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Japan

Amendment of the depreciation method

On April 1, 2007, an Enforcement Order of Amended Corporate Tax Law (the "Enforcement Order") became effective. The amendment of the depreciation method (the "Amendment") will have a significant impact on the commercial activities of Japanese entities, as no amendment has been made in the past 40 years.

Before the Amendment, the depreciation method for Japanese tax purposes was as follows:

- (1) The residual value reaching to the tax useful life is 10%;
- (2) Even if the depreciable asset is used after the completion of the tax useful life, the depreciation is limited up to a statutory limited amount (equivalent to 95% of the book value); and
- (3) The tax useful life is generally longer than the tax useful life in a foreign tax regime.

The amendment was primarily made for the above issues (1) and (2), and a partial amendment was made to (3) in above, for the purpose of promoting investments in the new facilities of entities and to ensure the corporate competitiveness on an international basis. This article deals with the outline of the Amendment.

1. An outline of the amendment of the depreciation method

- (1) With regard to depreciable assets acquired on and after April 1, 2007, the limited amount of the depreciable assets (95%) has been abolished, and the depreciable assets may be depreciated up to 1 yen.
- (2) Replacing the previous declining balance method, a 250% declining balance method is introduced.
- (3) With regard to depreciable assets acquired on and before March 31, 2007, depreciation is

allowed up to 1 yen over five (5) years after the assets are depreciated up to the statutory limit of the depreciation (95% of the acquisition cost).

- (4) The tax useful life has been shortened for certain facilities such as flat panel display manufacturing facilities.

2. The depreciation method and the tax statutory depreciable amount

With regard to depreciable assets acquired on or after April 1, 2007, a depreciation method that enables faster depreciation is applied. On the other hand, depreciable assets acquired on or before March 31, 2007 are subject to the previous depreciation method.

Acquisition date of the depreciable assets	Depreciation method	Statutory limited depreciation amount (residual value)
Acquired or put into business use on or after April 1, 2007	Straight line method, declining method (250% declining method)	Up to the residual book value of 1 yen
Acquired and put into business use on or before March 31, 2007	Old straight line method, old declining method	Up to 95% of the acquisition cost (After 95% depreciation, depreciation is allowed up to residual book value of 1 yen)

Assets acquired and put into business use on or before March 31, 2007 are subject to the old depreciation methods. However, for the purpose of distinction with the newly adopted depreciation method, the depreciation methods before the Amendment are referred to as the "Old straight line method" and the "Old declining method".

3. New depreciation method (the depreciation method for depreciable assets acquired or put into business use on or after April 1, 2007)

With regard to the depreciable assets acquired or put into business use on or after April 1, 2007, the statutory depreciable amount and the residual book value have been abolished, and they may be depreciated up to 1 yen of the residual book value. We will show how to calculate the tax statutory limited depreciation amount with examples below.

(1) Straight line method

The difference between the Old straight line method and new one is that the amount of depreciation expense is calculated based on the entire acquisition cost rather than 90% of the acquisition cost (that is equivalent to the tax depreciable amount).

The amount of depreciation expense = The acquisition cost x Depreciation rate of the straight line method (under table 10 of the Cabinet Order on Tax Useful Life).

The depreciation rate is provided under table 10 that is newly provided under the Cabinet Order of the amended tax useful life. For example, in case of a tax useful life of five (5) years, the depreciation rate under the straight line method is 20%. The depreciation expense calculation in case of the acquisition cost of 1,000,000 JPY is stated below.

Fiscal years	1	2	3	4	5
Acquisition cost	1,000,000				
Beginning book value	1,000,000	800,000	600,000	400,000	200,000
Tax statutory depreciation amount	200,000	200,000	200,000	200,000	199,999
End year book value	800,000	600,000	400,000	200,000	1

(2) Declining method (so-called 250% declining method)

The amount of depreciation expense under the new declining method is calculated as the depreciation

rate multiplied over the acquisition cost of the depreciable assets

Although the calculation method is the same as the Old declining method, the new declining method allows accelerated depreciation by applying "Depreciation rate of the declining method" that was set at 2.5 times of the straight line depreciation rate.

Further, if the depreciation expense as calculated above is below a certain amount (the depreciation expense that is calculated assuming that the book value at the residual period of the tax useful life (unused period over the tax useful life) is depreciated equally), the depreciation method is changed from the declining method to equal depreciation within the residual useful life (that is, a change from the declining method to the straight line method).

If the declining method is continuously applied, the depreciation expense becomes smaller as the tax useful life passes, which makes it impossible to depreciate the expense down to 1 yen within the tax useful life. In order to avoid this disadvantage, the depreciation method is changed to equal depreciation when the residual amount reaches a certain amount. This "certain amount" is the amount in which the certain rate (guarantee rate) is multiplied over the acquisition cost from a perspective to reduce the administrative burden for taxpayers. The guarantee rate is provided under the Beppyo 10 of the Cabinet Order.

The calculation of the tax statutory limited depreciation amount is as follows:

① The fiscal year in which "Depreciation expense before the adjustment(*1) ≥ Guaranteed depreciation amount(2)
 The tax statutory limited amount of the depreciation = Undepreciated amount × Depreciation rate under the declining method (Beppyō 10)

② The fiscal year in which "Depreciation expense before the adjustment < Guaranteed depreciation amount:
 The tax statutory limited amount of the depreciation = Amended acquisition cost (*3) × Amended depreciation rate (Beppyō 10)

*1 : Depreciation expense before the adjustment: Undepreciated amount x depreciation rate under the declining method
 *2 Guaranteed depreciation amount: The guarantee rate is multiplied over the acquisition cost
 *3 Amended acquisition cost: The beginning book value of the first fiscal year in which the depreciation amount before the adjustment is less than the guaranteed depreciation amount.

In case that the acquisition cost is 1,000,000 JPY with a tax useful life of 10 years, the calculation of the tax statutory depreciation amount is as follows:

Fiscal year	1	2	3	4	5	6	7	8	9	10
Acquisition Cost	1,000,000	-	-	-	-	-	-	-	-	-
Beginning book value	-	750,000	562,500	421,875	316,407	237,306	177,980	133,485	88,902	44,319
Depreciation amount before the adjustment	250,000	187,500	140,625	105,468	79,101	59,326	44,495	33,371	22,225	11,079
Guaranteed depreciation amount	44,480	44,480	44,480	44,480	44,480	44,480	44,480	44,480	44,480	44,480
Judgment	1	1	1	1	1	1	1	2	2	2
Amended depreciation amount	-	-	-	-	-	-	-	44,583	44,583	(44,583)
× Amended depreciation rate										
Tax statutory limited amount of the depreciation	250,000	187,500	140,625	105,468	79,101	59,326	44,495	44,583	44,583	44,318
The ending book value	750,000	562,500	421,875	316,407	237,306	177,980	133,485	88,902	44,319	1

4. Tax statutory depreciation amount of depreciable assets acquired on or before March 31, 2007

With regard to depreciable assets that were acquired on or before March 31, 2007, the old

depreciation methods apply, i.e. the Old straight line method and the Old declining method. However, the Amendment enables the old depreciable assets to be depreciated down to 1 yen of the residual book value. Specifically, with regard to those depreciable assets which accumulated depreciation amount becomes 95% of the acquisition cost, the tax

statutory limited depreciation amount is calculated by equal amortization over five (5) years from the fiscal year following the year in which the accumulated depreciation amount becomes 95% of the acquisition cost. Specifically, the calculation formula is as follows:

The tax statutory limited depreciation amount = $\langle \text{Acquisition cost} - (95\% \text{ of the acquisition cost} \div 60 \times \text{the number of the month of the fiscal year}) \rangle$

Please note that special attention should be paid to the applicable period of the equal depreciation over five (5) years. Since this calculation system is effective from "the fiscal year beginning on and after April 1, 2007", a company whose fiscal year end is December each year may commence the equal depreciation on or after December of 2008 fiscal year. Also, it should be noted that the equal depreciation may be commenced only when the accumulated depreciation amount at the "end of the previous fiscal year" becomes 95% of the acquisition cost. Consequently, if the accumulated depreciation amount exceeds 95% of the acquisition cost in the fiscal year commencing on or after April 1, 2007, the depreciation amount is the amount up to the 95% of the acquisition cost, and the equal depreciation is allowed from the subsequent fiscal year.

5. Tax treatment of the capital expenditure

The Amendment provides a depreciation method for the capital expenditure (the expenditure to extend the useful period of the fixed assets or to increase the value of the assets) made on or after April 1, 2007.

(1) Basic principle

Any capital expenditure made on or after April 1, 2007 is deemed for tax purposes that a new depreciable asset is acquired. The existing assets themselves are subject to the current depreciation method.

(2) Special exception

There are the following exceptions:

- (a) In case of capital expenditure for assets subject to the declining method (new method)
At the time of the commencement of the fiscal year following the year of the capital expenditure, the book value of the depreciable asset that was the subject of the capital expenditure (the old depreciable asset) may be aggregated with the asset of the capital expenditure (the additional depreciable asset) and it is deemed for tax purposes that a single depreciable asset is newly acquired.
- (b) In case of a multiple number of capital expenditures within the same fiscal year
Among the additional depreciable assets subject to the declining method (the new declining method), the total amount of the book value of assets whose type and tax useful life are the same, may be deemed as the amount of the single depreciable asset (excluding asset applicable to (a) above) at the time of the commencement of the fiscal year following the year of the capital expenditure.
- (c) If capital expenditure for asset was acquired on or before March 31, 2007
The capital expenditure may be added to the existing assets in the year of the capital expenditure. In this case, the depreciation is made according to the type and tax useful life of the existing depreciable asset.

6. Reporting the depreciation method

(1) Election of the depreciation method

Basically, the depreciation methods elected by taxpayers for the depreciable assets acquired on or after April 1, 2007 should be reported to the tax office by the final corporate tax return due date, by separating the depreciable assets acquired on or before March 31, 2007 according to the types of the assets.

If assets acquired on or before March 31, 2007 are

depreciated under the old straight line method, old declining method or old activity-based depreciation and the assets that are acquired on or after April 2007 and deemed that they were acquired on or

before March 31, 2007, it is deemed that the straight line method, old declining method or old activity-based depreciation shall apply when taxpayers do not elect the depreciation method.

△: Reporting required ⊙: Reporting not required

		Assets acquired on and after April 1, 2007 that are regarded to be classified under the same asset group			
		The straight line method	The declining method	The activity-based method	Others
Assets acquired on And after March 31,2007	Old straight line method	⊙	△	△	△
	Old declining method	△	⊙	△	△
	Old activity-based method	△	△	⊙	△
	Others	△	△	△	△

(2) Procedures to change the depreciation methods

When taxpayers intend to change the depreciation methods, the "Application to change the depreciation methods" should be filed with the director of the tax office under jurisdiction by the date prior to the beginning of the fiscal year in which the new depreciation method will apply and approval should be obtained.

However, if taxpayers intend to change the depreciation method in the fiscal year ending on or after April 2007, the above application may be filed by the final corporate tax return due date as an exception.

7. Relationship with corporate accounting

The Japanese Institute of Certified Public Accountants (JICPA) announced the Report No. 81 entitled as "The treatment of depreciation for audit purposes at the present stage" (the "Report") on April 25, 2007. This report was prepared by the Audit and Assurance Practice Committee of JICPA.

In the Report, the Committee states the difference in the depreciation for auditing purposes as follows:

"The depreciation rule for corporate tax purposes is aimed to calculate the tax statutory limited amount of depreciation and such depreciation calculation would not be compulsory for accounting purposes. Thus, we believe that even after the 2007 tax reform, the Old straight line method and the Old declining method will not be denied. This means that for the depreciation methods for accounting purposes based on cost allocation, there are four (4) elections for depreciation methods, i.e., the Old straight line method, the new straight line method, the old declining method and the new declining method. "

Although the above report states that four elections are available, it should be noted that the change of the deprecation method is regarded as a significant change in accounting policy with justifiable reason.

(1) When the conditions below are satisfied, a significant change in the accounting policy with

justifiable reason is admitted since the similarity of the depreciation methods is recognized.

- * In case the new straight line method is applied for the new assets when the old straight line method is employed for the existing assets; or
- * In case the new straight declining method is applied for the new assets when the Old declining method is employed for the existing assets.

(2) On the other hand, the similarity of the depreciation methods is not recognized for the cases below so a justifiable reason is required for the significant change in the accounting policy.

- * In case the new declining method is applied for the new assets when the Old straight line method is employed for the existing assets; or
- * In case the new straight line method is applied for the new assets when the Old declining method is employed for the existing assets.

(3) If the depreciation method is changed for the existing assets in order to integrate the depreciation method with the new assets, a justifiable reason is required.

Also, the equal depreciation over five (5) years after the residual value becomes 95% of the acquisition cost is treated as follows in the Report:

"If such asset is continuously offered for business use, the treatment of the residual book value should remain unchanged. However, if equal depreciation is made over five (5) years and the depreciation expense is treated as the cost of sales or periodical expense for accounting purposes, such treatment is admitted as appropriate for auditing purposes.

It should be noted that if the equal depreciation is adopted, disclosure is

required for the additional information. It should be noted also that this method should apply to all depreciable assets and no partial application is allowed.

On the other hand, the treatment of the residual book value as a loss inclusively requires a justifiable reason, i.e. in the case where the loss is recognized for asset-impairment accounting purposes."

8. Shortening of the tax useful life

Before the Amendment, there was criticism that the tax useful life is comparatively longer than that of other countries. Under the Amendment, the tax useful life is amended for depreciable assets with a short duration that is subject to significant technological innovation. Specifically, the following changes have been made:

- (1) Flat panel display facilities: From 10 years to 5 years;
- (2) Flat panel film material manufacturing facilities: From 10 years to 5 years; and
- (3) Semiconductor photo-resist manufacturing facilities: From 8 years to 5 years.

The shortening of the tax useful life is required for all depreciable assets, and there is debate concerning the administrative procedure for reporting and the complicated classification of assets. These issues still need to be taken into account for further reform. In the "Large package of 2007 tax reform" issued by the Liberal Democratic Party, it is stated that a further investigation and analysis for the current status of the depreciable assets will be carried out in order to review the tax useful life and classification of assets as well as the simplification of the administrative procedures".

Asia

Establishment of Integrated PRC Income Tax - Impact on Japanese taxation

At the China's Peoples' Congress that was held on March 16, 2007, The "PRC Corporate Income Tax Law" (the "New Law") was enacted. This law integrates tax regulations that have been separately applied to foreign-capitalized enterprises marketed in PRC and PRC domestic enterprises, in order to meet the request of WTO for the elimination of discrimination of domestic and foreign enterprises.

The New Law will become effective on January 1, 2008, and will apply to fiscal years beginning on or after that date. The characteristics of the New Law are simplified taxation, wide range of tax base, low tax rate and strict tax collection system. Specifically, a review on preferred tax treatment, special tax adjustments (for transactions between related parties) and a change of the tax rate are regarded to have a certain impact on Japanese taxation. The practical contents of the preferred taxation and details of the applicable range will be provided under Enforcement Regulations that will be issued on a later date.

I. Review of the preferred tax treatment

1. Outline of the preferred tax treatment

The preferred tax treatment under the New Law is set out by industry and business line, and tax benefits that are only available for restricted areas will be decreased. Tax benefits currently available for manufacturing enterprises under the Foreign-Capitalized Enterprise Income Tax Law (the "Old law") will be eliminated. While the tax benefits mainly focus on high-technology industries, environmental protection, energy-saving and water conservation as well as investments to ensure security of production sites under the New Law, the details will follow in the Enforcement Regulations that will be issued later on.

As for the tax benefits of the reduced tax rate and tax reduction and exemption currently available, the grandfather clause of five-year-tentative treatment will apply as described below. It should be noted that this tentative treatment applies only to those enterprises that are approved for incorporation before the issuance of the New Law, i.e., before March 16, 2007, and will not apply to enterprises that are incorporated after the issuance of the said law.

(1) Tentative treatment for the current reduced tax rate
For enterprises that were approved for incorporation before the issuance of the New Law, i.e. March 16, 2007 and received a tax benefit at the reduced tax rate under the Old law, the tax rate will be increased gradually up to 25% within five (5) years, from 2008 to 2012.

(2) Tax exemption and reduction

For enterprises receiving tax benefits in which tax is exempted for the initial two (2) years and 50% reduced for the next three (3) years, such benefit is available until the completion of the tax exemption and reduction period (five (5) years) consecutively regardless of the issuance of the New law. If the tax benefit of the tax exemption and reduction is not applicable as of the current fiscal year of 2007, the applicable period will be five (5) years counting from the year of the enactment of the New law, that is 2008. If the full period applies, the benefit will be terminated in 2012.

2. Impact on Japanese taxation

An abolishment of the current preferred tax treatment is likely to have a direct impact on Japanese-capitalized enterprises such as subsidiaries of Japanese entities, who currently enjoy the tax merit under the preferred treatment. In cases where the new tax benefit under the New law

is applicable, the increase in the tax burden might be limited in substance, however, the new preferred tax treatment is significantly different from the current one so that enterprises enjoying the current tax benefit may not be able to be benefit.

In addition, particular attention should be paid to the "deemed foreign tax credit" for Japanese tax purposes. The deemed foreign tax credit is the tax credit whereby a reduced or exempted tax amount under the preferred tax treatment in PRC is deemed to be paid and is applicable to be credited for Japanese tax purposes. This consequently reduces the Japanese tax liability and will result in a reduction of the tax burden for the whole entity group.

It should be noted, however, that the deemed foreign tax credit is applicable to limited types of reduced or exempted tax amounts. Specifically, the Old law prescribes the special clause to designate the eligible type of tax amount, and along with the abolishment of the Old law, the tax credit items would be eliminated. This means that deemed foreign tax credit is no longer available under the New law.

In order to benefit from the constructive foreign tax credit, both Japanese and Chinese governments should agree with the application of the tax credit. However, at the present stage, there is no movement towards such an agreement.

II. Regulated tax measures to transactions between related parties

1. Outline of the New law

The New law provides measures to prevent tax avoidance activities among related parties (Articles 41 to 48) as stated below. These are mainly aimed to regulate transactions between related parties.

(1) Transfer pricing taxation

In addition to the general transfer pricing taxation, cost sharing, advanced pricing agreement (APA), obligation to submit information, documentation

obligation and presumed taxations are included.

(2) Thin capitalization rule

If the portion of interest payable with regard to the loan payable and contribution exceeds the statutory limitation that is provided by taking into certain gearing ratio, such exceeding portion is not tax deductible.

(3) Anti-tax haven legislation

If a related foreign subsidiary that is located in a country with a low tax rate does not pay dividend without justifiable reason, the retained earnings of the said subsidiary are included in the taxable income of the parent company in PRC. Under the current circumstances, the case where a foreign-capitalized enterprise locates its Chinese subsidiary as an investment base for third countries is not feasible so that the anti-tax haven legislation is mainly aimed at domestic enterprises investing in PRC.

2. Impact on Japanese taxation

Among the measures to prevent tax avoidance activities under the New law, particular attention should be paid to the measures relating to the transfer pricing taxation. While contents of major rules will be maintained, there are many opinions saying that the fact that these measures became regulated means a change of PRC government's stance. Namely, it seems that PRC government will put more emphasis on the transfer pricing taxation.

In fact, there have been many cases where Japanese-capitalized enterprises were subject to the PRC transfer pricing taxation, and newspaper articles reporting the strengthening of transfer pricing taxation have been seen recently. Enterprises with subsidiaries in PRC who conduct transactions with Japanese parent companies should pay more attention to transfer pricing taxation. Further, for the advance preparation or dealing with matters such as the transfer price study, the use of APA becomes more important.

III. Reduction of basic tax rate

1. An outline of the new tax rate

Under the New law, the corporate tax rate is 25% (currently 33%). In the case of certain small-sized enterprises with low margin, a reduced tax rate of 20% will apply, and further reduced tax rate of 15% will apply to certain high-technology enterprises. However, definitions and range of these small-sized enterprises with low margin and high-technology enterprises are not announced.

2. Impact on Japanese taxation

Tax reduction to a uniform tax rate of 25% in PRC is significantly important for Japanese parent companies with subsidiaries in PRC, as the subsidiaries are subject to Japanese anti-tax haven legislation.

For current Japanese anti-tax haven legislation purposes, the retained earnings of subsidiaries located in tax haven countries are included in the Japanese taxable income of their parent companies for Japanese corporate tax purposes. Subsidiaries located in tax haven countries are defined as foreign subsidiaries whose tax burden is 25% or less of the effective tax rate. Specifically, subsidiaries located in PRC will be included in this definition as a result of the tax reduction to 25% under the new law.

On the other hand, Japanese anti-tax haven legislation provides measures of "non-applicable rules" whereby retained earnings of the related foreign subsidiaries are not included in the taxable income of their parent companies provided that the subsidiaries have reasonable business substance and business activities. The judgment of the reasonableness is made according to the following tests:

- (1) Business test: Their main business is not related to holding company function.
- (2) Substance test: Physical facilities such as offices should be located in the head office country.
- (3) Administration and control test: The head office

has administration and control functions.

- (4) Non-related parties test: In the case of wholesalers, transaction volume with non-related parties should be more than 50%.
- (5) Location test: Actual business activities are conducted in the head office country.

If the above tests are satisfied, anti-tax haven legislation does not apply for Japanese tax purposes even if PRC subsidiaries are subject to the anti-tax haven legislation.

Taking a look at Japanese enterprises conducting business in PRC, many of them can be called "umbrella type company" who conducts business locating several business companies in PRC. While the umbrella company is regarded as the ultimate parent company in PRC, and it seems to conduct administration and control activities for subsidiaries in PRC, what is important is the judgment of the business category of the umbrella company.

If the umbrella company functions as a holding company, it does not satisfy the business test. Also, if it functions as an intermediary party for administration purposes, it does not satisfy the non-related party test. From these reasons, it becomes necessary to investigate and consider the business substance and functions of umbrella type companies as a result of the reduction of the basic tax rate to 25% in PRC

North America

FIN 48 - An Overview

Multinational companies that are listed in the US have been dealing with how the Financial Accounting Standards Board (FASB) Interpretation No 48 ("FIN 48") will apply to them. Since the implementation date for FIN 48 was for periods beginning after December 15, 2006, there has been much activity in this area.

FIN 48 prescribes a comprehensive model for how a company should recognize, measure, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. It is applicable only to taxes that are based on income that are accounted for pursuant to FAS 109, and is not intended to apply to other taxes such as consumption and property taxes.

The scope of FIN 48 is broad enough to be applicable to Japanese subsidiaries of US parent companies that are SEC registrants.

Background

The evaluation of a tax position in accordance with FIN 48 is a two-step process. The first step is recognition: The company must determine whether it is more-likely-than-not that a tax position will be sustained upon examination based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the company should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements.

Identifying Uncertain Tax Positions

In applying FIN 48, companies will need to determine and assess all material positions existing as of the date they adopt FIN 48, including all significant uncertain tax positions, in all tax years that are still subject to a tax examination.

The starting point for the analysis is to identify the appropriate unit of account (i.e. the level of detail to assess each tax position). Among the factors that should be relevant in making this determination are the following:

- *The significance of the transaction/activity as compared to the entire tax return;
- *Should the transaction be considered on its own or in conjunction with other transactions that may have similar results;
- *The manner in which the company prepares its tax returns and the company's documentation practices in the tax working papers; and
- *The anticipated level at which the tax examiners will review the issues during a tax examination.

Once a unit of account for a given tax position has been identified, the question then becomes one of recognition. For a position to qualify for benefit recognition under FIN 48, the position must have at least a more-likely-than-not chance of being sustained based on the position's technical merits if challenged by the tax authorities. Assuming that the tax authority has full knowledge of the position and all relevant facts, management must be able to conclude that the tax law, regulations, and other information regarding the technical merits of the position support the position being greater than 50% sustainable. If management cannot reach this conclusion, none of the tax benefit provided by the position can be currently reflected in the financial

statements.

A large number of tax positions will be clearly supportable under the tax law, regulations, case law, etc. and will not require substantial documentation efforts to satisfy the more-likely-than-not threshold. However, there will be positions that require significant effort from management to support its assertion that the more likely than not recognition threshold has been satisfied.

Examples of tax positions of Japanese subsidiaries of foreign companies that management may need to review and document include any deduction or income item, transfer pricing (e.g. related party services, sale of goods, use of intangibles such as technology, trademarks/tradenames, and financing), permanent establishment (e.g. dependent agent attribution of activities to a foreign party), withholding tax, tax treaty, and donation income and expense issues. Where appropriate, management should document its conclusions, the information and factors considered in arriving at its conclusions, how those factors were weighted, and which factors might be susceptible to changes and therefore, should be monitored on an ongoing basis.

Management has a wide range of potential sources to consider when concluding that the more likely than not recognition threshold has been satisfied. The company should ensure that all relevant tax law, regulations, etc. have been considered. In addition, management should also determine whether the company has sufficient internal documentation to assess an uncertain tax position or whether the company will need support from third parties to make an assessment (e.g. opinion letters from tax advisors).

Measurement of the Tax Benefit

After concluding that a particular filing position has a more-likely-than-not chance of being sustained, a company must measure the amount of benefit to be recognized. FIN 48 uses a new measurement methodology that is based on cumulative probability,

resulting in the recognition of the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the taxing authority.

The assessment of an uncertain tax position is a continuous process. As of each balance sheet date, management needs to reassess unresolved uncertain tax positions, and determine whether the factors underlying the conclusion that the position is more-likely-than-not sustainable have changed and whether the amount of the recognized tax benefit is still appropriate.

Changes need to be based on new information rather than simply on a re-evaluation of existing information. Potential sources of new information could include developments during a tax audit; statements by the tax authority, APA or Competent Authority; developments in the law; etc.

Further, a taxpayer is required to accrue interest and penalties that, under relevant tax law, the taxpayer would be regarded as having incurred. Accordingly, under FIN 48, interest would start to accrue in the period that it would begin accruing under the relevant tax law, and penalties should be accrued in the first period for which a position is taken (or is expected to be taken) on a tax return that would give rise to the penalty. How a company classifies interest and penalties in the income statement is an accounting policy decision.

Disclosures

It is important to understand that FIN 48 provides for an increase in disclosure requirements, including the following:

- *a qualitative discussion of only those positions that management expects will change significantly within the next twelve months;
- *a quantitative roll-forward of the worldwide aggregated unrecognized tax benefits from uncertain positions; and
- *the total amount of unrecognized tax benefits

that, if recognized, would impact the effective tax rate.

One of the ongoing issues relating to the FIN 48 disclosure requirements is the concern about whether the tax authorities will obtain this detailed information on uncertain positions. This will continue to be a concern.

PwC Services

Implementation of FIN 48 will require companies to have a complete inventory, and perform an evaluation, of all material tax positions. To approach this effectively, companies will need to coordinate

with its various departments including tax, finance, and legal to develop a structured plan of implementation.

PwC Tokyo has extensive experience in assisting companies with their FIN 48 implementation. Our services can cover the full scope of the FIN 48 review and implementation process from meeting with Japanese management and appropriate members of the independent auditing engagement team to discuss FIN 48 and related financial reporting to assisting with the identification of significant uncertain tax positions and assisting in gathering the supporting documentation for the identified uncertain tax positions.

Europe 1

2007 UK Budget

Changes to UK corporation tax rates and reliefs

Corporation tax rates

Historically, UK corporation tax rates were considered to be relatively low. However, over recent years this competitive edge has been eroded by other European territories that have reduced their tax rates below that of the UK. In recognition of this, the rate of UK corporation tax is to be reduced from 30% to 28% with effect from 1 April 2008.

Capital allowances and other reliefs

The main changes announced were as follows:

- The rate of writing down allowances (tax depreciation) on plant and machinery is to be reduced from 25% per annum to 20%.
- Industrial Buildings Allowances are to be gradually phased out by 2010-11.
- The rate of writing down allowances on long-life assets is to be increased from 6% to 10%.
- R&D tax credits for large companies are increasing to 130% of qualifying R&D expenditure (from

125%).

Taxation of shareholder debt

No changes to the rules introduced in 2005 have been announced in the Budget. However the Government has repeated recent statements that it intends to carry out a review of the rules that apply to shareholder debt with features of equity to ensure the existing rules operate as intended.

In addition, an announcement is to be made later this spring concerning (i) expedited procedures for agreement with HMRC concerning relief from UK withholding tax on loan interest paid to non-residents and (ii) an extension to the circumstances in which UK residents can enter into thin capitalisation agreements.

Tax clearance procedures - the substantial shareholdings exemption

In November 2006, HMRC committed to extending existing tax clearance procedures so as to give

businesses greater certainty on the tax implications of significant commercial issues where there is uncertainty in the legislation. Accordingly, with effect from 1 June 2007, Code of Practice 10 will be reapplied to the substantial shareholding legislation with the effect that it will be possible to seek advance clearance on whether the substantial shareholdings exemption will be available on the disposal of shares in a company.

VAT

Asset deals: changes in transfer of going concern rules

HMRC announced changes to the record keeping requirements so that when a business is sold by way of a sale of assets which qualifies as a VAT free transfer of going concern (or TOGC) for VAT purposes, the seller will in all but a few specified cases, retain the business records.

Previous VAT regulations meant that following a TOGC, all business records should be transferred to and retained by the buyer. This requirement was at odds with direct tax, company law and insolvency law rules and HMRC has today announced that the requirement to transfer records for VAT purposes will now be amended. This effectively leads to a situation where the seller will retain business records post completion unless it also transfers its VAT registration number. It will be necessary for certain undertakings to be made to the buyer regarding access to these records.

The changes will also confirm that it is possible to effect a TOGC where assets relating to a part of a business are sold as long as those assets are capable of separate operation as a business and the other criteria for a valid TOGC are satisfied.

VAT changes in the telecommunications and IT industries

The Budget extended the list of goods to which businesses involved in buying or selling mobile telephones or computer chips / microprocessors / central processing units are jointly and severally

liable for VAT if they had grounds for suspecting that VAT would go unpaid elsewhere in the supply chain.

These changes come days after the issue of an HMRC press release dated 19 March 2006 concerning HMRC's initiative to tackle missing trader intra-community (MTIC) fraud, which shifts the liability to account for output VAT on sales of goods falling into the defined categories from the seller to the buyer.

These changes effectively mean that from 1 June 2007, sellers of these goods will no longer have to account for output VAT on the sale of those goods but buyers will be making sense of the Budget obliged to carry out a 'reverse charge' on the purchase, effectively bringing output and input tax into account simultaneously.

The further goods now caught by these provisions will be 'certain sorts of electronic equipment, of a kind ordinarily owned by individuals and used by them for the purposes of leisure, amusement, or entertainment'.

The changes will particularly affect the VAT accounting and compliance demands of businesses within the telecommunications sector.

Other matters

UK taxation of foreign profits

The Government has held a productive dialogue with business on the taxation of foreign profits in the context of maintaining the overall competitiveness of the UK. The Government will issue a consultation document later in the spring, which will consider, in particular, the taxation of foreign dividends received by UK companies and the controlled foreign companies (CFC) rules. This is an area where business has expressed a preference for reform and where options that will be considered include European-style exemption for foreign dividends and income-based CFC rules. The document will also consider the implications of any such reform for other aspects of the UK tax regime, such as interest

relief.

HMRC approach to compliance risk management for large business policy document

HMRC has issued a policy statement setting out its approach to risk assessment of large business customers. Under this approach more resources will be devoted to high risk customers. In assessing risk HMRC will look at various factors including: the

nature and extent of tax planning, level of disclosure, complexity of corporate structure, previous compliance record, tax compliance systems and processes, adequate and accountable staffing, strong governance based on a clear tax strategy and principles endorsed by the Board.

Note: The above article is reproduced from the website www.budgetpwc.com of PricewaterhouseCoopers UK.

Europe 2

2008 Corporate Tax Reform Bill in Germany

The cabinet formally adopted a Corporate Tax Reform Bill on March 14, 2007 (Proposed 2008 Tax Reform) and filed to Bundestag (Federal Parliament) on late March for the discussion. Although the Tax Reform Bill is still under the discussion and some modification is expected to be made in the discussion, we believe that it is still useful to provide this information at current stage.

I. Tax rate change

The government intends to reduce the overall effective tax rate charged on corporate profits to around less than 30% (currently approximately 40%).

Currently, the corporate tax rate is 25% and base trade tax is 5% with Municipal tax rate of 450% (Dusseldorf). The tax rate of Trade tax is 22.5% assuming the Municipal tax rate is 450% (5%*450%). Additionally the solidarity charge of 5.5% is imposed on the corporate tax amount. In this case, the effective tax rate is 39.90%, as trade tax is deductible for both Corporate tax purpose and Trade tax purpose (Corporate tax 20.41%, Solidarity charge 1.12% and Trade tax 18.37%).

The Proposed 2008 Tax Reform allows a reduction of Corporate tax rate to 15% and base trade tax

rate to 3.5%, although the trade tax becomes a non deductible expense. Under the above assumption Municipal tax rate is 450%, the effective tax rate becomes 31.58% after the Tax Reform. (Corporate Tax 15%, Solidarity Charge 0.83 %, and Trade tax 15.75%)

II. Trade tax as non-deductible expense

As described above 1, the Proposed 2008 Tax Reform said that trade tax becomes a non-deductible expense both for Corporation tax and Trade tax.

III. Limitation on the deductibility of interest

The present thin-capital rule is limited on the deductibility of the interest on shareholders' loan. In the proposed 2008 Tax Reform, the new general rule on the deductibility of interest is introduced as replaced to present thin-capital rule.

The net interest expense is to be disallowed to the extent it exceeds 30 of the annual taxable income before interest. The disallowed amounts are to be carried forward for deduction in later years, the corresponding 30% ratio permitting. There is to be no limitation on deductibility of interest;

*Where the net interest expense is not more than EUR 1M

*Where the company is not part of a consolidation group, whether as parent or subsidiary, and interest paid to shareholders of more than 25% does not exceed 10% of their net interest expense, or

*For consolidation group subsidiaries paying more than 10% of their net interest expense to a shareholder of more than 25%, but only where their debt-equity ratio is no more than 1% worse than its ratio of the consolidation group. The consolidation group ratio is to be based on local financial statements adjusted to the same convention. This "exception from the exemption" is likely to be restrictively applied.

IV. Transfer Pricing

There are two major changes in the Transfer Pricing area in the proposed 2008 Tax Reform.

a) Transfer Pricing Method

The Foreign Tax Act is to be amended to establish a firmer, more precise legal basis for the determination of the arm's length price and the increasing tax office popularity of estimating it on the basis of ranges derived from publicly available information. The revised provision requires measurement of the arm's length standard by reference as appropriate to comparable uncontrolled prices, to the resale price less a reasonable profit margin, or to the cost-plus method. The transfer price taken by the taxpayer is to be accepted if it falls anywhere within the range of available direct comparisons, or within a "narrowed-down" range where the comparisons are only indirect. If the price falls outside the relevant range, adjustment is to be to the median. If no comparison can be found, the taxpayer is required to make a theoretical calculation of the lowest price at which a supplier would be willing to sell and the highest price buyer would be willing to pay. Both values depend on profit expectations. Adjustment is then to the most realistic point within this range with adjustment to the mean as the fall-back position.

b) Transfer of functions

Transfers of complete functions including intangibles are to be valued as a package, unless the taxpayer can demonstrate the contrary. Where complete packages include significant intangibles, the value is to reflect the profit expectations of the parties. If actual events lead to a substantially different result, there is a rebuttable presumption that independent third parties would have made provision for a retrospective adjustment in view of the uncertainty surrounding the deal. If the presumption cannot be refuted, adjustment is to be made to what is now to be seen as the appropriate package price. However:

- *Adjustment may only be made in the absence of an appropriate price adjustment clause
- *Adjustment may only be made in answer to developments within the first ten years of the transfer
- *Only one adjustment may be made within that period
- *Adjustment is as of the year following that in which the event leading to it occurred.

V. Time for production of documents halved

Unusual transactions are to be properly documented as the time and should therefore be available at the start of a tax audit. The period for their production has now been shortened from 60 to 30 days of the demand.

VI. Loss carry-forward on change of shareholders

Under the present regulation, the loss carry-forward is fortified when the 50% of shareholders are changed and new capitals are supplied.

In the proposed 2008 Tax Reform, the loss carry-forward is to be reduced or fortified in accordance with the proportion of the share transfer within 5 years from the first transfer by a single acquirer or his related party.

- *Less than 25%: not changed.

- *More than 25% but less 50%: reduced in accordance with the proportion of transferred share.
- *More than 50%: fortified altogether.

These principles also apply to corporate reorganizations within groups without a change in ultimate ownership.

VII. Deductibility on small assets

Small value assets presently costing individually less than EUR 410 can be charged to expense directly as purchased, although they must be recorded separately. The Proposed 2008 Tax Reform reduces the maximum value to EUR 100, but the record requirement is to be abolished. Fixed assets costing more than EUR 100 but no more

than EUR1,000 are to be grouped in annual blocks to be written off straight-line over five years.

VIII. Tax base for trade tax

The present disallowance of 50% of long-term loan interest is to be replaced with a general disallowance of 25% of all financing cost over EUR 100,000 in the Proposed 2008 Tax Reform. Financing cost is to be seen as:

- *All interest
- *All cash discount given
- *20% of leasing and hiring fees paid for movable assets
- *75% of property rentals
- *25% of royalties, other than certain selling royalties

Finance

2007 Japanese Tax Reforms with respect to Trusts

1. Enactment of the new Trust Law

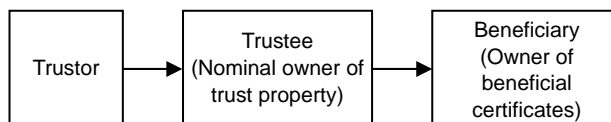
The new Trust Law was announced on December, 15 2006. This new law will come into effect within 18 months from the day of announcement. Trusts set up prior to the effective date will be governed by the old Trust Law. The various types of trusts introduced in the new Trust Law are outlined as below:

- Establishment of Purpose Trust (Trust which does not provide for any beneficiaries)
- Establishment of Trust created by Declaration (Trust where the trustor doubles as the trustee)
- Improvement of the environment for adopting "Business Type" Trust
- Merger or division of Trust
- Allowance of Trust Issuing Beneficiary Securities

2. Meaning of Trust

A "Trust" is the establishment of a legal relationship where according to certain purposes a specified party is to manage or dispose of properties and to take other necessary actions for accomplishing such purposes (Article 2 of the new Trust Law).

- Transfer of property right
- Trust deed (by agreement/ will)
- Distribution of trust profit



3. 2007 Tax Reforms with regard to Trusts

(1) Main points of the 2007 Tax Reforms with regard to Trusts

The main points of the 2007 tax reforms relating to Trusts are summarized below:

- Taxation measures regarding tax treatments of trusts corresponding to the new types of trusts under the enactment of the new Trust Law
- Preventing tax avoidance using trust structure
- Organizing and clarifying the definitions and concepts for trusts

(2) Tax system for trusts under the 2007 Tax Reforms (Corporation Tax, Individual Income Tax)

Under the tax system for trusts corresponding to the new types of trusts, three taxation methods are proposed depending on the types of trusts, (i) Taxation at beneficiary level at the time trust income arises, (ii) Taxation at beneficiary level when the distributions of trust income are received by a beneficiary and (iii) Taxation at trustee level as same as a corporation. The following outlines summarize the three taxation methods as described above.

(i) Taxation at beneficiary level at the time when trust income arises

With regard to general trusts for the management of immovable and movable properties, as the trust assets are deemed to be owned by the beneficiaries, the beneficiaries are subject to taxation for trusts when the trust income arises. The proposed tax reform has improved the following:

- Improvement with regard to the scope of the party to whom the assets/liabilities belonging to trust properties and the income/expenses relating to trust properties are attributed
- The measure of non-deductible adjustment with regard to certain trust losses.

(a) Improvement with regard to the scope of the party to whom the assets/liabilities belonging to trust properties and the income/expenses

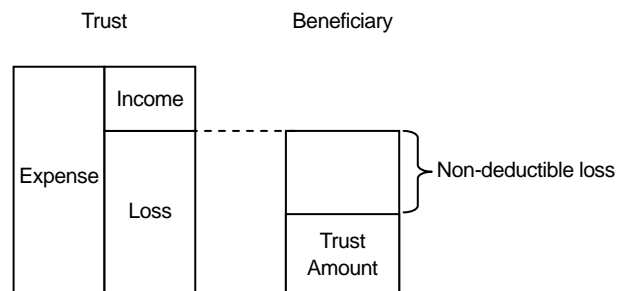
relating to trust properties are attributed

The beneficiaries of a trust (restricted to the beneficiaries owning their rights as beneficiaries at present) are deemed to own the assets/liabilities belonging to trust properties and the income/expenses relating to trust properties are deemed to be the income/expenses of the beneficiaries. In addition, the party who has the right to amend the trust deed at present and who receives the benefit from the trust is deemed to be a beneficiary of the trust.

(b) The measure of non-deductible adjustment with regard to certain trust losses

For an individual beneficiary, the loss under a trust that is incurred from real estate is deemed to be unrealized. For a corporate beneficiary, if the loss under a trust exceeds the trust amount, such exceeded amount should be treated as non-deductible expenses, as per the chart indicated below (however, if the beneficiary has an agreement compensating for the loss, then the total amount of the loss should be treated as non-deductible expenses).

[Treatment under reformed corporation tax law]



(ii) Taxation at beneficiary level when the distributions of trust income are received by beneficiary

Collective investment trusts (shudantoshishintaku), retirement pension trust, specified public trust, etc. are stipulated as being trusts taxed at beneficiary level when the distributions of trust income are received by beneficiary under the reformed tax law.

(a) Collective investment trust is defined as follows:

- Joint operation trust
- Certain investment trusts (securities investment trust, domestic public offering investment trust and foreign investment trust)
- Specified trust issuing beneficiary securities (Trust Issuing Beneficiary Securities (a trust where it is stipulated in its trust deed to issue beneficiary securities) which meets certain conditions)

A Trust Issuing Beneficiary Securities which meets, amongst others, the following conditions set out below is recognized as a Specified Trust Issuing Beneficiary Securities. A Trust Issuing Beneficiary Securities which does not fall within the definition of Specified Trust issuing Beneficiary Securities is subject to taxation at trustee level as same as a corporation:

- The trustee is a corporation that has obtained approval from the director of a tax office
- Undistributed profit of the trust is 2.5% of the total amount of trust principal or less
- Computation period of the trust is not over one year, etc.

(b) Merger or division of collective investment trust

In the case of a merger or division of a collective investment trust, being one of the forms of investment trust whereby no title to property other than a beneficial certificate of the new trust can be transferred, realization of the profit or loss on the transfer of beneficial certificates of the original trust can be carried forward to a later date.

(iii) Taxation at trustee level the same as a corporation

The types of trusts which are subject to taxation at trustee level the same as a corporation are stipulated as a Trust Taxed the same as a Corporation (Houjinkazeishintaku) under the 2007 Tax reforms. Where a trust falls within the

definition of a Trust taxed the same as a Corporation, a trustee as taxpayer is subject to corporation tax. The Trust taxed the same as a Corporation is defined as follows:

- A Trust Issuing Beneficiary Securities (other than Specified Trust Issuing Beneficiary Securities)
- A Trust that has no beneficiary (including deemed beneficiary)
- Certain trusts entrusted by a corporate trustor
- An investment trust other than a collective investment trust
- A Specific Purpose Trust

The main points in these tax reforms with regard to Trusts Taxed the same as a Corporation are as follows:

(a) Taxation at trustee level

With regard to a Trust Taxed the same as a Corporation, the trustee is subject to corporation tax on the trust income incurred from the trust properties. The trust income is to be separately recognized from the income incurred from its own assets

(b) Taxation at investor level

In a Trust Taxed the same as a Corporation, the beneficiary certificates are deemed to be shares or capital subscriptions and the beneficiary is recognised as being equivalent to a shareholder.

(c) A trust that is entrusted by a corporate trustor is recognized as a Trust Taxed the same as a Corporation if one of the following conditions is met

- Where "all or primary part of the business" is entrusted and more than half of the beneficial certificates are to be transferred to its shareholders
- Where the trust term of a Trust created by Declaration is more than 20 years (excluding trusts where the useful life of primary depreciable assets entrusted is more than 20 years etc.)
- Where the beneficiary certificates of a Trust

created by Declaration are owned by a special related person such as its subsidiary etc. and the distribution ratio of profits or losses is variable

(3) Effective date

The above tax reforms will apply to trusts which become effective on or after the enforcement of the new Trust Law.

TP1

Deferral of Tax Payment under Special Taxation Measures Law for Transactions between Corporations and Foreign Related Persons (Deferral of Tax Payment for Transfer Pricing)

1. Introduction

A new mechanism for the deferral of tax payments in relation to transfer pricing was introduced in the 2007 tax revision (provisions of the Special Taxation Measures Law as an amendment to the Income Tax Law). A taxpayer can apply for a deferral of tax payment for transfer pricing, when they file their request for mutual agreement procedures ("MAP") in accordance with the relevant Tax Treaty. In such cases, the tax payment shall be deferred until the competent authorities reach agreement. The amendment, that came into force on April 1, 2007, is expected to reduce the financial burden on taxpayers.

In Japan, requests for MAP are generally filed after tax assessments have been made. Historically, the additionally assessed taxes had to be paid by a predetermined date. On the other hand, MAP normally last for an extended period, even if the result is a reduction in taxable income and a corresponding refund of tax paid. As a result, taxpayers often suffered financially, and felt that unnecessary payments were being imposed. Therefore, as taxpayers in countries such as the U.S. can file requests for MAP before paying any additionally assessed taxes, a similar arrangement was sought by taxpayers in Japan.

2. Articles

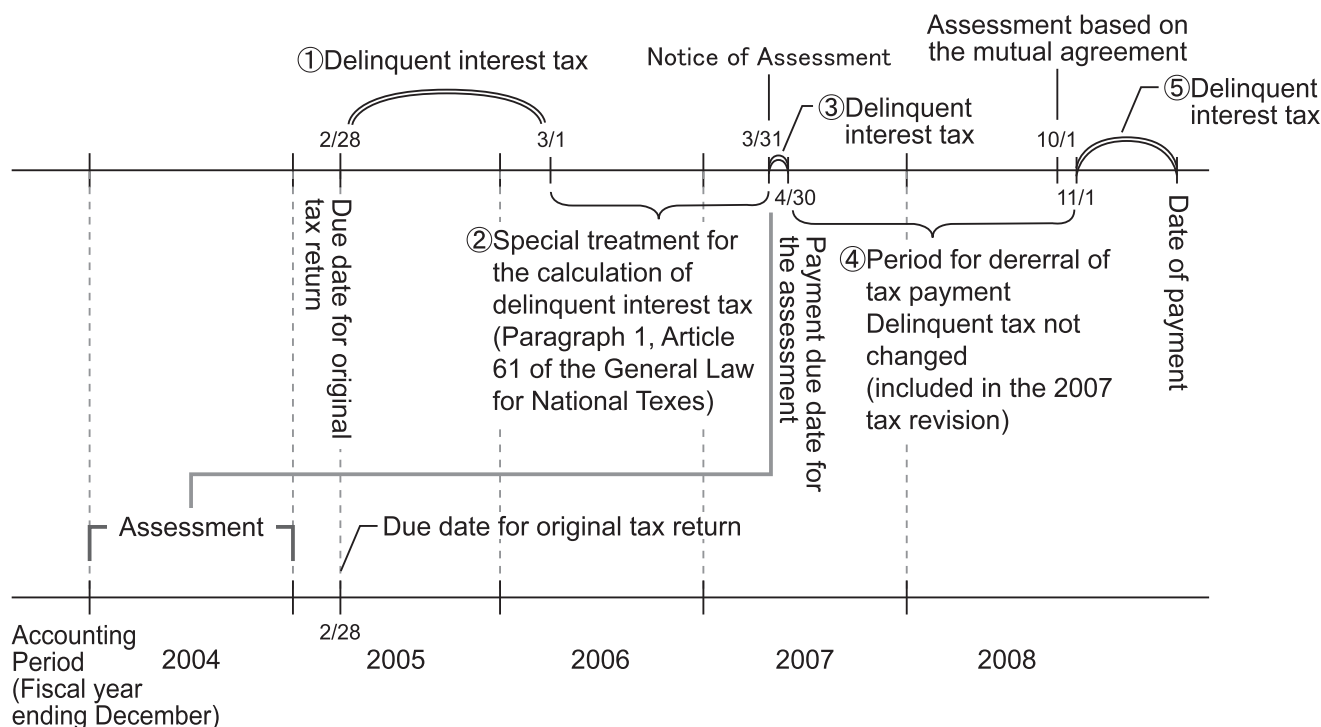
The mechanism for deferral of tax payments for transfer pricing is set out in Special Taxation Measures Law Article 66-4-2 ("STML Art. 66-4-2"), "Deferral of

Tax Payment under the Special Taxation Measures Law of Transactions between Corporations and Foreign Related Persons". As this measure is an amendment to the Special Taxation Measures Law, it is applied ahead of the General Law for National Taxes. Following the introduction of the deferral of tax payment, the "Commissioner's Directive on Mutual Agreement Procedures (Administrative Guidelines)" was also revised on March 30, 2007, which describes how the deferral of tax payment will be applied in practice by the Japanese tax authority.

3. Requirements to Apply for the Deferral of Tax Payment

The primary requirements to apply for the deferral of tax payment for transfer pricing are as follows:

- *An assessment or determination of tax is made based on the Transfer Pricing Legislation (STML Art. 66-4).
- *Based on the assessment or determination mentioned above, additional corporate taxes are payable.
- *The corporation taxes payable are subject to MAP in accordance with the Tax Treaty with the relevant treaty partner country.
- *A request for MAP is filed in accordance with the provisions of the applicable Tax Treaty (in the event that the taxpayer is a foreign corporation, its request is filed to the competent authority of the treaty partner country).
- *The taxpayer applies for a deferral of the tax



payment.

*There is no delinquent national tax payable (only the corporation taxes subject to the application for deferral).

*Collateral equivalent to the amount of the deferred tax payment must be provided.

4. Points to be Noted

The deferral of tax payment is only applicable when a request for MAP is filed. Taxes that are subject to the deferral are corporation taxes and associated penalty taxes related to the assessment or determination made (Paragraph 1, STML Art. 66-4-16). Therefore, it should be noted that assessments or determinations for taxes other than those related to transfer pricing mentioned above (e.g., assessments made in relation to entertainment expenses, or for errors in calculating periodic income) are not subject to deferral of tax payment. In addition, as an amendment dealing with deferral of tax payments was not included in the 2007 revision to local taxes, no deferrals will apply to local taxes such as corporate enterprise tax (even though these are affected by a transfer pricing assessment or determination of national corporation

taxes).

5. Deferral of Tax Payment Process

The potential effective period for a deferral of tax payment starts on the due date for additionally assessed, or determined, taxes, (i.e., one month after the notice of assessment or determination is issued). However, when an application is made for a deferral of tax payment after the due date, the period for the deferral starts on the date of the application. The effective period for a deferral of tax payment ends one month after an assessment has been reached in the MAP. For cases where the competent authorities fail to reach an agreement, the treatment of a deferral will be stipulated by Cabinet Order.

The following chart outlines the process for a deferral of tax payment for transfer pricing.

6. Conclusion

As stated above, it is expected that this new rule will reduce the financial burden of taxpayers exposed to double taxation. In addition, taxpayers in Japan can

now file requests for MAP before paying any additionally assessed taxes, in the same manner as taxpayers in countries such as the U.S. On the other hand, there is a concern that the reduced financial burden on taxpayers may lead to "easy" assessments by the Japanese tax authority, without

thorough examination. As a result, it is hoped that the tax authority understands the context in which the deferral of tax payment provisions were introduced, i.e., to assist with appropriate implementation of the transfer pricing legislation.

TP2

Announcement of Proposed Revision to "Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guideline)" and "Commissioner's Directive on the Operation of Transfer Pricing for Consolidated Corporations (Administrative Guideline)"

I. Introduction

The number of transfer pricing cases targeting large corporations in Japan and the subsequent assessment amounts have increased significantly. In Administrative Year 2005¹, the total assessed income and the number of cases reached record highs. In fact, total assessed income and the number of cases were up 130.8% and 145.1%, respectively, from the previous year. In April 2007, the National Tax Agency ("NTA") announced that it has considered partially revising the "Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guideline)" and "Commissioner's Directive on the Operation of Transfer Pricing for Consolidated Corporations (Administrative Guideline)" (collectively referred to as "**Administrative Guidelines**"). Following this announcement, the NTA invited comments from the public², and received numerous responses from tax professionals and public accountants. Due to increased transfer pricing exposure in Japan, the Ministry of Economic, Trade and Industry established a transfer pricing study group ("**METI TP Study Group**")³, and also provided

comments to the NTA's announcement on its website⁴ on May 16, 2007.

This article provides some general background to the NTA's proposed revisions to the Administrative Guidelines, including an outline of the proposed amendments. A summary of the comments made by the METI TP Study Group is also introduced.

II. Background to Administrative Guidelines

The Japanese transfer pricing legislation consists of Special Taxation Measures Law ("**STML**") Article 66-4; related STML Enforcement Order Article 39-12; related Enforcement Regulation Article 22-10; Commissioner's Directives for Interpretation of STML Article 66-4; and Administrative Guidelines⁵.

According to the NTA, the Administrative Guidelines are currently under consideration for amendment. The Administrative Guidelines were introduced in June 2001 in order to improve transparency and unification of tax enforcement procedures, as well as to ensure predictability for taxpayers. The

¹ Administrative Year 2005 is the fiscal year ended June 30, 2006.

² The NTA announced that it has considered partially revising Administrative Guidelines on April 13 and collected comments from the public during the period from April 13 to May 12, 2007.

³ A study group was launched by the METI as a forum to discuss issues and countermeasures related to transfer pricing taxation, as a result of growing public concern over the increase in transfer pricing audit cases and related tax assessments. The purpose of the group is to ensure the prompt and clear enforcement of transfer pricing taxation in order to improve international economic development.

⁴ <http://www.meti.go.jp/>

⁵ In the same manner, there are also separate guidelines for consolidated corporations.

Administrative Guidelines are issued by the Commissioner of the NTA to the Regional Commissioners of the Regional Taxation Bureaus, including the Okinawa Regional Taxation Office. These guidelines are manuals intended for internal use within the taxation bureaus.

Regarding the Japanese transfer pricing regulations, several revisions have been made since June 2001, which are briefly summarized in the table below.

Time of Revision	Revised Points of Regulation and Commissioner's Directives, etc.	Purpose of Revision
June 2002	Treatment of Intra-group Services (Commissioner's Directive on the Operation of Transfer Pricing 2-10)	Guidance to ensure that foreign subsidiaries pay service fees to their Japanese parent company for management services provided on their behalf. Historically, few Japanese parent companies required foreign subsidiaries to pay for such services.
2003 tax revision	Revision to Schedule 17(3) "Detailed Statement Regarding Foreign Affiliated Companies" (formerly, Schedule 16(4))	Requires taxpayers to disclose details of intercompany transactions, including amounts and the methods used to derive arm's length prices.
2004 tax revision	Introduction of Transactional Net Margin Method (TNMM)	Reasonableness of transfer prices to be examined not only on the gross margin basis but also on the operating margin basis
2005 tax revision	Expansion of definition of a foreign related person	Clarification of the definition of a foreign related entity and transactions to be covered by the scope of an audit
March 2006	Commissioner's Directive on Intangible Assets and Cost Contribution Arrangements	Guidelines for expanding examination of transactions involving intangible assets
2006 tax revision	Prescription of the deferral of tax payments, and delinquent interest tax discharged	In order to reduce the financial burden of taxpayers exposed to double taxation

As shown in the table above, several amendments to the regulations have been made from time to time; however, actual enforcement and interpretation of these regulations are not always clearly defined, but are left to the discretion of the individual tax examiners to a large extent. As a result, companies are increasingly dissatisfied over the revisions that have occurred to date⁶. In fact, the number of cases in which companies voluntarily

disclose information about their tax assessments and file official complaints or lawsuits against the tax authorities has increased.

In response to such criticisms, the Japan Economic Federation ("JEF") submitted its proposals for the 2007 tax revision, and METI TP Study Group was launched to address the current transfer pricing environment in Japan. These measures taken by the JEF and METI reflect a demand from businesses for improvement in the Japanese transfer pricing taxation system. In addition, it is speculated that the NTA's announcement of proposed revision to the Administrative Guidelines may be a result of growing pressure for change.

III. Summary of Proposed Key Amendments

The primary revisions are mentioned below⁷.

1. Revisions with respect to definition of applicable standards
 - (1) Definition of applicable standards for transactions involving intangible assets
 - (2) Definition of applicable standards for provision of services
 - (3) Clarification of the Transfer Pricing Methodology ("TPM") to be applied
2. Revisions with Respect to Advance Pricing Arrangements ("APA")
 - (1) Policy of APA System
 - (2) Points to be noted when applying for an APA
 - (3) Cases where an APA should not be applied for
 - (4) Effects of APA
3. A separate volume composed of transfer pricing examples under the transfer pricing legislation (and a separate volume composed of transfer pricing examples under the transfer pricing legislation for Consolidated Corporations) will be issued by the NTA.

⁶ Regarding the proposed revisions, the NTA commented that the Commissioner's Directives for interpretation of relevant transfer pricing laws and the Administrative Guidelines have been maintained and revised in order to ensure predictability for the taxpayers. Applicable standards and policies have been defined through the announcement of these revisions. (1. Overview of the Issue)

⁷ <http://www.nta.go.jp/>

IV. MEIT TP Study Group's Comments

The METI TP Study Group submitted its comments on May 16, 2007 regarding the proposed revisions mentioned in section III above on its website⁸. These include (i) four comments with regard to the treatment of intangible asset transactions; (ii) four comments with regard to the selection of the TPM; (iii) ten comments with regard to other related TPM issues; and (iv) four comments with regard to APA. In addition, the METI TP Study Group submitted five other requests advocating increased transparency and efficiency related to transfer pricing enforcement, although these requests were not directly relevant to the proposed revision.

V. Conclusion

In the proposed revision, the key points to focus on

are the clarification of the TPM to be applied and APA issues. The NTA anticipates publishing an additional volume containing transfer pricing examples for reference. This publication is a significant step in an attempt to provide more transparent interpretation and practical guidelines for implementation of the transfer pricing regulations. However, there may be some cases which may not be applicable to the actual business environment. Also, there is a concern that these case studies may become predetermined standards used by the tax authorities during transfer pricing audits, without thorough examination of material facts, including the substance and specific nature of each transaction.

Despite these concerns, the NTA's proposed initiative is important in addressing the current state of the transfer pricing taxation system in Japan.

⁸ <http://www.meti.go.jp/>

Customs

Customs Issues for Tax and Accounting Executives Installment #5

AGREEMENT BETWEEN THE KINGDOM OF THAILAND AND JAPAN FOR AN ECONOMIC PARTNERSHIP

I. Introduction

The Agreement between the Kingdom of Thailand and Japan for an Economic Partnership (JTEPA) was finally signed on April 3, 2007 by Prime Minister of the Kingdom of Thailand, Surayud Chulanont, and Prime Minister of Japan, Shinzo Abe, after three years of discussions between both countries, and some additional delays due to political unrest in Thailand.

As the chart 1 shown in the following page, Japan has signed EPAs with Philippines, Malaysia, Chile

and Thailand, since the EPA with Mexico went into force on April 1, 2005. Of the four EPAs signed by Japan, above, EPA with Malaysia had already gone into force as of the date of this publication. Also, quite notably, Japan is currently in EPA negotiations with a number of countries, including Indonesia, Switzerland and Australia.

Given the anticipated expansion of EPA networks to which Japan is a party, how to realize potential benefits from these networks of EPAs is anticipated to become increasingly important for many Japan-based MNCs operating on a global basis.

In light of the Japan's apparent appetite for additional trade agreements, in the fifth installment of "Customs Issues for Tax and Accounting Executives", we would like to revisit EPAs (please see Gets Vol. 28, June 2005 for discussions on Japan Mexico EPA), and introduce the basics of such bilateral trade agreements which tax and accounting executive should know, using JTEAP as examples.

II. Difference between Free Trade Agreement (FTA) and Economic Partnership Agreement (EPA)

No clear definition of FTA and EPA exists. However, each type of trade agreement is understood to have the following characteristics.

1) FTA (Free Trade Agreement)

FTA is a trade agreement between or among countries which seeks to liberalize trade of goods mainly through the elimination of, or reduction to, tariff.

2) EPA (Economic Partnership Agreement)

EPA is also a trade agreement between or among countries which seeks to liberalize trade, but is generally broader than EPA, encompassing such areas as trade of services, investment, environmental, public health/safety, technological cooperation, etc.

III. TARIFF ELIMINATION OR REDUCTION UNDER JTEPA

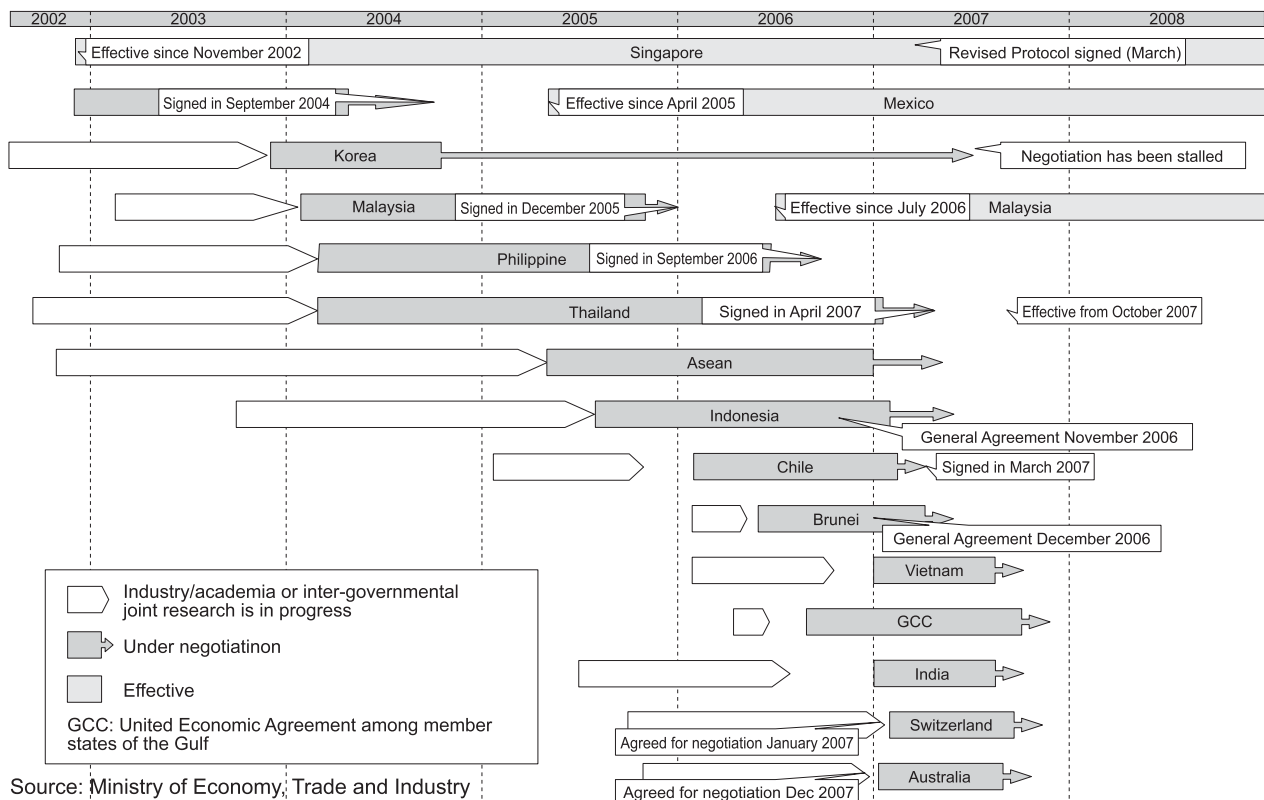
1) General

Once JTEPA takes effect, approximately 97 per cent of Japanese exports to Thailand, and 92 per cent of Thai exports to Japan will be tariff-free within 10 years.

2) Examples

Under bilateral trade agreements, tariff elimination or reduction schedule is agreed to between the parties on a commodity-by-commodity basis. JTEPA is no exception, and the following illustrates such

Chart 1 "Japan's Trade Agreement Negotiations"



Source: Ministry of Economy, Trade and Industry

commodity-by-commodity agreements reached by Japan and Thailand.

●Automotive

Thailand has agreed to reduce tariffs on automobiles with engines of 3,000cc or larger from the current 80% to 60% by the fourth year of the JTEPA's entry into force. Also, Thailand has agreed to meet with Japan to discuss potential tariff reductions and other market access measures for other vehicles during the sixth year of the JTEPA's entry into force.

As to auto parts, Thailand has agreed to reduce duty on OEM parts that have import duty of more than 20% to 20% immediately upon the JTEPA's entry into force; and will eliminate tariffs on them by the sixth year (eighth year for certain sensitive items) of the JTEPA's coming into effect.

●Automobile

*Passenger vehicles (over 3,000cc): Tariffs will be reduced from the current 80% to 60% over 4

years after the JTEPA's takes effect

*Passenger vehicles (3,000cc or less): Renegotiation in the sixth year of the JTEPA's entry into force

●Auto Parts (OEM)

*OEM parts with tariffs of over 20%: Tariffs will be reduced to 20% immediately, and will be eliminated within six years

*OEM parts with tariffs of 20% or less: Tariffs will be eliminated within six years

*Engines and other sensitive items: Tariff will be eliminated within eight years

●Tariff Elimination or Reduction Schedule for Top Ten Exports from Japan

The chart 2 shown as below, is a summary of tariff elimination or reduction schedule for top ten exports from Japan to Thailand (based on 2006 Export Statistics). For example, HS Code 870899900 (Automotive parts and accessories (other)) is included in "Auto parts with tariffs of over 20%", above, and accordingly, the first year duty rate is set at 20%, and the duty is eliminated in the sixth year,

Chart 2 "Top Ten Exports to Thailand"

Rank	HS Codes	Description	Export amount (k yen)	%against total Export amount	Tariff Schedule of Thailand							
					1st years	2nd years	3rd years	4th years	5th years	6th years	7th years	8th years
1	870899900	Parts and accessories of the motor vehicles (Other)	70,723,684	2.65%	20%	20%	20%	20%	20%	0%	0%	0%
2	870840000	Parts and accessories of the motor vehicles (Gear boxes)	56,854,761	2.13%	20%	20%	20%	20%	20%	0%	0%	0%
3	847989900	Presses for the manufacture of particle board or etc.(Other)	48,549,780	1.82%	0%	0%	0%	0%	0%	0%	0%	0%
4	854221190	Monolithic integrated circuits (MOS technology, uncased, other)	44,097,034	1.65%	0%	0%	0%	0%	0%	0%	0%	0%
5	840991100	Parts suitable for spark-ignition internal combustion piston engines	42,185,212	1.58%	15%	15%	15%	15%	15%	15%	15%	0%
6	847330000	Parts and accessories of auto data processing machines (Other)	39,388,124	1.48%	0%	0%	0%	0%	0%	0%	0%	0%
7	840734900	Spark-ignition internal combustion piston engines (of cylinder capacity exceeding 1,000cc)	38,535,186	1.45%	15%	15%	15%	15%	15%	15%	15%	0%
8	854229100	Monolithic integrated circuits (uncased, other)	38,297,454	1.44%	0%	0%	0%	0%	0%	0%	0%	0%
9	854140990	Photosensitive semiconductor devices and light emitting diodes.	35,612,668	1.31%	0%	0%	0%	0%	0%	0%	0%	0%
10	852990900	Parts and accessories of the transmission apparatus (Other)	33,307,295	1.25%	0%	0%	0%	0%	0%	0%	0%	0%

Trade Statistics of Japan

provided that these are OEM parts.

IV. Analyzing the Benefits of Duty Cost Reduction

1) Customs Classification Code

As can be seen in the above example, the tariff elimination/reduction schedule is agreed to by a commodity-by-commodity basis based on Customs classification code. Therefore, in analyzing potential benefits of any EPA, including JTEPA, it is very important to begin your analysis with the accurate classification of the goods in question. However, because it is not likely that tax or accounting departments have such data readily available, it may be necessary for tax or accounting departments to have closer communications, for example, with logistics or other departments responsible for the maintenance of the classification code (please see Gets Vol. 31, December 2007 for more discussions on the HS code and classification).

2) Margin of Preference

A potential reduction in duty cost under EPA or FTA is a function of a margin of preference, or a difference between the applicable duty rate without the application of EPA or FTA, and the applicable preferential rate under EPA or FTA. The applicable duty rates without the application of EPA or FTA are so-called Most Favored Nation (MFN) rates in many instances, and determining the margin of preference is a fairly simple task in these cases. However, for countries like Thailand where various local preferential programs exist, finding out the rates actually applied to a specific item may become a bit more involved. Also, a closer examination of these preferential programs or preferential rates is necessary because such preferential rates may be given to importers for a specific period, or the programs themselves may be terminated in the future. Accordingly, it is important for tax and accounting departments to maintain closer communications with people on the ground in this regard as well.

3) Mid to Long-Term Impact

Under JTEPA, many commodities are subject to a gradual reduction of tariffs over many years. Therefore, understanding the duty reduction schedule is critical in assessing the mid- to long-term impact of JTEPA. At the same time, future development of various preferential programs (e.g., BIS 19, preferential rates for certain OEM auto parts, etc.), as well as potential reductions to MFN rates, should be considering in assessing the JTEPA's benefits. It should be noted that, MFN rates can become lower than the JTEPA rates with respect to certain items due MFN rates of such items being reduced more rapidly than JTEPA calls for.

4) Other Considerations

In order to assess the overall benefits of JTEPA, factors other than the margin of preference should also be examined. For example, there will be additional costs associated with obtaining necessary data in determining the Country of Origin, applying for and obtaining Certificates of Origin, etc. Also, the fact that businesses sometimes face some difficulty in obtaining the needed data from their suppliers should be taken into account. It should also be noted that these additional processes tend to lead to an associated increase in compliance burden.

Finally, if you have manufacturing operations in Thailand and have the ability to source the same raw materials, components, etc. from suppliers located in different countries, it may be worthwhile to consider preferential trade agreements to which Thailand is a party. For instance, if the same raw materials may be procured from Japan and one of the Asean countries, AFTA rates and JTEPA rates, in addition to unit price, transportation and other costs, may be considered in comparing the total procurement costs of such raw materials. The following is a list of selected preferential trade agreements to which Japan or Thailand is a party (the following list includes those signed, but not yet entered into force):

<u>Japan</u>	<u>Thailand</u>
Singapore	ASEAN
Mexico	China (as part of ASEAN-China)
Malaysia	Australia
Philippines	New Zealand
Chile	India

V. Rules of Origin

Preferential duty rates, discussed thus far, are offered to products only if such products satisfy "rules of origin" (please see a flowchart "Applying EPA Preferential Rates" Page54), and applicable Certificates of Origin are obtained (please see a flowchart "Certificate of Origin" Page54).

Under JTEPA, the following four rules of origin are employed in determining the country of origin:

1) Wholly Obtained or Produced

This rule is applied to commodities, such as live animals, agricultural products, minerals, etc. Under this rule, goods which are wholly obtained or produced in the territory of Japan and Thailand are considered to be originating in Japan and Thailand, respectively.

2) "Tariff Shift" Rule

Under "Tariff Shift" Rule, goods produced in Japan or Thailand is considered to be originating in Japan or Thailand, respectively, if all of the non-originating materials in the subject goods have undergone the applicable "tariff shift" - i.e., a change from one classification code to another specific classification code. This rule is applied to certain processed agricultural products as well as to certain industrial products. For example, if surgical glove (HS4015.11) is manufactured in Thailand, from imported synthetic rubber (HS 4002.11), then the surgical glove is considered be originating in Thailand.

3) Qualifying Value Content

Under this rule, when Qualifying Value Content (QVC) of a product equals or exceeds a certain percentage of the total value of goods, such product is considered to be originating in Japan or Thailand.

QVC can be expressed by the following formula:

$$QVC = (FOB - VNM) / FOB \times 100$$

Where:

- 1)QVC = a ratio of QVC to total value (FOB), expressed in percentage
- 2)FOB = FOB price of the subject goods
- 3)VNM (Value of Non-originating Materials) = value of non-originating materials used in the production of the subject goods
- 4)Processing Requirements

Under processing requirements, goods processed in Thailand or Japan is considered to be originating in the country in which certain enumerated processes are performed. This rule may be applied, for example, to certain chemical products, textiles, etc.

VI. Closing

Japan-based MNCs, who export finished goods from Japan to Thailand, or who have a manufacturing base in Thailand and import raw materials and components from Japan into Thailand, may be able to gain a competitive advantage over U.S or European rivals when JTEPA comes into effect. However, Japan MNCs are considered to be lagging behind its counterparts in US or Europe in terms of planning and know-how in fully recognizing benefits afforded by bilateral or regional trade agreements. Also, because most of Japan's EPAs are fairly new, de facto standard with respect to application and issuance processes for Certificate of Origin, document retention requirements, and compliance issues, are still being developed, making it more difficult for businesses to realize the full potential of such EPAs in an efficient manner.

It is hoped that the Japanese Government and Japanese businesses will continue to work together to establish more efficient systems into the future.

Finally, Japan MNCs operating in Thailand should be reminded of Customs exposure which may exist with respect to its operations in Thailand. Post-entry audit conducted by Thai Customs has caused

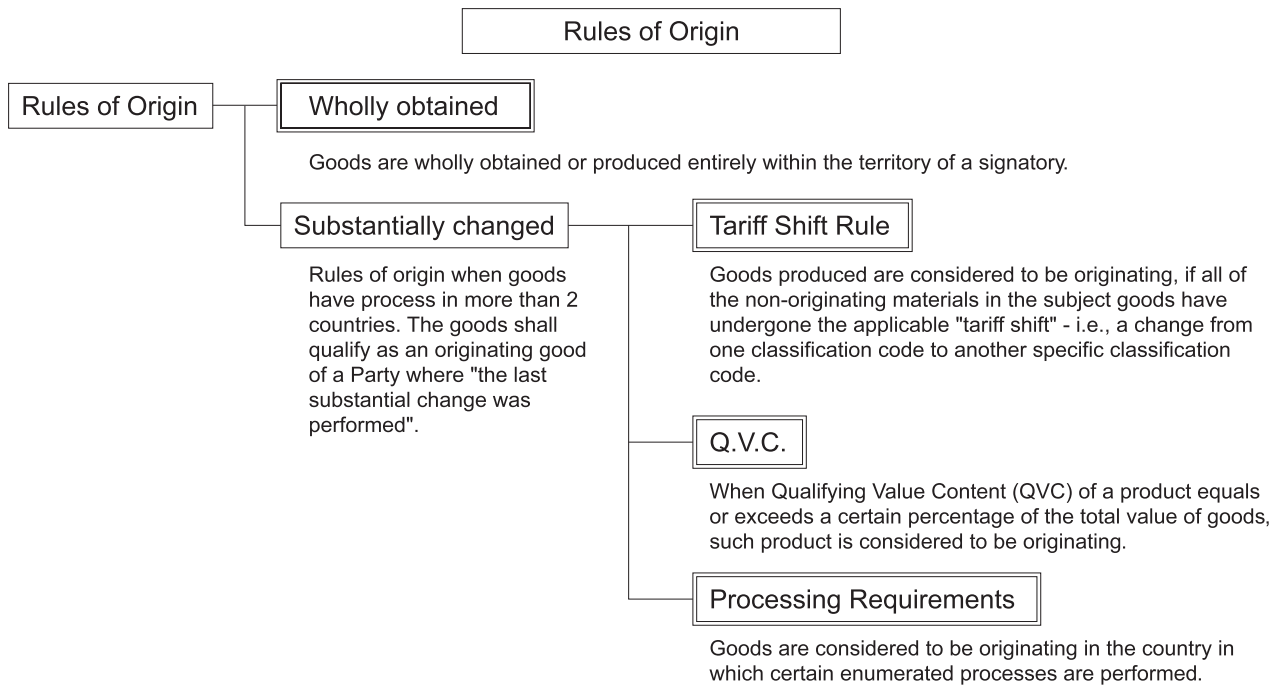
problems for many Japanese businesses, and such exposures should be managed through properly planned internal control procedures, regardless of the use of JTEPA.

「Japan Thailand Economic Partnership」 (Ministry of Foreign Affairs)

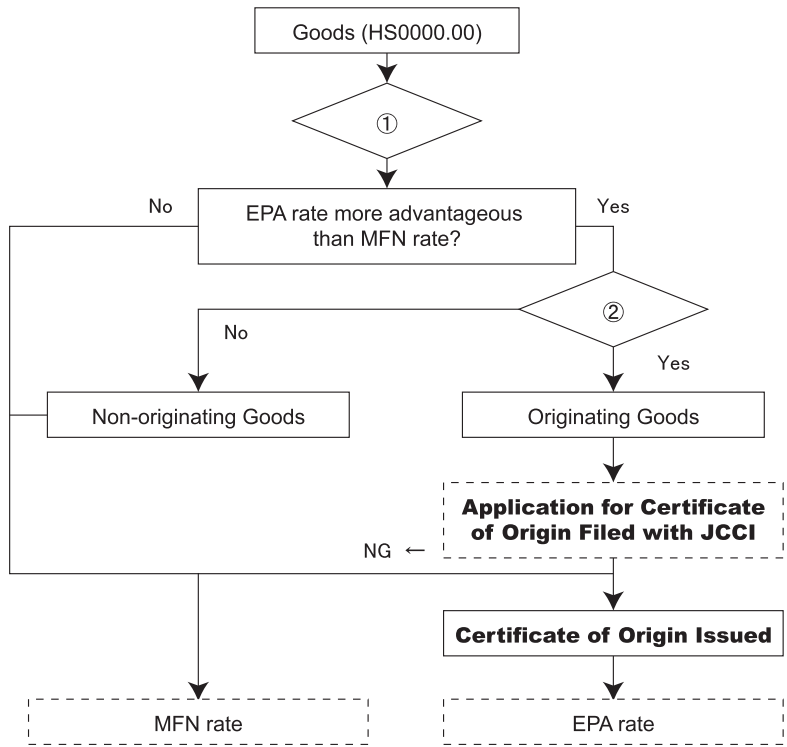
「JETRO Tax, Legal Seminar」 12/1/2006 (PwC)

「EPA Manual」 1/31/2007 (JETRO)

Chart 3 "Rules of Origin"



Applying EPA Preferential Rates

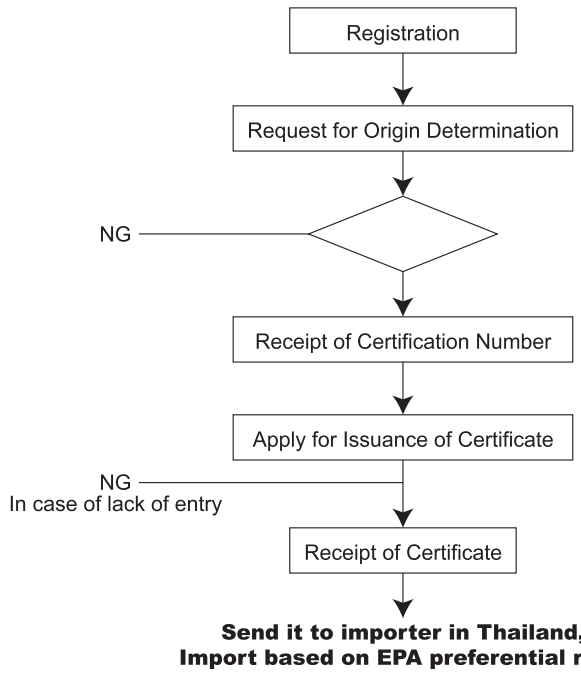


① Compare MFN rates against EPA rates

② Determine the applicable rules of origin and country of origin.

Application filed with JCCI (Japan Chamber of Commerce and Industry)

Certificate of Origin



Register as an exporter or a producer with JCCI Visit website below.
<http://www.jcci.or.jp/gensanchi/index.htm>

Certification Number will be effective for one year, if there is no change in contents of application.

Exporter needs one certificate for each shipment. For shipments of a product for which a certification number has been obtained, Exporter can request Certificate of Origin without making a request for Origin Determination again.

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The comments included in this brochure are not intended to be a complete definitive analysis of the law. Further information on any of the matters discussed herein may be obtained from PricewaterhouseCoopers, Japan.

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