

Japan Tax Update

Monthly tax update

June 2006, Issue 20

PricewaterhouseCoopers Tax (Zeirishi-Hojin Pricewaterhouse Coopers) is the largest professional tax corporation in Japan with more than 350 staff.

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The intention of this Japan Tax Update is to provide an outline of the Japanese tax reforms for 2006.

Diet approval of the reforms was received on March 27, 2006 and Cabinet Orders and Enforcement Orders enacting the changes were issued on March 31, 2006.

We recommend that you consult with PricewaterhouseCoopers for specific advice and do not take any action based solely on the contents of this newsletter.

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Outline of 2006 Tax Reform

On March 31, 2006, the Tax Reform Act was promulgated and subsequently enacted on April 1, 2006. This issue provides an outline of the tax reform.

1. Corporate taxation

- R&D tax credit
- Introduction of a special tax credit for investment in information security facilities
- Incentives for IT investment
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- Elimination of top taxpayer listing
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- Expansion of reasons for filing amended corporate tax returns
- Amendment to penalty rate for late filing of corporate income tax returns
- Amendment to penalty rate for late payment of National withholding tax
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1. Corporate taxation

R&D tax credit

Old law

Previously, a taxpayer could claim an R&D credit equal to 15% of the excess of current R&D expense over the “comparative R&D expense” provided that the current R&D expense exceeded both the “comparative R&D expense” and “standard R&D expense”¹. However, the maximum amount of credit was limited to 12% of the corporate tax for the year.

Alternatively, a taxpayer could claim a credit equal to the current R&D expense multiplied by a certain percentage. The applicable percentage was based on the corporation’s “R&D ratio”. The “R&D ratio” was calculated as the current R&D expense divided by average sales for the last 4 years (up to and including the current year). The corresponding tax credit rates were as follows:

R&D ratio 10% or more:	10%
R&D ratio less than 10%:	8% ²

In the case of small and medium-sized corporations (defined as corporations with capital of JPY 100 million or less, the applicable tax credit rates were 15% (for beginning between April 1, 2003 and March 31, 2006) or 12% (for years beginning before March 31, 2003).

Under the alternative method, the tax credit could not exceed 20% of the corporate tax for the year, with any excess tax credit being eligible for one year carryforward, subject to certain conditions being satisfied.

New law

For tax years beginning on or after April 1, 2006, the R&D tax credit for large corporations (defined as corporations with capital in excess of JPY 100 million) is equal to the sum of a) and b) of the following provided that the current R&D expense is more than the “comparative R&D expense” and the “standard R&D expense”:

- a) Total R&D expenses up to the “comparative R&D expense”^{*} × a percentage between 8% and 10% (amount depends upon the R&D ratio); and
- b) Total R&D expenses over the “comparative R&D expense” × (the tax credit ratio expressed as a percentage + 5%) (i.e. range is between 13% to 15%)

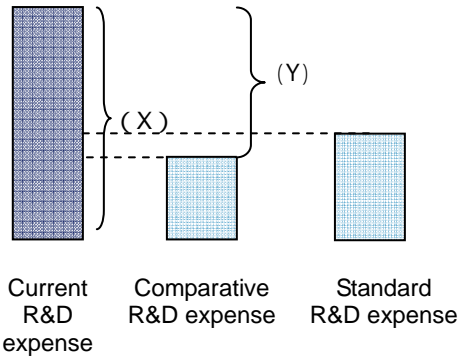
* The “comparative R&D expense” is defined as the average amount of R&D expense for the three years prior to the current year.

¹ “Comparative R&D expense” was defined as the average R&D expense for the top 3 fiscal years out of the previous 5 fiscal years. “Standard R&D expense” was defined as either the R&D expense for the immediately preceding fiscal year or the fiscal year 2 years before the current fiscal year, whichever is the greater.

² For tax years beginning during the period January 1, 2003 to March 31, 2006, an additional 2% was added to these percentages so that the tax credit rates for these tax years were 12% and 10% respectively.

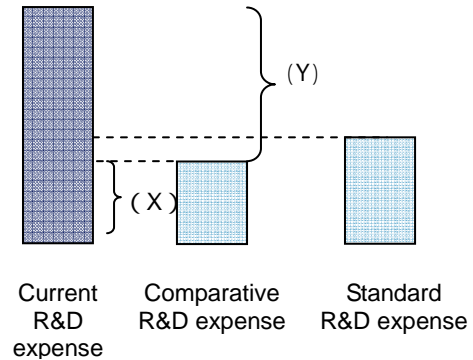
Previous credit system

The taxpayer is able to elect a credit of either (10% to 12% of (X)) or (15% of (Y)) (is applicable provided that the current R&D expense is over both the “comparative R&D expense” and the “standard R&D expense”)



New credit system

The taxpayer is able to credit of (8% to 10% of (X)) or sum of and (13% to 15% of (Y)) provided that the current R&D expense is over both the “comparative R&D expense” and the “standard R&D expense”

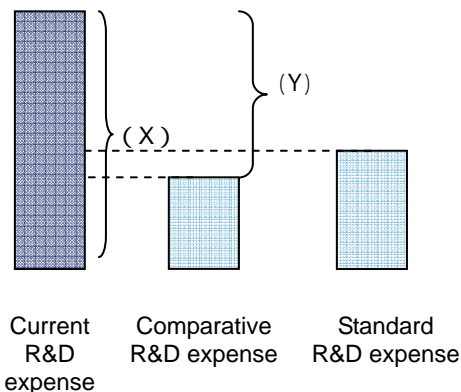


In the case of small and medium sized corporations whose capital is JPY100,000,000 or less, the R&D tax credit will be equal to a) or the sum of a) and b) of the following provided that the current R&D expense is over both the “comparative R&D expense” and the “standard R&D expense”:

- a) Total R&D expenses up to the “comparative R&D expense” x 12%
- b) Total R&D expenses in excess of the “comparative R&D expense” x 17%

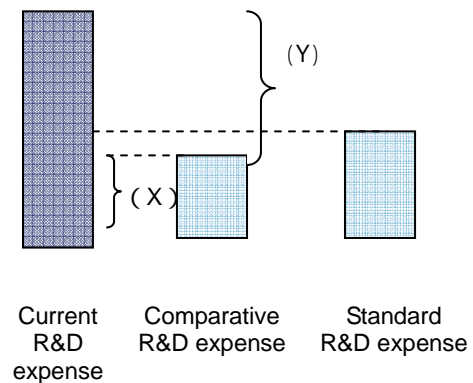
Previous credit system

The taxpayer is able to elect a credit of either (12% or 15% (*3) of (X)) or (15% of (Y)) (is applicable provided that the current R&D expense is over both the “comparative R&D expense” and the “standard R&D expense”)



New credit system

The taxpayer is able to credit of (12% of (X)) or sum of and (17% of (Y)) provided that the current R&D expense is over both the “comparative R&D expense” and the “standard R&D expense”



(*3) For years beginning before March 31, 2003, the applicable percentage is 12% and for years beginning between April 1, 2003 and March 31, 2006, the applicable percentage is 15%.

In addition, in the case of small and medium sized corporations whose capital is JPY 100,000,000 or less, the credits will also be deducted from the corporate tax liability which is the taxable basis for local inhabitants tax purposes (local inhabitants tax is essentially a percentage, with adjustments, of the national tax).

The maximum amount of the tax credit, regardless of the size of corporations, will be limited to 20% of the taxpayer's corporation tax liability, with certain excess tax credit being eligible for a one year carryforward, subject to certain conditions.

This new system is applicable for fiscal years beginning from April 1, 2006 to March 31, 2008.

Introduction of special tax credit for investment in information security facilities

In the case of a corporation filing a blue form tax return that acquires information security facilities during the period from April 1, 2006 to March 31, 2008 and uses them for its business in Japan, the corporation will be able to elect either to take a tax credit equal to 10% of the base acquisition cost (equal to 70% of acquisition cost) of the facilities or a special allowance for accelerated depreciation equal to 50% of the base acquisition cost of the facilities.

Information security facilities are the following facilities that are certificated by ISO15408:

- a) OS, including the associated server
- b) Database control software, including the associated application software and
- c) Firewall systems (described as the system that prevents invasion from the outside to the company's computer network).

To be eligible for the above incentives for facilities, the total acquisition cost of the facilities in an accounting year must be at least 100 million yen (at least 3 million yen for corporations with capital of 100 million yen or less and at least 30 million yen for corporations with capital of over 100 million yen and 1,000 million yen or less).

Where a small- and medium-sized corporation whose capital is ¥100,000,000 or less leases information security related facilities where the amount of the total lease fees is ¥4,200,000 or more, the payment of the lease fees will also be eligible for the tax credit which is calculated as follows:

$$\diamond \text{ Total lease fees} \times 42\% \times 10\%$$

The maximum amount of the special tax credit will be limited to 20% of the taxpayer's corporation tax liability, with any excess tax credit being eligible for a one year carryforward, subject to certain conditions.

Incentives for IT investment

Under the 2003 Tax Reform, corporations were permitted to take a tax credit equal to 10% of the acquisition cost of "qualified IT related investment". Alternatively, the corporation could elect to take an increased special allowance for accelerated depreciation equal to 50% of the cost of "qualified IT related investment".

This incentive was abolished for assets that are acquired or placed into business use after March 31, 2006 under the 2006 Tax Reform.

Accelerated depreciation for acquisition of R&D facilities

Under the 2003 Tax Reform, corporations were permitted to take a special allowance for accelerated depreciation equal to 50% of the acquisition cost of the R&D facilities.

This special allowance for accelerated depreciation was abolished for R&D facilities that are acquired or placed into business use after March 31, 2006 under the 2006 Tax Reform.

Tax deductible remuneration paid to directors

As a part of the 2006 corporate tax reform, the deductibility of remuneration paid to company directors has been expanded. Under the previous law, remuneration paid to directors on an irregular basis (i.e. in a manner other than equal monthly installments) or remuneration that was determined in proportion to the company's earnings was treated as a non-deductible directors' bonus for corporate tax purposes.

Effective from fiscal years commencing on or after April 1, 2006, the following payments to directors are deductible:

- (1) fixed monthly payments;
- (2) fixed payments in accordance with an advance notice to the tax office; and
- (3) certain performance bonuses paid by public companies in Japan in proportion to the company's earnings to directors who engage in the operation of the company's business.

Fixed monthly payments

This type of payment is deductible without any advance notice to the tax office or disclosure provided the relevant legal procedures have been followed (i.e. approval at the shareholders meeting or within the maximum amount specified in the company's by-laws). However, it should be noted that if the monthly amount is increased or decreased by way of a resolution at a shareholders meeting or compensation committee, such revision should be made within 3 months from the beginning of the fiscal year. If a revision is made after 3 months from the beginning of the fiscal year, in principle, a deduction will be limited.

A company can make a downward revision at any time during the fiscal year due to its financial results being worse than expected without any impact on deductibility.

Fixed payments in accordance with advance notice to tax office

A pre-determined bonus is deductible provided the company has filed an advance notice with the tax office by the earlier of (i) 3 months from the beginning of the accounting fiscal year, or (ii) the day immediately before the relevant director commences the provision of his/her services. The notice must be filed annually for each director in respect of which a fixed bonus is expected to be paid. If the actual payment is different from the amount specified in the advance notice, the company cannot claim a deduction for any of the payment.

Performance bonuses

A deduction for this type of payment can only be claimed by a company which is subject to an external audit pursuant to the Japanese Securities Exchange Act (essentially companies listed in the Japanese capital markets). A bonus that is determined in proportion to the company's earnings is deductible provided the following conditions are satisfied:

1. The remuneration is paid to directors who engage in the operation of the company's business (excluding family companies or group subsidiary companies).
2. The remuneration formula is decided at a shareholders' meeting or by a compensation committee, audit committee or any similar organization within 3 months from the beginning of the fiscal year.

3. The remuneration formula and the definition of profit to which the formula is applied (by class of directors) is disclosed in the Japanese 10-K (a report similar to that filed by listed companies in other countries disclosing information relating to financial position and corporate activities).
4. The remuneration to be paid to each operating director (with prescribed ceiling) is calculated using the same formula.
5. The remuneration is paid or expected to be paid within 1 month after the profit of the company is approved at the shareholders' meeting.
6. The amount of the remuneration is recognized as an expense in the company's income statement.

Deduction for stock options expenses

New accounting guidelines on stock options apply to issuing companies for stock options that will be granted under the New Corporation Law. According to the accounting guidelines, the fair value of the stock option on the date of grant is amortized on a straight-line basis over the period from the grant date to the vesting date. Under the 2006 Tax Reform, the issuing company is able to deduct such accounting expenses for tax purposes in the year the option is exercised if the compensation income that is realized upon exercise is subject to individual income tax (i.e., the stock option income is not part of a tax qualified stock option plan) as either salary income, retirement income, business income or miscellaneous income. As long as it is included within the individual's income, the corporate tax deduction will be equal to the accounting expense even though this will likely be a different amount than recognized as income by the individual. No deduction is allowed for tax qualified stock options.

Restriction on use of tax losses of certain companies

The 2006 Tax Reform contains provisions to limit the use of net operating losses ("NOLs") and built-in losses when there is an ownership change followed by a change in the business within a 5 year period.

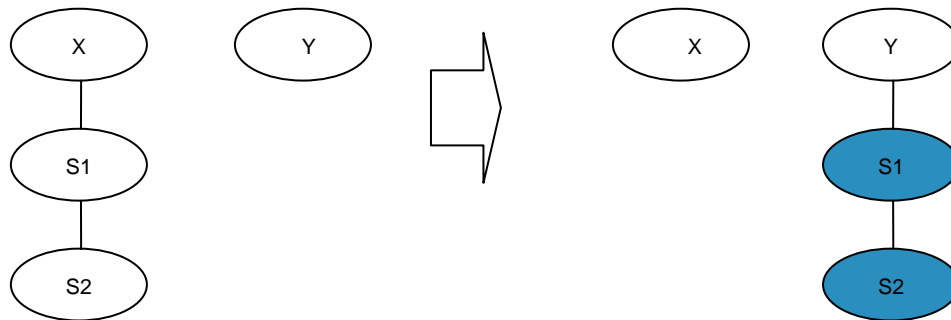
After the 2006 tax reform, a loss company (the "Company") is not be able to use its accumulated NOL carryforwards if (1) the Company becomes under the "special control" of another person/entity and (2) specific events provided under the tax law occur within a maximum of 5 years from the date on which the special control is created. The period can be shortened if "special control" no longer applies, a specified amount of debt of the Company is forgiven, or designated rehabilitation process of the Company occurs.

(1) Special control

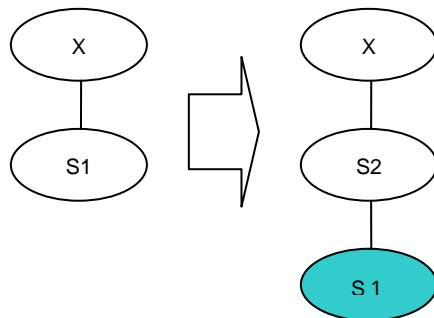
"Special control" applies when another person/entity owns, directly or indirectly, more than 50% of the shares outstanding of the Company. A relation is excluded where the Company becomes owned by the same person/entity as before, i.e., the "special control" is created within the existing group companies.

For example, in Case 1 below, the rule is applicable to S1 and S2 by change of shareholder from X to Y. In Cases 2 and 3, the rule is not applicable to S1 by change of shareholder from X to S2 due to the above exception.

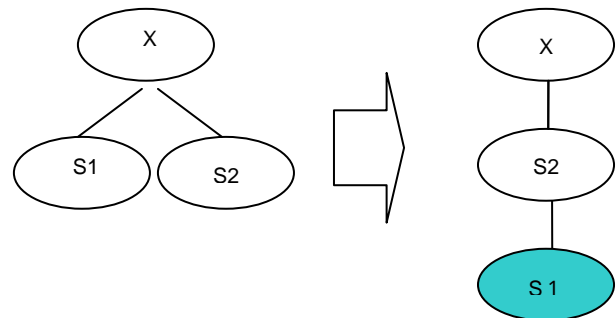
(Case 1)



(Case 2)



(Case 3)



Note that this rule is not applicable to the creation of special control as a result of (1) a tax qualified corporate reorganization (merger, spin-off, split-out, contribution in kind, share for share swap and share transfer) or (2) the issue or transfer of shares of the Company in accordance with the Corporate Rehabilitation Law.

(2) Events that take place within 5 years from the Acquired Date that will trigger the application of the rule

- i) The Company, which is dormant prior to the Acquired Date, starts new business.
- ii) The Company, which discontinues or is expected to discontinue all the business carried out prior to the Acquired Date, increases its cash or assets (via loan, capital increase, merger or corporate spin-off) to more than 5 times of the business size before the Acquired Date.
- iii) The Company has a new loan that is more than 5 times the business size before the Acquired Date where the person/entity having the special control over the Company or its related person/entity has acquired debt of the Company from a third party (excluding debt that is expected to be forgiven).
- iv) The Company carries out a qualified merger or a qualified spin-off where the Company is merged into another company or the transferor company of assets in a reorganization while the Company falls in any one of i, ii, or iii above.
- v) After the Acquired Date, all the directors of the Company resign, approximately 20% or more of the employees engaged in the business of the Company prior to the Acquired Date are no longer employed by the Company, and the size of the business (which is operated by the new employees hired after the Acquired Date) expands to more than 5 times of the business size prior to the Acquired Date.

(3) *The tax loss which will not be deductible from the taxable income of the Company consists of:*

- i) NOL carryovers from years prior to the Acquisition Year (i.e., the fiscal year prior to the year during when the event as provided (2) takes place.
- ii) The built-in losses of assets owned by the Company as at the Acquired Date (i.e., the date on which the Company became under the special control of another person/entity). The assets subject to this rule are similar to those subject to the limitation of the loss deduction as a result of a tax free corporate reorganization. Any capital loss that is realized upon disposition of these assets within the earlier of (i) three years from the date when the events triggering the application of the rules occurs or (ii) five years from the Acquired Date, will not be deductible for corporate tax purposes.

(4) *Interaction with the other reorganization rule*

The above rule will override the provision which allows carrying over NOLs of the merged company and the surviving company as a result of the qualified merger that is carried over after the event as provided in (2) takes place.

(5) *The application of the above rule*

The above rule is applicable to the loss carrying company that is majority owned by certain shareholder(s) on or after April 1, 2006.

2. Measures relating to small and medium-sized corporations and Venture Capital corporations

Surtax for undistributed profits of a family corporation

A "family corporation" was defined as a corporation that is directly or indirectly more than 50% owned by three or fewer shareholders (including related individuals and corporations). Under the 2006 Tax Reform, the definition of a family corporation was changed to a corporation that is more than 50% owned, directly or indirectly, by one shareholder (including related individuals and corporations).

An additional tax is imposed on the family corporation's current undistributed earnings less the undistributed earnings allowance. The undistributed earnings allowance is the greater of the following bases:

- ◇ Income base: Taxable income for the year × 35%

Under the 2006 Tax Reform, the percentage rate was generally be increased from 35% to 40%. It will be increased to 50% in the case of a corporation whose capital is ¥100,000,000 or less.

- ◇ Fixed amount base: ¥15,000,000

Under the 2006 Tax Reform, this fixed amount was increased to ¥20,000,000.

- ◇ Accumulated retained earnings base: 25% of the capital of the family corporation at the end of the fiscal year less the accumulated retained earnings at the end of the fiscal year

- ◇ Under the 2006 Tax Reform, a fourth base (i.e. equity capital ratio base) can be considered in the case of small- and medium-sized corporations whose capital is

¥100,000,000 or less. This equity capital ratio base is the following: 30% of the total assets of the family corporation less the sum of the equity capital (includes capital, additional paid-in capital, and retained earnings) plus debt from the shareholders to the family corporation.

The above reform applies to fiscal years beginning on or after April 1, 2006.

The distribution of earnings surplus resolved at a shareholders meeting prior to the settlement of the accounts will be treated as the distribution in the fiscal year which its payment base date belongs. This revision applies to the distribution of earnings surplus whose payment base date belongs to fiscal years ending on or after the effective date of the new corporation law (i.e. May 1, 2006).

In the case of a small and medium sized corporation which has obtained approval to implement a "management innovation plan" as stipulated in the "Law to Facilitate the Creation of New Business" and carries out such business in accordance with the plan, the surtax that is imposed on the undistributed profits under the family corporation rules is not be imposed. This revision is applicable for fiscal years beginning during the period from April 1, 2006 to March 31, 2008.

The suspension of the surtax for undistributed profits for small- and medium-sized corporations for the first 10 years from the date of the establishment of the company, as stipulated in the "Law to Facilitate the Creation of New Business", which was introduced under the 2000 Tax Reform, was abolished for fiscal years beginning on or after April 1, 2006.

The suspension of the surtax for undistributed profits for small- and medium-sized corporations whose capital is ¥100,000,000 or less and whose equity capital ratio is 50% or less, which was introduced under 2003 Tax Reform, was abolished for fiscal years beginning on or after April 1, 2006.

Non-deductible entertainment expenses

Currently, a corporation whose capital is ¥100,000,000 or less can deduct 90% of the first ¥4,000,000 of entertainment expenses. Entertainment expenses in excess of ¥4,000,000 are disallowed as deductions for corporate tax purposes. This measure was introduced under the 2003 Tax Reform and is applicable until March 31, 2006. The applicable period for this measure is extended for a further 2 years (until March 31, 2008).

In addition, drinking and eating expenses totaling ¥5,000 or less per person, except for those expenses that are incurred by directors and employees of the corporation, will be excluded from the definition of "entertainment expenses" in the case where a corporation maintains specific documents. It should be noted that irrespective of its capital, this revision will be applied to all corporations.

The above reform will apply to fiscal years beginning on or after April 1, 2006.

Immediate write-off for low cost depreciable assets

Where small- and medium-sized corporations whose capital is ¥100,000,000 or less, excluding subsidiaries of large corporations, purchases an asset for less than ¥300,000 per asset and uses it in their business from April 1, 2003 to March 31, 2006, the corporation is permitted to take a deduction for the total acquisition cost of the asset.

Under the 2006 Tax Reform, the applicable period for this special measure will be extended for a further 2 years (until March 31, 2008). However, if the company acquires assets, whose total amount for the year exceeds ¥3,000,000, the excess portion over ¥3,000,000 will not be eligible for immediate write-off.

The above reform will apply to purchases of assets on or after April 1, 2006.

Tax incentives for investments by small and medium-sized corporations

Where small- and medium-sized corporations whose capital is ¥100,000,000 or less, excluding subsidiaries of large corporations, acquire certain machinery and equipment and uses such machinery and equipment for business in Japan, the corporation is permitted to take a special allowance for accelerated depreciation equal to 30% of the acquisition cost of such machinery and equipment. Further, if the capital of the corporation is ¥30,000,000 or less, the corporation will be able to elect either to take a special allowance for accelerated depreciation equal to 30% of the acquisition cost or a tax credit equal to 7% of the acquisition cost of such machinery and equipment. The maximum amount of the special tax credit will be limited to 20% of the taxpayer's corporation tax liability, with any excess tax credit being eligible for a one year carryforward, subject to certain conditions.

Under the 2006 Tax Reform, the applicable period for this tax incentive will be extended for a further 2 years (until March 31, 2008). Certain software and digital multifunction machines will be added to the types of assets that qualify for this incentive, However, certain equipment, other than computers, will be excluded from the types of assets that qualify for this incentive.

The above reform will apply to purchases of assets on or after April 1, 2006.

Suspension of ability to carryback tax losses

With the exception of certain small or medium-sized companies whose capital is ¥100,000,000 or less, excluding subsidiaries of large corporations, the tax loss carryback provisions (allowing the carryback of tax losses for one year for national corporation tax purposes) were suspended until March 31, 2006.

Under the 2006 Tax Reform, this suspension will be extended for a further 2 years (until fiscal years ending on or before March 31, 2008). The exception that allows certain small or medium-sized companies whose capital is ¥100,000,000 or less and has been in existence for less than 5 years, excluding subsidiaries of large corporations, to carryback their tax losses will be extended and is applicable to fiscal years ending until March 31, 2008.

3. International tax regime

Interest paid to controlling foreign shareholders (thin capitalization rules)

If a Japanese corporation pays interest on debt to a controlling foreign shareholder (defined as a foreign company that owns 50% or more of the shares in the Japanese corporation) and the average balance of debt on which that interest is paid is more than three times the equity of the controlling foreign shareholder in the net assets of the interest-paying corporation, the excess interest paid by the interest-paying corporation to the controlling foreign stockholder is not allowed as deduction for Japanese tax purposes.

Under the 2006 Tax Reform, these thin capitalization rules have been reformed as follows:

- ◇ The debt on *Saiken-Gensaki* (Japanese Repo) where the borrowing is related to the lending can be excluded from the category of debt. In this case, the applicable debt to equity ratio is 2:1, instead of the current 3:1

The above reform will apply to fiscal years ending on or after April 1, 2006.

- ◇ The following items are included in the category of debt and interest on debt under the thin capitalization rules:
 - a) debt obtained from a third-party company if the repayment is guaranteed by the controlling foreign shareholder – the third party debt will be treated as debt that is owed to a controlling foreign shareholder. The interest on such third party debt and any guarantee fee to the controlling foreign shareholder will be treated as same as interest that is paid to the controlling foreign shareholder;
 - b) debt obtained from a third-party company with a bond which is borrowed from the controlling foreign shareholder being used as collateral – the third party debt will be treated as debt that is owed to a controlling foreign shareholder. The interest on such third party debt and the consideration for the bond borrowing that is paid to the controlling foreign shareholder will be treated as same as interest that is paid to the controlling foreign shareholder; and
 - c) debt from a third party using a combination of the above - the third party debt will be treated as debt that is owed to a controlling foreign shareholder. The interest on such third party debt, the guarantee fee that is paid to the controlling foreign shareholder, and the consideration for the bond borrowing that is paid to another third party will be treated as same as interest that is paid to the controlling foreign shareholder.

The above reform will apply to fiscal years beginning on or after April 1, 2006.

Domestic law revisions in response to new tax treaties

The new tax treaty between Japan and the United Kingdom includes a limitation on benefits article. The domestic laws measures below have been implemented in a similar manner to the tax treaty between Japan and the United States.

- ◇ The regulation for application for competent authority determination to apply the limitation on benefits article
- ◇ The regulation for application for the limitation on benefits article

The above reform will apply on or after the date of implementation of the new tax treaty between Japan and the United Kingdom.

4. Transfer pricing

Expansion of the tax authorities' ability to estimate arms length price

Under current law, if a company fails to provide to the Tax Authorities, without delay, books and records that are necessary to calculate an arms length price in accordance with Japanese transfer pricing principles, the Tax Authorities may estimate the arm's length price by using the resale price method, the cost plus method or other similar method. (Paragraph 7, Special Taxation Measures Law Article 66-4). The Tax Authorities can make this estimate based on the gross profit ratio of a corporation that engages in the same kind of business as the business to which the company's foreign related transaction is related to and whose business scale and other factors are similar to those of the company.

Under the 2006 Tax Reform, the transactional net margin method and the profit split method can also be used by the Tax Authorities in estimating the arm's length price. This change is effective for fiscal years starting on or after April 1, 2006.

5. Amendment of tax laws in accordance with new Corporation Law

In connection with the introduction of the new Corporation Law, which became effective on May 1, 2006, certain provisions of the Income Tax Law and the Corporation Tax Law were amended. Some amendments will be effective from the effective date of the new Corporation Law (May 1, 2006), while others will be effective from April 1, 2006 or October 1, 2006 (new rules for share for share swap and share transfer).

The details of the amendments are described below.

Amendments relating to dividend income

➤ Distribution of retained surplus

Under the new Corporation Law, any form of repatriation, including not only dividends but also capital repayments, repurchase of shares, etc., are required to be made as a distribution of retained surplus. For example, if a cash distribution is made by way of a capital repayment, the transaction would consist of two steps: (i) a decrease in capital with a corresponding increase in retained surplus; and (ii) a distribution of retained surplus created upon the capital decrease. While the distribution of retained surplus is made in accordance with the procedures for the declaration of a dividend, the tax treatment of the distribution will be determined based on the source of the retained surplus from which it was made. Thus, any distribution out of retained earnings will be treated entirely as a dividend whereas a distribution out of capital or capital reserve will be treated as a capital repayment resulting in shareholders taxation for dividend income and capital gain/loss, if any. Before the reform, if a company distributed a dividend by decreasing the capital reserve, the distribution is treated entirely as dividend. After the reform, the amount of deemed dividend will be calculated in the same manner as a capital repayment.

The above amendment will apply to the distribution of earning surplus on or after May 1, 2006. Note that if the base period for the distribution ends before May 1, 2006, while the distribution is made on or after May 1, 2006, such distribution is governed by the old tax law.

➤ Deemed dividend on treasury shares repurchased by corporation issuing different classes of shares

Under the current tax law, where a corporation repurchases its treasury shares, the amount of the repurchase price in excess of the capital attributable to the repurchased shares is deemed to be a dividend. The capital attributable to the repurchased shares is computed in accordance with the following formula:

$$\frac{\text{Capital}}{\text{Total number of shares issued}} \times \text{Number of shares repurchased}$$

In the above formula, even where a company has different classes of outstanding shares, the deemed dividend would be computed based on the total number of the issued shares including all classes of shares. The amended tax law provides that the capital attributable to the repurchased shares will be computed separately for each class of shares.

The above amendment will apply to share purchase made on or after April 1, 2006. With respect to a company which has issued different classes of shares as of April 1, 2006, a transitional measure will apply (i.e., capital amount per each class of share should be computed by certain formula such as issue price basis, fair market value basis, or other method.)

Amendments relating to share transactions

- Allotment of new shares or rights to subscribe for new shares without additional contribution by shareholders

Under the new Corporation Law, a company can allot new shares or rights to subscribe for new shares without receiving additional contributions from existing shareholders. Under the old Commercial Code, a company can split its shares to achieve, economically, the same result. However, under the new Corporation Law, a different class of shares or rights can be allotted to existing shareholders (e.g., distribution of a poison pill right). The amended tax law provides that the allotment of new shares/rights to existing shareholders will not be a taxable event for those shareholders to the extent such allotment will not disfavor certain shareholders.

The above amendment will apply to an allotment made on or after May 1, 2006.

- Exercise of rights to request repurchase of shares/share subscription rights

Under the new Corporation Law, where a company has issued shares/share subscription rights with a right to request repurchase of the shares/share subscription rights upon request of the holders, the company may repurchase the shares/share subscription rights in exchange for cash, share subscription rights or another class of shares.

The amended tax law provides that if the holders of the shares/share subscription rights receive only a different class of shares/share subscription rights as a consideration for the repurchase, the exchange will be made on a no gain / no loss basis to the extent that the value of the transferred shares/share subscription rights is equivalent to that received.

The above amendment will apply to requests for repurchases made on or after April 1, 2006.

- Repurchase of treasury stock

Before the reform, treasury stock is considered an asset for tax purposes notwithstanding that for accounting purposes, it reduces the amount of equity. The amended tax law provides that when treasury stock is repurchased, capital and/or capital surplus will be reduced by an amount equal to the repurchase price (less the amount of deemed dividend, if any), so that the tax treatment is consistent with the accounting treatment.

The above amendment will apply to treasury stock purchased on or after April 1, 2006, although a transitional measure will apply to treasury stock held as of March 31, 2006, i.e., the balance of capital surplus is required debited to the capital surplus account for tax purposes (the balance of capital surplus is reduced).

- Increase in capital and capital surplus upon issue of new shares

Before the reform, upon the issuance of new shares, the aggregate of capital and capital surplus of the issuing company increases by the amount of the total issue price of the new shares pursuant to a provision of the old Commercial Code. In compliance with the new Corporation Law, the amended tax law provides that the aggregate of capital and capital surplus will increase by (i) the amount of cash contribution, or (ii) in the case of a contribution in kind, the fair market value of the contributed assets.

The above amendment will apply to the issuance of new shares resolved on or after May 1, 2006.

The above amendment raises an issue in relation to how much capital and capital surplus should increase in the case of a debt-equity swap where a loan with a face value lower than its fair market value is contributed to the debtor company. If capital and capital surplus increases by

the amount of the fair market value, the difference between the face value and the fair market value may be treated as debt forgiveness income. However, under the tax law, the definition of the fair market value of the loan is not clearly defined. Under Japanese GAAP, a reasonably appraised value such as the net present value of the future cash flow from the loan is used as the value which is used on the books of the creditor to record the value of shares received upon the debt-equity swap. It could be argued that such value should be considered the fair market value for tax purposes.

On the other hand, it is arguable that from the perspective of the debtor (the issuer of the shares), the value of the debt should be the face value of the loan. This position appears to be supported by the new Corporation Law, which provides that where the face value of the loan is used as the value of the contribution, a valuation of the contributed assets by a court appointed inspector is exempted. This suggests that for the purposes of the new Corporation Law, the fair market value is the face value. In any case, debt forgiveness income has not been recognized in most debt-equity swaps made by financial institutions and the amendment may affect this practice.

- Deduction of expired tax losses to be used for offsetting debt forgiveness income arising from debt-equity swap

Before the reform, where a debtor has filed an application for corporate rehabilitation proceeding or similar events provided under the tax law, the deduction of expired tax losses is allowed up to a certain amount. The amended tax law provides that the deduction of expired tax losses will also apply to a debt-equity swap where the debtor has recognized debt forgiveness income on or after May 1, 2006.

- Tax qualified stock options - "eligible person" extended to include chief executive officer (Shikkoyaku)

Under current tax law, individuals who are directors and employees are eligible to participate in a tax qualified stock option plan. However, a chief executive officer ("Shikkoyaku") of a company which has a committee (i.e. nominating committee, audit committee and remuneration committee) as its governing body, is excluded from the definition of "eligible person" notwithstanding that an executive officer is equivalent to a director of a company which has a board of directors as its governing body. It should be noted that an executive officer ("Shikko yakuin"), which is not a term provided under the Commercial Code but used by companies as a title for a person who is involved in the management of the company without being a director for Commercial Code purposes, is different from the chief executive officer, which is a term provided under the current Commercial Code and the new Corporation Law. An executive officer is an employee under the definition of the Commercial Code and is eligible to participate in a tax qualified stock option plan under current tax law.

The amended tax law provides that a chief executive officer under the new Corporation Law will be eligible to participate in a tax qualified stock option plan. This amendment will apply to the stock option granted on or after May 1, 2006.

- Tax treatment of Kaikei-sanyo

As a corporate organization, a company which is not required to have a statutory auditor is able to have a Kaikei-sanyo under the new Corporation Law. A Kaikei-sanyo will be treated as a Director for tax purposes.

- Family corporations

As discussed above, under current tax law, a family corporation is defined as a corporation that is directly or indirectly more than 50% owned by three or fewer shareholders (including related

individuals and corporations) in terms of the aggregate number of shares held by these shareholders. Before the reform, the determination of whether a corporation is a family corporation is based on the number of issued shares held by shareholders including both ordinary shares and non voting shares.

The amended tax law provides that voting rights will be taken into consideration in determining whether a corporation is a family corporation.

The above amendment will apply to fiscal years beginning on or after April 1, 2006.

Corporate reorganization rules

- Treatment of share for share exchange (Kabushiki Kokan) and share for share transfer (Kabushiki Iten) to be aligned with other forms of corporate reorganizations

A share for share exchange (Kabushiki Kokan) is a legal procedure under which a company (the “acquiring company”) acquires 100% of the shares of another existing company (the “acquired company”) in exchange for its shares issued to the shareholders of the acquired company. A share for share transfer (Kabushiki Iten) is a legal procedure similar to a share for share exchange under which a new acquiring company is incorporated and acquires 100% of the shares of an acquired company in exchange for its shares issued to the shareholders of the acquired company. This procedure is used for creating a holding company between the acquired company and its shareholders.

The amended tax law provides that the tax treatment of a share for share exchange/transfer will be aligned to that of other forms of reorganization such as a merger, demerger, etc.

Tax treatment of shareholders of the acquired company

The amended tax law provides that any capital gain or loss arising from the exchange of shares upon the share for share exchange/transfer will be deferred as long as the shareholders receive only shares of the acquiring company.

Tax qualified share for share exchange

The proposed amendment provides that upon a share for share exchange/transfer, certain assets owned by the acquired company will be revalued and any revaluation gain or loss will be included in the computation of taxable income. Assets subject to revaluation include fixed assets, land, securities, monetary receivables and deferred assets but exclude any assets with unrealized gains or losses of which the amount of such gain or loss is less than the smaller of (i) 50% of capital/capital surplus, and (ii) Yen 10 million. However, the revaluation requirement will be exempted if the acquisition of the acquired company is made solely for stock (i.e., no cash consideration) and the transaction meets the conditions for a tax qualified reorganization (i.e., a reorganization between more than 50% related companies or for the purposes of conducting a joint business).

A deemed dividend will not arise even if a share for share exchange/transfer is not tax qualified.

In the case of non consolidated filing, there will be no restriction on the utilization of tax losses irrespective of whether a share for share exchange/transfer is a tax qualified reorganization. In the case of consolidated filing, a revaluation of assets upon the entry to the consolidated tax group will be exempted if a share for share exchange/transfer is a tax qualified reorganization.

In the case where a company (the acquiring company) is incorporated by way of a share for share exchange and files consolidated tax returns with the acquired company, under the current law, the existing tax losses of the acquired company can survive after the entry to the consolidated tax group under certain conditions. Under the proposal, such tax losses will be

forfeited unless the share for share transfer is a tax qualified reorganization.

The above amendment will apply to share for share exchange/transfer made on or after October 1, 2005.

➤ Transfer of assets/liabilities in non qualified reorganization

Under current tax law, in a non qualified reorganization (e.g. merger or demerger), assets and liabilities of the transferor company are deemed to be transferred to the transferee company at their fair market value. However, any liabilities that are not fixed and determinable, such as a reserve for retirement allowance, cannot be transferred for tax purposes and the tax treatment of such liabilities succeeded by the transferee is unclear (e.g. there is a view that income equal to the amount of such liabilities should be recognized by the transferee for tax purposes).

The proposed amendment provides that a reserve for retirement allowance can be transferred in a non qualified reorganization and such liabilities can be recorded as liabilities on the tax balance sheet and shall be added back in the future years per the tax return.

In addition, any difference between (i) the fair market value of the transferred assets and liabilities that were stated on the balance sheet of the transferor, and (ii) the consideration for the transfer, which is typically the shares of the parties to the reorganization, will be recorded as an asset or liability for tax purposes. This difference will be recognized as goodwill (positive value or negative value) such that the tax treatment will be consistent with the purchase accounting treatment of corporate reorganizations prescribed by Japanese GAAP. Positive goodwill or negative goodwill shall be deducted or added back over 5 years per the tax return.

The above amendment will apply to non qualified reorganizations made on or after May 1, 2006.

6. Taxation on financial transactions

Tax exemption for interest and discount on private foreign bonds issued outside Japan (Minkan Kokugaisai)

Interest and the discount on Minkan Kokugaisai paid to non-residents or foreign corporations are exempt from Japanese withholding tax provided the investors file the necessary declaration documents. This treatment is extended for a further 2 years to March 31, 2008.

Tax exemption for interest from deposits in special offshore accounts

If a foreign corporation deposits or lends money into a foreign exchange bank provided for under the Foreign Exchange and Foreign Trade Law Art. 21(3), and credits it to a special international finance account ("offshore account"), interest on the deposit or the lending is exempt from tax under certain conditions. This treatment is extended for a further 2 years to March 31, 2008.

Tax exemption for interest received in connection with Saiken-Gensaki (Japanese Repo) transactions by foreign financial institutions

If foreign financial institutions (i.e., a foreign company that is engaged in the banking, securities or insurance business or a foreign central bank or international institution) enter into a specific bond repurchase transaction, in which certain conditions are met, with a designated domestic financial institution which is subject to the Netting Law of the Bank of Japan ("Designated Domestic Financial Institutions") and receive interest for the repurchase transaction from the Designated Domestic Financial Institutions, the interest is exempt from tax provided the necessary procedures are complied with. This treatment is extended for a further 2 years to March 31, 2008.

Dividend income excluded from taxable income

Before the 2006 Tax Reform, when a holding company of a bank owns all the shares of an issuing financial institution under certain conditions at the end of each fiscal year and pays interest on bonds issued ("Special Interest"), the amount of the Special Interest is not included when calculating the amount of the dividend income excluded from taxable income. According to the 2006 Tax Reform, this treatment was abolished.

Special account for stock transactions (Tokutei Kouza)

Before the 2006 Tax Reform, if an individual investor holds stock that is listed on a stock exchange and other certain securities ("Listed Stocks") in a Special Account (*Tokutei Kouza*), the gains from these securities are taxed via a withholding tax and need not be reported on a tax return. If the investor does not own any Listed Stocks in the Special Account and does not have any transaction for 2 years, such Special Account will be deemed to be closed. According to the 2006 Tax Reform, the Special Account can be maintained if the investor submits the necessary declaration documents.

The above reform will apply to application submitted on or after April 1, 2006.

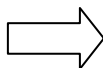
7. Individual taxation

Definition of non-permanent resident (National)

Under the 2006 Tax Reform, the definition of a nonpermanent resident was amended as follows:

[Current law]

An individual who is a resident of Japan but who does not intend to stay permanently in Japan and who has not continuously maintained a domicile or residence in Japan for a period of 5 years or more up to the current date.



[Draft tax revision]

An individual who is a resident of Japan but who does not have Japanese citizenship and who has not maintained a domicile or residence in Japan for an aggregate of 5 years or more within the preceding 10 years.

The effect of this amendment is to expand the definition of a permanent resident to include any individual who has resided in Japan for a total of 5 years or more within the preceding 10 year period and is not a Japanese citizen.

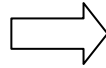
This amendment will be applicable on or after April 1, 2006.

New tax rates (National and Local)

The 2006 Tax Reform reflects a desire to shift a portion of tax revenue from the national government to the local government, the following are the changes in the national income tax and local inhabitants tax rates. In summary, the current local tax system is replaced with a flat local tax rate of 10%. To offset the increase in local taxes, the national tax system is expanded to a 6-tier structure as following:

[Current law]
(National income tax)

〔Taxable income〕		〔Tax rate〕
Over	Not over	Plus % of the excess
-	3,300,000	10%
3,300,000	9,000,000	20%
9,000,000	18,000,000	30%
Over 18,000,000		37%

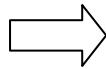


[New law]

〔Taxable income〕		〔Tax rate〕
Over	Not over	Plus % of the excess
-	1,950,000	5%
1,950,000	3,300,000	10%
3,300,000	6,950,000	20%
6,950,000	9,000,000	23%
9,000,000	18,000,000	33%
Over 18,000,000		40%

(Prefectural inhabitant tax)

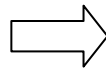
〔Taxable income〕		〔Standard tax rate〕
Over	Not over	Plus % of the excess
-	7,000,000	2%
Over 7,000,000		3%



〔Taxable income〕	〔Standard tax rate〕
Flat tax based on taxable income	4%

(Municipal inhabitants tax)

〔Taxable income〕		〔Standard tax rate〕
Over	Not over	Plus % of the excess
-	2,000,000	3%
2,000,000	7,000,000	8%
Over 7,000,000		10%



〔Taxable income〕	〔Standard tax rate〕
Flat tax based on taxable income	6%

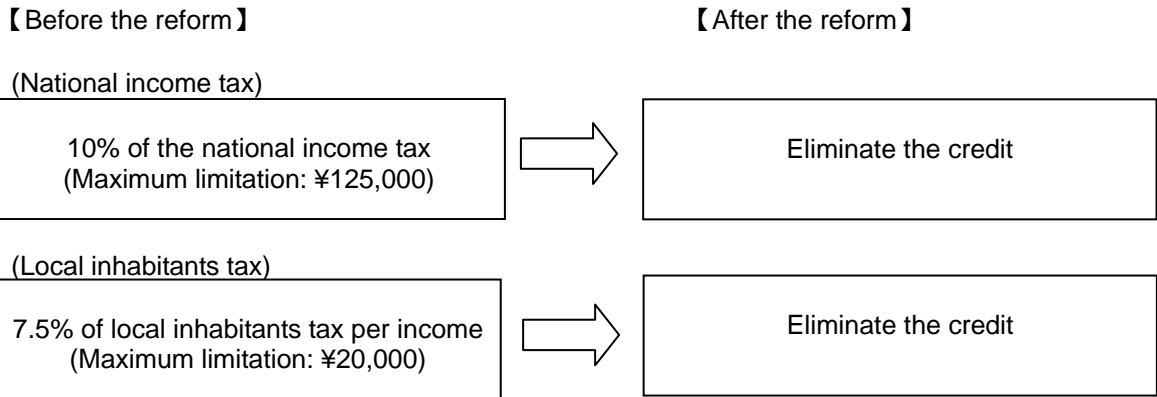
In order to offset the additional tax burden arising from the differences in personal deductions between the national income tax and the local inhabitants tax systems, an additional personal deduction for local inhabitants tax purposes has been added.

The allocation of the local inhabitants tax rate between the prefectural tax and municipal tax in connection with the separate taxation of certain types of income will be changed. However, the total local inhabitants tax rate that will apply under the separate taxation system will not change.

The above changes will be applicable from 2007 in the case of national taxes and local taxes payable from June 2007 (which are based on the year 2006 income.)

Special tax credit for individuals (National and Local)

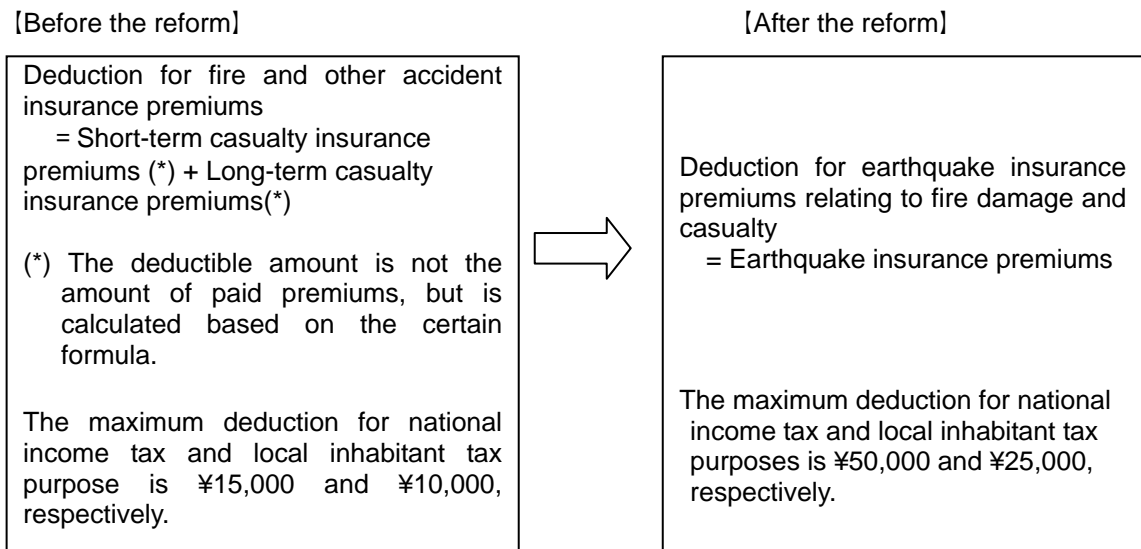
Special tax credits for both national income tax and local inhabitants tax purposes were enacted in 1999 as part of the government's economic stimulus policy. The 2005 tax reform reduced these tax credits by 50% for the 2006 tax year. The 2006 Tax Reform completely eliminated these credits. Below is a summary of the special tax credit system before and after the 2006 tax reform.



The 2006 Tax Reform eliminated the special tax credits applicable from 2007 in the case of the national income tax and local taxes payable from June 2007 (which is based on the year 2006 income).

Introduction of deduction for earthquake insurance premiums (National and Local)

For purposes of relieving citizens from the financial burdens arising from damage to property due to earthquakes, the 2006 Tax Reform revised the deduction for fire and other accident insurance premiums under the old law to allow for a deduction for earthquake insurance premiums. Under the reform, where the earthquake insurance contract or earthquake mutual aid covers a house or personal property and the insurance proceeds and mutual proceeds are paid as a result of fire damage and casualty losses arising from an earthquake, the earthquake insurance premiums will be eligible for a deduction.



This deduction will be applicable from 2007 in the case of the national income tax and local taxes payable from June 2008 (which is based on the year 2007 income).

As an interim measure, long-term casualty insurance contracts that were entered into on or before December 31, 2006 will be subject to a maximum deduction of ¥15,000 and ¥10,000 for national income tax and local inhabitant tax purposes, respectively. Where both a deduction for earthquake insurance premiums and a deduction for long-term casualty insurance premiums are

applicable, the maximum deduction for national income tax and local inhabitant tax purposes is ¥50,000 and ¥25,000, respectively.

Special tax credit for earthquake retrofit of main home (National)

The 2006 Tax Reform includes a provision to promote quake-proofing renovation work to better ensure that houses avoid damage from earthquakes. Under the proposal, if the individual completes such renovations between April 1, 2006 and December 31, 2008, the individual can report a special tax credit against the national income tax liability for the year that such earthquake-proofing renovation work is completed. The credit is the following:

- ◇ Special tax credit for earthquake renovations = The renovation expenses × 10%
- The maximum tax credit will be ¥200,000.

Tax deduction for donations/charitable contributions (National)

The 2006 Tax Reform includes a reduction in the floor for charitable contributions that can be deducted from ¥10,000 to ¥5,000.

8. Other reform

Elimination of top taxpayer listing

Since 1947, the Tax Authorities have published annual lists that disclose the names of the top taxpayers in various categories. The 2006 Tax Reform eliminates this practice for privacy reasons, effective April 1, 2006.

Obligation to submit Business Outline Report

Before the 2006 tax reform, a "Business Outline Report" used to be submitted with the corporate tax return at the taxpayer's discretion. This Report includes information relating to the number of branches and subsidiaries of the taxpayer, the number of employees and Directors, financial information (e.g. sales, cost of sales, type of expenses, etc.), explanation of the business activities, etc.

However, the submission of the Report becomes compulsory under the 2006 Tax Reform and should be attached to the final corporate tax return.

Enterprise tax - extension of the special treatment to deduct capital decrease with no consideration from capital

The new Enterprise Tax, which applies to corporations with capital stock in excess of JPY100 million, is calculated by taking into consideration three factors: an income-based factor, a capital factor, and a value-added factor.

Under an amendment to the new Enterprise Tax law, if a company offsets its accumulated deficit against capital surplus for legal and accounting purposes, the offset is not recognized for tax purposes. Accordingly, for purposes of applying the new Enterprise tax, the pre-offset capital surplus amount is taken into account for purposes of determining the capital factor.

Under an exception to this rule, for fiscal years starting on or after April 1, 2004 until March 31, 2006, where a company has undertaken on or after April 1, 2001 a capital reduction in order to offset an accumulated deficit, the capital amount for purposes of the new Enterprise Tax is reduced accordingly.

This special treatment is extended for a further two (2) years (i.e. until March 31, 2008) under the 2006 Tax Reform.

Expansion of reasons for filing amended corporate tax returns

If the taxable base or the tax liability that is originally reported in the corporate income tax return is found to be overstated, or in certain cases, where the underlying facts are different from those that form the basis of the calculations in the corporate tax return as a result of a legal decision, etc., a taxpayer may file an amended corporate tax return.

Under the 2006 Tax Reform, where a change in the interpretation of the tax laws or regulations is announced by the Director of the National Taxation Agency (“NTA”) and this change would affect the taxable base or tax liability that was originally calculated and reported on the corporate income tax return, a taxpayer may file an amended corporate income tax return within two (2) months from the date following the date when the facts about the change were announced by the Director of the NTA. This amendment is applicable to any change in the interpretation of the tax laws or regulations announced by the Director of the NTA on or after April, 2006.

Amendment to the penalty rate for the late filing of corporate income tax returns

If a National corporate income tax return is not filed by the statutory due date (including extensions), a late filing penalty of 15% is currently imposed. The penalty can generally be reduced to 5% if the return is filed prior to the late filing issue being raised by the Tax Authorities (e.g. at the time of a notice of a tax audit).

Under the 2006 Tax Reform, the penalty is (i) 15% in the case that the corporate income tax liability is less than or equal to 500,000 JPY and (ii) 20% if the corporate tax liability is more than 500,000 JPY. However, if the corporate income tax return is filed within two (2) weeks after the statutory due date (including extensions), and the corporate tax liability is paid by the payment due date, the late filing penalty is not imposed. These amendments are applicable to National and local corporate tax returns whose filing due date (including extensions) is on or after January 1, 2007.

Amendment to the penalty for late payment of National withholding tax

If the National withholding tax (e.g. for salary payments) is not paid by the statutory due date (which is the 10th day of the month following the month of the salary payment), a 10% penalty for the late payment is generally imposed on the unpaid withholding tax. The penalty can generally be reduced to 5% if the payment is made prior to the late payment issue being raised by the Tax Authorities (e.g. prior to the time of a notice of a tax audit being issued).

Under the 2006 Tax Reform, if (i) the National withholding tax is paid within one (1) month after the statutory due date for the payment, (ii) there were no late payments of National withholding tax within the last one (1) year, and (iii) if the payment is made prior to the late payment issue being raised by the Tax Authorities (e.g. prior to the time of a notice of a tax audit being issued), no late payment penalty will be imposed. This exception applies to National withholding tax payments whose statutory due date is on or after January 1, 2007.

Taxation on real property

(1) Registration tax

The reduced tax rates on the registration of real property that were implemented under the 2003 Tax Reform were abolished.

Under the 2006 Tax Reform, the reduced rates that applies to the registration of real property for

the period from April 1, 2006 to March 31, 2008 are as follows:

- ✧ Transfer of ownership by sale: 1.0% (originally 2.0%)
- ✧ Entrustment of ownership: 0.2% (originally 0.4%)

When certain conditions are met, TMKs (special purpose companies) purchase of real property in accordance with an Asset Liquidation Plan or Investment Corporations (including J-REITS), purchase real property, the registration tax rate that is imposed on the transfer of ownership of real property increases from 0.6% to 0.8% and the transfer of ownership on a pledge or mortgage increases from 0.1% to 0.15%. These new rates applies for the period from April 1, 2006 to March 31, 2008.

(2) Real property acquisition tax

According to the 2006 Tax Reform, the reduced real property acquisition tax of 3% (originally 4%) is changed as follows:

- ✧ The term of the reduced 3% rate for residential premises and sites is extended to March 31, 2009.
- ✧ The term of the reduced 3% rate for land, other than a residential site in a commercial area, is extended to March 31, 2009.
- ✧ The term of the reduced 3% rate for buildings, other than certain shops and offices, will be abolished. Instead, a 3.5% rate is applicable for the period from April 1, 2006 to March 31, 2008.

For certain residential land, the tax base is currently reduced by one-half of its assessed value. This concessionary treatment will be extended to March 31, 2009.

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