up to 5 million yen of the gifted funds are exempt from gift tax, if certain conditions are met.

2010 Tax Reform Proposal

- 1) The applicability of this exemption will be extended until December 31, 2011 and the maximum tax-exempt amount will be increased as follows:
 - Taxpayer is gifted the funds during 2010 15 million yen
 - Taxpayer is gifted the funds during 2011 10 million yen
- 2) Taxpayers who are eligible for this tax exemption are limited to persons whose total taxable income in the year of the gift is 20 million yen or less.

Options – special rule for funds received in 2010

A taxpayer who is gifted the funds in 2010 can elect the treatment under either the current law (i.e. pre-tax reform) or the under the tax reform proposal.

4.2.2 Revision of the special treatment for the purchase of a residence under the unified gift/inheritance tax system

Under this system, a gift of 25 million yen by a parent who is 65 years or older to a child who is 20 years or older is not subject to a gift tax. However, in the case where the funds are used to purchase a residence, there is no restriction on the age of the parent and up to 35 million yen of funds can be provided without being subject to gift tax.

This special treatment for purchase of a residence under the unified gift/inheritance tax system that applies to taxpayers who are 20 years old and over will be revised as follows.

- Additional allowance of 10 million yen will be terminated (i.e. maximum amount that can be gifted without being subject to gift tax is reduced from 35 million yen to 25 million yen).
- The rule that provides for a special exemption based on the donor's age will be extended an additional two years.

4.2.3 Revision of special treatment applicable to small-scale residential land

Only a portion of the value of qualified residential land is included in the tax base on the inheritance tax. The percentage of the value of the small-scale property to be included in the tax base will depend on the use of the inherited property. The special treatment with respect to the use of the property to continue a business or residence of the decedent or the heir will be revised. These revisions will be applicable for inheritances or devises received after April 1, 2010.

4.2.4 Revision of deferral of Inheritance tax /gift tax payment on unlisted shares

In the case where an individual receives certain unlisted shares as an inheritance or a gift, a certain amount of the inheritance or gift tax can be deferred. Certain requirements will be clarified and the computation method for determining the amount of tax to be deferred will be revised.

4.2.5 Revision of the base age for credit for a handicapped person

A handicapped successor or donee may take a credit against the inheritance tax based on a statutory formula. The age for the inheritance tax credit for a handicapped person will be increased from 70 to 85. This revision will be applicable to inheritances or devises received after April 1, 2010.

4.3 Valuation method for periodic benefit (e.g. individual annuity, etc.)

Before 2010 Tax Reform

The primary method to value a periodic benefit is as follows:

Payment of periodic benefit has started

- 1) Fixed term benefit
Lesser of i and ii

- i Anticipated total amount of benefit for the remaining period × Portion described below

Remaining period of the benefit	Portion
5 years or less	70%
Over 5 years – 10 years	60%
Over 10 years – 15 years	50%
Over 15 years – 25 years	40%
Over 25 years – 35 years	30%
Over 35 years	20%

- ii Anticipated annual payment × 15

2) Lifetime benefit

Anticipated annual payment × Multiple number described below

Age of acquisition of the right	Multiple number
25 year or less	11
Over 25 year to 40 year	8
Over 40 year to 50 year	6
Over 50 year to 60 year	4
Over 60 year to 70 year	2
Over 70 year	1

Payment of periodic benefit has not started

Total amount of paid insurance premium until the acquisition of the right × Portion described below

Period between the start date and acquisition of the right date	Portion
5 years or less	90%
Over 5 years – 10 years	100%
Over 10 years – 15 years	110%
Over 15 years	120%

2010 Tax Reform Proposal

Because the current valuation method does not reflect the net present value of the actual amount paid, the method will be revised as follows:

- (1) If the payment of the periodic benefit has started, the greater of 1), 2) or 3).
 - 1) Equivalent to cancellation return;
 - 2) If heir can select lump-sum payment, equivalent to the lump-sum payment; or
 - 3) Computed amount based on guaranteed yield.
- (2) If the payment of the periodic benefit has not started, the value will be equivalent to the amount that would be received on cancellation of the periodic benefit.

This revision will be applicable to inheritances or devises received after April 1, 2010.

5. Individual income tax

A number of reforms have been proposed in relation to individual income taxation, including: (i) changes to various deductions, including the abolishment of the deduction for families with children under the age of 16, (ii) changes to the tax system on finance and corporate securities and (iii) the reform of special taxation measures will be introduced.

We have summarized below the main proposals in relation to finance and corporate securities below.

5.1 Exemption for certain amounts of dividend income and capital gain arising from listed stocks in an Exempt Account

An exemption for a certain amounts of dividend income and capital gains arising from listed stocks held in an Exempt Account (described in 3) below) will be introduced. This reform is in accordance with the

implementation of the concessional tax rate of 20% (current tax rate at 10%) for listed stocks.

5.1.1 Dividend income

If (i) a Japanese resident individual receives dividends from listed stocks held in an Exempt Account opened with a financial instruments business ("**Exempt Listed Stocks**") within 10 years from January 1 in the year in which the Exempt Account is opened and (ii) the financial instruments business handle payment of the dividends, such dividends will not be subject to individual income and inhabitant tax.

5.1.2 Capital gains

If, within 10 years from January 1 in the year in which the Exempt Account is opened, a Japanese resident individual realizes capital gains on the disposal of Exempt Listed Stocks held in the Exempt Account, then provided that the disposal of the Exempt Listed Stocks is handled by the financial instruments business, the capital gains will not be subject to individual income and inhabitant tax. Capital losses realized on the disposal of Exempt Listed Stocks will be disregarded for individual income and inhabitant tax purposes.

5.1.3 Exempt Account

An account which meets following conditions will be treated as Exempt Account:

- a) The account holder is a Japanese resident individual who is 20 years old or more as of January 1 in the year when the account is opened;
- b) The Japanese resident individual submits an application form providing details including their name, address and other information, together with certain documentation confirming these details and a form for opening the exempt account to the financial instruments business; and
- c) The account is a book-entry account for listed stocks, which will be opened from 2012 till 2014 (one person can open only one account per a year).

An Exempt Account must only hold listed stocks newly acquired from the opening of the Exempt Account till December 31 in the year including such opening day. The Exempted Listed Stocks must be acquired through the financial instruments business maintaining the Exempt Account and the acquisition cost can not exceed JPY 1 million from the opening day of Exempt Account.

The scope of Exempt Listed Stocks will be the same as that of listed stocks under the current concessional provisions for the tax rate at 10%.

Certain measures including the procedures of applying the confirmation form of Exempt Account will be introduced.

5.2 Abolishment of special taxation for deemed dividends where listed companies purchase their own shares through a tender offer

Currently, if a listed company purchases its own shares through a tender offer, deemed dividends are not recognized under a special taxation provisions. Under the 2010 Tax Reform Proposal, these special taxation provisions will be abolished with effect from December 31, 2010. In accordance with the abolishment of the special taxation provisions, the following measures will be introduced with regard to the special treatment of withholding obligation on deemed dividends derived from listed companies:

- (1) The base date for determining whether shareholders receiving deemed dividends are classified as major shareholders will be the ending date of the tender offer; and
- (2) A listed Japanese corporation that is deemed to pay a dividend will be required to provide a notice of detailing certain information including the reason for deemed dividends and the amount of the deemed dividends to a financial instruments business as the paying agent of dividend.

5.3 Abolishment of special treatment for acquisition cost of listed shares

Under the 2010 Tax Reform Proposal, the special treatment of acquisition costs for listed stocks purchased on

or before September 30, 2001 will be repealed with effect from December 31, 2010.

5.4 Measures for listed specified trusts issuing beneficiary certificates (Japanese Depositary Receipt)

The 2010 Tax Reform will introduce the following measures;

- (1) Profit distributions from the termination or partial redemption of a listed specified trust will be included in the scope of the concessional taxation treatment for redemption of listed securities investment trusts; and
- (2) Where a Japanese resident individual receives assets, including cash, arising from a termination or partial redemption of a listed specified trust, the value of such assets will be deemed as the sales proceeds from the sale of shares. This payment will be included in the scope of payment record for the redemption of certain securities investment trusts.

6. Consumption tax

Proposed changes to the adjustment of excess purchase tax credits

Before 2010 Tax Reform

When a taxpayer claims purchase tax credits for the acquisition of fixed assets (e.g., residential apartments) and there is a significant change in taxpayer's taxable sales ratio in successive taxable periods after the claim, then an adjustment of the purchase tax credits claimed may be made in the taxable period during which three years have elapsed from the first day of the taxable period in which the assets subject to adjustment were purchased.

Under current law, to avoid an adjustment, it may be possible for a taxpayer to elect non-taxpayer status or the simplified tax system during the third-year taxable period.

2010 Tax Reform Proposal

When a taxpayer acquires certain fixed assets which may be subject to adjustment (i.e., assets, excluding inventory, with an acquisition cost of JPY 1 million or more), and claims purchase tax credits, the taxpayer will not be able to elect non-taxpayer status or the simplified tax system for a period of three years including the taxable period when the taxpayer acquires the fixed assets.

This revision will apply to the taxable periods starting on or after April 1, 2010, or to company established on or after April 1, 2010.

For more information, please consult your international tax representative or contact any of the following members listed below:

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