



Financial Services Tax Group

News Letter

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Size-based taxation (“Gaikei Hyojun Kazei”) on corporation enterprise tax

The 2003 Japanese Tax Reform introduced a size-based taxation system on corporation enterprise tax. Under the Local Tax Law (“LTL”), this system is applied to certain corporations for fiscal years commencing on or after April 1, 2004. In this News Letter, we summarize the applicability and outline of size-based taxation system on corporation enterprise tax.

Corporation enterprise tax before adoption of size-based taxation

Before the application of the 2003 Japanese Tax Reform, corporation enterprise tax was levied on ordinary income or liquidation income only, as attributed to the corporation’s business activity (with exceptions for certain businesses such as electric power supply and insurance companies). Therefore, the enterprise tax was not imposed on corporations that had no taxable income for corporation tax purposes (“taxable income”) and liquidation income.

Applicability and outline of size-based taxation on corporation enterprise tax

Applicable entity

Size-based taxation is introduced in order to ensure the fairness of taxation in accordance with corporation’s business scale and to maintain the stability of local governments’ tax revenues.

Size-based taxation is applied to corporations whose capital is above JPY 100 million at the end of the fiscal year (at the end of first 6 months of the fiscal year, in case of interim tax returns) commencing on or after April 1, 2004. However, regardless of the amount of the capital, size-based taxation is not applied to certain corporations, such as Investment Corporation and Special Purpose Companies.

Whether a Japan branch of a foreign corporation is subject to the size-based taxation or not is determined by the amount of capital of the head office of such corporation.

Taxable base and tax rate

In the size-based taxation system, corporation enterprise tax is calculated as a total of “added value basis”, “capital basis” and “income basis” amount. The taxable base and applicable tax rate for each basis are discussed below:

Added value basis

The taxable base for added value basis is calculated as the total of profit distributed and annual profit. Profit distributed is the aggregate amount of salary, net interest payment and a net rent payment. Annual profit means profit for tax purposes (before deduction of carried over loss). Further details are set out in the LTL. The standard rate for added value basis is 0.48% (0.504% for Tokyo).

Capital basis

The taxable base for capital basis is the capital amount. In case of the Japanese corporation, the capital amount means the total of paid-in capital and capital reserve at the end of the fiscal year. In case of the Japan branch of foreign corporation, the capital amount is calculated as follows:

$$(\text{Paid-in capital} + \text{capital reserve}) \times \frac{\text{The number of employees at Japan branch}}{\text{Total number of employees of the foreign corporation}}$$

The taxable base for capital basis means the total of paid-in capital and capital reserve. Contrast this to whether the size-based taxation is applied or not is determined by the

amount of paid-in capital only. The Japan branch of a foreign corporation's taxable base for capital basis is not the total amount of paid-in capital and capital reserve on a world-wide basis, rather, the total amount of paid-in capital and capital reserve appropriated to Japan branch as computed using the above formula. The standard rate for capital basis is 0.2% (0.21% for Tokyo).

Income basis

Taxable base for income basis is taxable income or liquidation income.

The applicable tax rate is:

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|--|---------------------------------------|
| JPY 4 million or less | Standard rate 3.8% (3.99% for Tokyo) |
| Over JPY 4 million and JPY8 million or less | Standard rate 5.5% (5.775% for Tokyo) |
| Over JPY 8 million | Standard rate 7.2% (7.56% for Tokyo) |

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