

# Japan Tax Update

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## PwC Japan Tax Newsletter

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The intention of this Newsletter is to provide an outline of the Japanese tax reforms for 2009 based on the Reform Act that was promulgated on March 31, 2009, and does not constitute the provision of advice or professional consulting of any kind. Before making any decision or taking any action, you should consult your usual PwC contact with all the pertinent facts relevant to your particular situation.

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## Outline of 2009 Tax Reform

The amended tax law was promulgated on March 31, 2009. This issue exclusively deals with the outline of the 2009 Tax Reform.

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## 1. International taxation

Before the amendment, the taxation of foreign dividends and the application of the foreign tax credit ("FTC") and anti-tax haven or controlled foreign corporation ("CFC") rules were closely related and their interaction in many cases give rise to complex issues. The principal of the FY2009 tax reform in relation to international taxation is the introduction of a foreign dividend exemption to replace the existing taxation and credit system. This is arguably one of the most significant of Japan's tax reforms in recent years as it represents a fundamental shift in the taxation of foreign dividends.

The change from a taxation and credit system to an exemption system requires corresponding amendments to both the FTC and CFC rules. We expect that the amended tax reform will present not only significant planning opportunities but also pitfalls for companies that do not fully understand the impact of the new laws on their global corporate structures.

In addition, as the companies most affected by the 2009 Tax Reform will likely be multinational companies with subsidiaries located in various countries, the impact of the amendments should also be assessed by taking into consideration proposed tax reforms in those countries. For example, the UK's proposed introduction of a foreign dividend exemption and the Netherlands' proposed reduction of its statutory tax rate to below 25% and simplification of its participation exemption will have a significant impact on the application of the CFC rules. PwC is taking a leading role in the consultative process with the relevant government authorities in these countries with respect to the development of the new tax laws and is uniquely placed to assess the combined impact of Japanese and global tax reforms on Japanese multinational companies. Please contact us should you wish to discuss these proposals in further detail.

### 1.1 Exemption of foreign dividends

#### *Before 2009 Tax Reform*

Before the amendments, a dividend received by a company from a shareholding in a foreign company was included in taxable income and subject to tax at normal rates of corporate tax, irrespective of the level of shareholding. Double taxation was eliminated through the FTC system as discussed further below.

#### *Under 2009 Tax Reform*

Under 2009 Tax Reform, 95% of a dividend received by a company from a foreign company in which it has held at least 25% of the outstanding shares for a continuous period of six months or more ending on the date on which the dividend is declared can be excluded from the company's taxable income. Please note that the 25% threshold will be limited to direct shareholdings i.e. individual shareholdings of less than 25% should not qualify for the exemption even if the aggregate shareholding held within a wholly-owned group is 25% or more.

If the foreign company is resident in a country with which Japan has concluded a tax treaty for the avoidance of double taxation, and such treaty provides for the allowance of an indirect FTC for taxes paid by the foreign company on the profits out of which the dividend is paid where the company holds a certain percentage of the foreign company's outstanding shares, that percentage will apply for the purpose of determining the availability of the above exemption to the extent that it is lower than 25%.

The new tax law would apply to foreign dividends received in fiscal years commencing on or after April 1, 2009.

#### *Comments*

- Although a dividend received by a company from another domestic company is included in taxable income, if the company has held at least 25% of the outstanding shares of the dividend paying company for a continuous period of six months or more ending on the date on which the dividend is declared, a deduction can be claimed for the amount of the dividend less any interest expense attributable to the dividend. In this regard, the conditions for the application of the proposed foreign dividend exemption

are similar to those for the domestic dividend exemption and the indirect FTC system discussed below. It appears that the taxation of 5% of the dividend is intended as an arbitrary amount to cover the costs of holding the shares including financing costs.

- Companies that have recognized a deferred tax liability for tax on foreign dividends that have not been repatriated to Japan may be able to write-back this liability. Depending upon the company's accounting policies, this could result in a reduction in the company's effective tax rate on its consolidated financial statements. Companies should discuss the appropriate accounting treatment with their independent auditors.
- The amended exemption of foreign dividends may result in the tax authorities increasing their scrutiny of other international tax-related areas such as transfer pricing and the application of the anti-tax haven rules, as they may anticipate abusive tax practices to take advantage of the new exemption.

## 1.2 Foreign tax credit system

### *Before 2009 Tax Reform*

As mentioned above, under the previous tax law, a dividend received by a company from a shareholding in a foreign company was included in taxable income and subject to tax at normal rates of corporate tax. However, in order to eliminate double taxation, a FTC was allowed for (i) foreign taxes directly paid by the company on the dividend (e.g. withholding tax imposed by the country in which the dividend paying company is located), and (ii) taxes paid by the dividend paying company ("1<sup>st</sup> tier subsidiary") and, if the 1<sup>st</sup> tier subsidiary has itself received dividends from its subsidiary ("2<sup>nd</sup> tier subsidiary"), taxes paid by the 2<sup>nd</sup> tier subsidiary. The latter was commonly referred to as the "indirect FTC system" and is available if, in the case of a 1<sup>st</sup> tier subsidiary, the company has held 25% or more of the total number of shares, amount of investment in capital or voting shares for at least six months prior to the dividend declaration date and, in the case of a 2<sup>nd</sup> tier subsidiary, the company has an indirect interest of at least 25% in the 2<sup>nd</sup> tier subsidiary and the 1<sup>st</sup> tier subsidiary has held 25% or more of the total number of shares or voting capital of the 2<sup>nd</sup> tier subsidiary for at least six months prior to the declaration date of the dividend from 2<sup>nd</sup> tier subsidiary to 1<sup>st</sup> tier subsidiary.

### *Under 2009 Tax Reform*

The introduction of the foreign dividend exemption will eliminate any potential double taxation and thus, the indirect FTC system will be repealed, although certain transitional measures will be provided for.

In addition, foreign tax directly paid on exempt dividends (e.g. withholding tax) will not be eligible for direct FTC claim or deduction from taxable income. Such tax should be added back to taxable income. Foreign tax directly paid on foreign dividends received from shareholdings of less than 25% will continue to be eligible for a direct FTC claim as the dividends would be taxable.

The new tax law would apply to foreign dividends received in fiscal years commencing on or after April 1, 2009.

### *Comments*

- As noted above, as the amendments only apply to exempt foreign dividends, foreign tax directly paid on shareholdings of less than 25% will continue to be eligible for direct FTC claim or deduction from taxable income. The tax reforms does not make any changes to the direct FTC system for other types of foreign source income (e.g. royalties, interest and profits of a foreign branch) and thus, foreign taxes paid on such income will continue to be eligible for FTC relief within the FTC limitation. As the amended tax laws do not quarantine different types of foreign source income or the countries from which such income is derived, it is possible for FTC relief in respect of one type of foreign source income from a high tax country to reduce the Japanese tax liability on another type of foreign source income from a low tax country (cross crediting). The repeal of the indirect and direct FTC for dividends will reduce the ability to cross credit

and could result in an increased Japanese tax liability on other types of foreign source income.

- A company that has branch in a foreign country is taxable on profits of that branch (with FTC relief being available for foreign taxes paid). Whether the proposed dividend exemption makes it more tax efficient to conduct a foreign business through a subsidiary rather than directly through a branch will need to be simulated and if necessary, the branch may need to be converted into a subsidiary.
- Whether the combined impact of the foreign dividend exemption, repeal of the indirect FTC system and disallowance of a direct FTC claim will increase or decrease a company's overall global tax liability on foreign dividends and its effective tax rate will vary from company to company depending upon its particular circumstances. Companies should prepare simulations to assess the combined impact of the new rules, transitional rules and related tax reform in foreign countries and if necessary, reconsider their policies for the repatriation of profits from foreign subsidiaries. This would include the timing of dividends i.e. before or after the effective date of the new rules. In some cases, it may be necessary for a company to undertake a reorganization of its foreign subsidiaries in order to maximize its tax position under the new rules.

### 1.3 Anti-tax haven rules

#### *Before 2009 Tax Reform*

Under the previous tax law, in general, when calculating the undistributed income of a CFC to be included in the taxable income of a Japanese shareholder, (i) a dividend received by the CFC is included in undistributed income, and (ii) a dividend paid by the CFC to a shareholder that is subject to tax on the dividend at a rate greater than 25% may be deducted from undistributed income.

If a company received a dividend from a foreign company where the dividend was paid from earnings that had previously been taxed to the company under the CFC rules ("previously taxed earnings"), double taxation was eliminated through the allowance of a deduction for previously taxed dividends, provided such earnings had been included in the company's taxable income within the previous ten years up to the end of the fiscal year preceding the year in which the dividend was received. However, the company was still entitled to claim a FTC for direct and indirect taxes paid in respect of the dividend, with an adjustment for any FTC claimed at the time the earnings were taxed under the CFC rules.

#### *Under 2009 Tax Reform*

When calculating the undistributed income of a CFC, a dividend paid by the CFC is not deductible.

However, a dividend received by the CFC from a company in respect of which it has held a shareholding of at least 25% of the company's outstanding shares for a continuous period of six months or more ending on the date on which the dividend is declared can be deducted from undistributed income. The tax reform does not make any distinction between a dividend received by the CFC from another company in the same country (domestic dividend) or from a different country (foreign dividend). Thus, the exclusion from the undistributed income of the CFC applies to both domestic and foreign dividends received by the CFC.

If a company receives a dividend from a foreign company where the dividend is paid from previously taxed earnings and 95% of the dividend is exempt under the foreign dividend exemption, a deduction for previously taxed dividends is not available. However, a corresponding "expense" deduction is allowed to the extent of the previously taxed earnings so that this can achieve the full tax exemption.

The new tax law would apply to the fiscal years of a CFC's commencing on or after April 1, 2009. For example, if a CFC has a fiscal year end of March 31, the new tax law will be applicable to the calculation of its undistributed income for the fiscal year April 1, 2009 to March 31, 2010.

*Comments*

- The amended tax law does not address the treatment of existing balances of previously taxed earnings. To the extent that dividends paid from such earnings qualify for the foreign dividend exemption, it is unclear whether any transitional measures will be introduced to adjust for Japanese tax previously paid.
- The exclusion of dividends received by a CFC from the calculation of undistributed income results in an equitable treatment of foreign dividends received through a non-CFC and a CFC. As the underlying policy of the 2009 reform is to exempt foreign dividends, it would be contrary to this policy if dividends received through a CFC were subject to Japanese tax through their inclusion in CFC income. This treatment may also minimize the adverse CFC impact of current tax reform proposals in the UK and the Netherlands that may affect Japanese multinational companies with holding companies located in these countries.

1.4 Case studies

The following case studies illustrate the potential impact of the proposed amendments. Please note that these case studies are based on simplified assumptions and tax calculations.

Case 1: A Japanese parent company (Parent) with an effective tax rate of 40% receives a dividend from its wholly-owned subsidiary (Sub) located in Country A, which has a tax rate of 15% and a withholding tax on dividends of 10%. Parent has other foreign source income in addition to the dividend from Sub. Sub is not subject to the application of the CFC rules.

*Before 2009 Tax Reform*

	Sub(Country A)	Parent(Japan)	Consolidation
Operating income	1,000	1,000	2,000
Dividend income	0	765	
Pre-tax income		1,765	2,000
Tax adjustment			
Dividend income, not taxable			
Directly paid foreign tax		85	
Indirectly paid foreign tax		150	
Taxable income	1,000	2,000	
Corporate tax due (Gross)	150	800	
FTC		(235) <sup>1</sup>	
Corporate tax due (Net)	150	565	800
After-tax income	850	1,200	1,200
Withholding tax on dividend	85		
Dividend to Parent (Net)	765		

Effective tax rate : 40% (= 800 ÷ 2,000)

<sup>1</sup>Corporate tax of Sub 150 + Withholding tax on dividend 85

*Under 2009 Tax Reform*

	Sub(Country A)	Parent(Japan)	Consolidation
Operating income	1,000	1,000	2,000
Dividend income	0	765	
Pre-tax income		1,765	2,000
Tax adjustment			
Dividend income, not taxable		(808) <sup>2</sup>	
Directly paid foreign tax		85	
Indirectly paid foreign tax			
Taxable income	1,000	1,042	
Corporate tax due (Gross)	150	417	
FTC			
Corporate tax due (Net)	150	417	652
After-tax income	850	1,348	1,348
Withholding tax on dividend	85		
Dividend to Parent (Net)	765		

Effective tax rate : 32.6% (= 652 ÷ 1,348)

<sup>2</sup> (Dividend to Parent (net) 765 + Withholding tax on dividend 85) x 95%

*Comment*

Under current tax law, in theory, the effective tax rate on a consolidated basis will be 40% (the effective tax rate in Japan) when Parent receives a dividend from Sub even if the tax rate in the country where Sub is located is lower than Japan. Under the proposed tax law, the effective tax rate will be based on the tax rate in Japan and the foreign country where Sub is located. Therefore, if the tax rate in the foreign country is relatively lower than Japan, the tax rate on a consolidated basis will be lower than 40%.

Case 2: Parent with an effective tax rate of 40% receives a dividend from Sub located in Country B, which has a tax rate of 35% and a withholding tax of 10% on dividends. Assume that Parent has other foreign source income in addition to the dividend from Sub.

*Before 2009 Tax Reform*

	Sub(Country B)	Parent(Japan)	Consolidation
Operating income	1,000	1,000	2,000
Dividend income	0	585	
Pre-tax income		1,585	2,000
Tax adjustment			
Dividend income, not taxable			
Directly paid foreign tax		65	
Indirectly paid foreign tax		350	
Taxable income	1,000	2,000	
Corporate tax due (Gross)	350	800	
FTC		(415) <sup>1</sup>	
Corporate tax due (Net)	350	385	800
After-tax income	650	1,200	1,200
Withholding tax on dividend	65		
Dividend to Parent (Net)	585		

Effective tax rate : 40% (= 800 ÷ 2,000)

<sup>1</sup>Corporate tax of Sub 350 + Withholding tax on dividend 65

*Under 2009 Tax Reform*

	Sub(Country B)	Parent(Japan)	Consolidation
Operating income	1,000	1,000	2,000
Dividend income	0	585	
Pre-tax income		1,585	2,000
Tax adjustment			
Dividend income, not taxable		(618) <sup>2</sup>	
Directly paid foreign tax		65	
Indirectly paid foreign tax			
Taxable income	1,000	1,032	
Corporate tax due (Gross)	350	413	
FTC			
Corporate tax due (Net)	350	413	828
After-tax income	650	1,172	1,172
Withholding tax on dividend	65		
Dividend to Parent (Net)	585		

Effective tax rate : 41.4% (= 828 ÷ 2,000)

<sup>2</sup> [Dividend to Parent (Net) 585 + Withholding tax on dividend 65] x 95%

*Comment*

In this case, the tax rate on income in Country B is lower than Japan. However, taking into account the withholding tax on the dividend, tax is effectively imposed at the rate of 41.5% [(350 + 65) ÷ 1,000]. In addition, only 95% of the received dividend is excluded from the taxable income of Parent. Consequently, the effective tax rate on a consolidated basis under the proposed tax law is higher than the tax rate in Japan. In particular, this situation would arise if the withholding rate in the country where Sub is located is relatively high (e.g. where no tax treaty is available).

Case 3: Parent with an effective tax rate of 40% receives a dividend from Sub located in Country C, which has a tax rate of 50% and no withholding tax on dividends. Assume that Parent receives 800 of foreign source royalty income which is subject to 10% withholding tax in Country C.

*Before 2009 Tax Reform*

	Sub(Country C)	Parent(Japan)	Consolidation
Operating income	1,000	200	2,000
Royalty income		720 <sup>1</sup>	
Dividend income	0	500	
Pre-tax income		1,420	2,000
Tax adjustment			
Dividend income, not taxable			
Directly paid foreign tax		80 <sup>2</sup>	
Indirectly paid foreign tax		500	
Taxable income	1,000	2,000	
Corporate tax due (Gross)	500	800	
FTC		(580) <sup>3</sup>	
Corporate tax due (Net)	500	220	800
After-tax income	500	1,200	1,200
Withholding tax on dividend			
Dividend to Parent (Net)	500		

Effective tax rate : 40% (= 800 ÷ 2,000)

<sup>1</sup>Royalty 800 – Withholding tax on royalty 80

<sup>2</sup>Royalty 800 x 10%

<sup>3</sup>Corporate tax of Sub 500 + Withholding tax on royalty 80

*Under 2009 Tax Reform*

	Sub(Country C)	Parent(Japan)	Consolidation
Operating income	1,000	200	2,000
Royalty income		720	
Dividend income	0	500	
Pre-tax income	<u>0</u>	<u>1,420</u>	<u>2,000</u>
Tax adjustment			
Dividend income, not taxable		(475) (*8)	
Directly paid foreign tax		80	
Indirectly paid foreign tax			
Taxable income	<u>1,000</u>	<u>1,025</u>	
Corporate tax due (Gross)	500	410	
FTC		(80) (*9)	
Corporate tax due (Net)	<u>500</u>	<u>330</u>	<u>910</u>
After-tax income	<u>500</u>	<u>1,090</u>	<u>1,090</u>
Withholding tax on dividend			
Dividend to Parent (Net)	500		

Effective tax rate : 45.5% (= 910 ÷ 2,000)

(\*8) Dividend to Parent 500 x 95%

(\*9) Royalty 800 x 10%

*Comment*

As the previous tax laws do not quarantine different types of foreign source income or the countries from which such income is derived, it is possible for FTC relief in respect of one type of foreign source income from a high tax country to reduce the Japanese tax liability on another type of foreign source income from a low tax country (cross crediting). Under the amended tax laws, the ability to cross credit would be reduced and could result in an increase in the company's effective tax rate.

1-5 Investment into certain partnerships and the 25/5 Rule

(1) Taxation in relation to foreign investment in certain Japanese partnerships (Determination of PE)

Before the 2009 tax reform, foreign investors investing in Japanese investment business limited partnerships (toushi jigyou yugen sekinin kumiai, or "IBLP") may have a risk of a permanent establishment in Japan. Under the amended rules, a foreign individual or corporate partner ("Foreign Partner") may invest in IBLPs without risk of a permanent establishment ("PE") in Japan on account of such investment provided certain requirements are met. These conditions include:

- a) The Foreign Partner has limited liability with respect to the IBLP;
- b) The Foreign Partner is not involved in the management or operation of the IBLP;
- c) The Foreign Partner's investment ratio in the IBLP is less than 25%;
- d) The Foreign Partner is not specially related to the general partner of the IBLP; and
- e) The Foreign Partner does not otherwise have a permanent establishment in Japan.

The above amendment applies to determinations on or after April 1, 2009 in connection with whether a Foreign Partner has a PE in Japan in relation to an investment in such IBLP.

(2) Application of the 25/5 Rule to certain foreign partners

Before the 2009 tax reform, a gain from the sale of shares of a Japanese corporation is subject to tax, even where the Foreign Partner does not have a PE in Japan, if the Foreign Partner (together with

specially related persons) sells 5% or more of the shares of such corporation during a fiscal year and such Foreign Partner (together with specially related persons) owns or has owned 25% or more of the shares in such company for a specified holding period. ("25/5 Rule").

The 2009 Tax Reform liberalizes the 25/5 Rule for certain transactions where the sale is by a IBLP or other foreign partnership fund similar to an IBLP, assuming certain criteria is met. This reform covers transactions where (1) a 1-year holding period criteria is met; and (2) the transaction does not involve a shareholding in certain distressed financial institutions.

If a transaction is a covered transaction, the 25% ownership threshold may be tested at the Foreign Partner level where the following conditions are met:

- 1) The Foreign Partner meets the criteria provided in 1) above; or
- 2) The Foreign Partner is in a partnership similar to an IBLP where (A) the Foreign Partner does not have a PE in Japan; (B) the Foreign Partner is a limited partner in the partnership; (C) the Foreign Partner does not own 25% or more of the shares of the corporation sold; and (D) the Foreign Partner is not involved in the management or operation of the partnership.

The above amendment applies to the sale of shares on or after April 1, 2009.

- (3) The range of Japanese sourced income with regard to redemption gain on discount bond received by a foreign corporation

The scope of Japanese sourced income in relation to redemption gains on discount bonds received by a foreign corporation is revised such that the taxation of redemption gains on discount bonds received by a foreign corporation should be the same as interest on bonds received by a foreign corporation. The following changes are made:

- (a) With regard to a redemption gain on a discount bond issued by a foreign corporation, the redemption gain attributable to any business conducted by the foreign corporation in Japan is deemed to be Japanese sourced income for corporation tax purposes; and
- (b) A redemption gain on a discount bond received by a foreign corporation without a PE in Japan is subject to withholding tax only, and the foreign corporation is not required to file a corporation tax return.

The above amendment applies to the discount bond issued on or after April 1, 2009.

## **2. Tax incentives for small-medium sized companies**

### **2.1 Applicable tax rate to first JPY 8 million of taxable income**

#### *Before 2009 Tax Reform*

A small or medium sized company (defined as including a company with paid-in capital of JPY 100 million or less, etc.) was subject to corporate tax rate of 22% (rather than 30%) on its first JPY 8 million of taxable income.

#### *Under 2009 Tax Reform*

For fiscal years ending from April 1, 2009 to March 31, 2011, a small or medium sized company will be subject to corporate tax rate of 18% (rather than 22%) on its first JPY 8 million of taxable income.

## 2.2 Tax loss carryback

### *Before 2009 Tax Reform*

Although tax losses can be carried back for one year, the provision allowing such carryback has been suspended for tax losses arising in fiscal years ending between April 1, 1992 and March 31, 2010 except for (i) losses of a small or medium sized company (excluding a subsidiary of a large sized company with capital of more than JPY 100 million, etc.) arising within five years of its establishment (until March 31, 2010) or, (ii) in the case of liquidation.

### *Under 2009 Tax Reform*

Tax losses recognized by a small or medium sized company defined as a company with the stated capital of JPY 100 million or less at the fiscal year end for fiscal years ending on or after February 1, 2009 can be carried back for one year.

## 2.3 Special depreciation or tax credit for qualified assets

### *Before 2009 Tax Reform*

Where a certain small and medium sized company acquires qualified machinery with a purchase price of JPY 2.8 million or more or equipment with a purchase price of JPY 1.2 million or more and satisfies certain requirements, it can claim depreciation of 30% of the acquisition cost or (in the case where the company's paid-in capital is JPY 30 million or less), a tax credit of 7% of the acquisition cost in the year of acquisition subject to limitation of 20% of the corporation tax.

### *After 2009 Tax Reform*

The above measures are extended for a further two years until March 31, 2011.

## 3. The tax system on finance

### (1) The tax system on corporate securities

#### 1) Taxation related to dividend income and capital gains on listed stocks for individuals

The existing concessional individual income tax rate of 10% (national 7%, local 3%) applies to dividend income paid from listed stocks and capital gains derived from the disposal of listed stocks from January 1, 2009 to December 31, 2011.

#### 2) Extension of withholding tax rate for dividends on listed stocks

(a) The existing concessional withholding tax rate of 10% (national 7%, local 3%), which applies to dividend income on listed stocks paid to Japanese resident individuals or non-resident individuals who have a PE in Japan, is extended for one year until December 31, 2011.

(b) The existing concessional withholding tax rate of 7%, which applies to dividend income on listed stock paid to non-resident individuals without a PE in Japan, Japanese corporations or foreign corporations, is extended to December 31, 2011 (before the 2009 tax reform: March 31, 2009).

#### 3) Extension of withholding tax rate, applied to a "Special Account" for individuals

The existing concessional withholding tax rate of 10% (national 7%, local 3%), which applies to dividend income from listed stocks kept in a Special Account for the period from January 1, 2009 to December 31, 2010, is extended for one year to December 31, 2011.

#### 4) Taxation of covered warrant for individuals

Capital gains derived from the sale of covered warrants listed on the financial instrument exchange

("Listed Covered Warrant") and income arising from the net settlement on Listed Covered Warrant fall within the category of other income derived from forward transactions which is subject to separate taxation for Japanese income tax purposes.

The above amendment applies to the disposal and net settlement of Listed Covered Warrant on or after January 1, 2010.

(2) Taxation related to TMK and investment corporation

1) Revision of the scope of Institutional Investor

A TMK is not included in the scope of an Institutional Investor for Japanese tax purposes ("QII"). Under the 2009 Tax Reform, if a TMK securitizes specified bonds issued by, or specified loan borrowed by other TMK backed by real property, the TMK conducting the securitization is included in the scope of a QII in determination of the following conditions when applying the dividend deductibility rules:

- (a) specified bonds are entirely underwrote by QII; and
- (b) specified loans are entirely financed by QII.

2) Revision of the 90% test for dividend deductibility

TMK or J-REIT are required to pay dividends in excess of 90% of "distributable taxable income" to meet the dividend deductibility test before the 2009 tax reform. This definition is revised to "distributable profit" for accounting purposes under the 2009 Tax Reform. However, there are certain adjustment measures to be introduced, for example, where negative goodwill is recognized, the negative goodwill is excluded from the "distributable profit" in the fiscal year of the date of recognition.

3) The treatment of cash delivered due to merger corresponding to dividends

The treatment of cash delivered due to merger (*Gappei Kofu-kin*) between J-REITs is clarified so that *Gappei Kofu-kin* corresponding to dividends is included in the scope of deductible dividends for J-REIT.

The above 1)-3) amendments apply to fiscal years ending on or after April 1, 2009.

4) Extension of special taxation measures for transfer taxes

- (a) The scheduled increase of reduced registration tax rates on the transfer of ownership of real property acquired by a TMK based on the Asset Liquidation Plan or acquired by a J-REIT on or after April 1, 2009 is suspended for one year and the existing reduced registration tax rates of 0.8% applies for a further one year.
- (b) The 1/3 tax-base exception on certain real property acquired by TMK based on the Asset Liquidation Plan or acquired by J-REIT with regard to real property acquisition tax is extended for two years.

## 4. Land taxation

### 4.1 Special deduction for long-term capital gain on land acquired from January 1, 2009 to December 31, 2010

#### *Before 2009 Tax Reform*

A capital gain from the transfer of land is fully taxable for Japanese individual and corporate income tax purposes. Under certain circumstances (e.g. expropriation of land, transfer of land as part of a public entity plan, etc.), certain special deductions are allowed to reduce the amount of the taxable gain.

*After 2009 Tax Reform*

If an individual or corporate taxpayer purchases land during the period from January 1, 2009 to December 31, 2010 and owns the land for more than 5 years as of January 1 in the year of sale, a special deduction of JPY 10 million will be allowed to reduce the capital gain derived from the sale. The special deduction is limited to the amount of the capital gain if the capital gain is less than JPY 10 million. The special deduction is also applicable for local individual inhabitant tax purposes.

4.2 Deferral of tax on gain from sale of land by reduction of tax basis of land acquired between January 1, 2009 to December 31, 2010

*After 2009 Tax Reform*

If an individual business enterprise or corporate taxpayer:

- acquires land (Land A) in Japan from January 1, 2009 to December 31, 2010;
- files a tax report to apply the special tax deferral of capital gain by the filing due date of the tax return in the year of acquisition; and
- within 10 years after the end of the fiscal year in which Land A was acquired, the taxpayer sells another piece of land (Land B),

80% of the capital gain derived from the sale of Land B can be deferred by reducing the tax basis of Land A by the same amount (60% if the land is acquired during the period from January 1, 2010 to December 31, 2010). This treatment is not applicable if land is considered as inventory of the taxpayer.

4.3 Extension of rollover relief for gains from sale of land

*Before 2009 Tax Reform*

Where a corporate taxpayer transfers land owned for at least ten years and acquires new land, if certain conditions are satisfied, a specified portion of the capital gain may be deferred by reducing the tax basis of the replacement property. This treatment is applicable until December 31, 2008.

*After 2009 Tax Reform*

The above treatment will be extended until December 31, 2011.

4.4 Suspension of increase in tax rates for registration tax

The reduced rates of registration tax applicable to the transfer of ownership of land be extended as follows:

Transfer of ownership	Original rate	Rate applicable for transfers during period			
		1 April 2009 to 31 March 2010	1 April 2010 to 31 March 2011	1 April 2011 to 31 March 2012	1 April 2012 to 31 March 2013
By sale	2.0%	1.0%	1.0%	1.3%	1.5%
By entrustment	0.4%	0.2%	0.2%	0.25%	0.3%
To Tokutei Mokuteki Kaisha under asset liquidation plan	2.0%	0.8%	TBD	TBD	TBD
By corporate division	2.0%	0.8%	0.8%	1.3%	TBD

## 5. Special credit for acquisition of houses, etc.

### 5.1 Extension of tax credit for residential mortgages

A tax credit is currently allowed to an individual taxpayer whose income for the year does not exceed JPY 30 million for interest on a loan to acquire, build or renovate his/her principal residence. The amount of credit is determined as a percentage of the outstanding mortgage at the end of the year. In the case of qualified long-term high quality housing, the amount of credit is higher. By the tax reform the tax credit is extended from 2009 to 2013 as follows:

Year of inhabitation	Creditable period	Standard housing		Qualified long-term high quality housing	
		Qualified amount of outstanding loan	Amount of tax credit	Qualified amount of outstanding loan	Amount of tax credit
2009	10 years	50 million or less	1.0%	50 million or less	1.2%
2010	10 years	50 million or less	1.0%	50 million or less	1.2%
2011	10 years	40 million or less	1.0%	50 million or less	1.2%
2012	10 years	30 million or less	1.0%	40 million or less	1.0%
2013	10 years	20 million or less	1.0%	30 million or less	1.0%

From 2009, the unused balance of the tax credit for housing loan may be applied to inhabitants tax of the following year, without any additional tax filings, if certain conditions are satisfied.

### 5.2 Introduction of tax credit for acquisition of qualified long-term high quality housing

Where a taxpayer acquires new long-term high quality housing, under certain conditions and as an alternative to the mortgage tax credit under 5.1b), a special tax credit for 10% of standard performance-enhanced costs (capped to a maximum of JPY 10 million) is available. If the amount of the tax credit exceeds the taxpayer's tax liability for the year in which the acquisition occurs, the excess may be carried forward to the following year.

### 5.3 Introduction of tax credit for qualified home improvements

#### a) Improvements for increased energy saving performance

Where an individual taxpayer incurs expenditure to improve the energy saving performance of his/her principal residence, under certain conditions, a tax credit of 10% of the expenditure will be available.

#### b) Improvements for barrier-free access

Where a qualified individual taxpayer incurs expenditure to improve the barrier-free access of his/her principal residence, under certain conditions, a tax credit of 10% of the expenditure will be available.

The above tax credits are not available where a mortgage tax credit is claimed under 5.1 or 5.4.

### 5.4 Special credit on housing loan for qualified additional construction and etc.

The applicable period for special credit on housing loan for qualified additional construction and etc. will be extended for 5 years.

### 5.5 Special credit for earthquake-proof improvement of an existing residence

The applicable period for special credit for earthquake-proof improvement of an existing residence is extended for 5 years.

## 6. Other corporate taxation

### 6.1 Corporate revitalization measures

#### *Before 2009 Tax Reform*

Banks and other financial institutions often grant debt forgiveness to companies in bankrupt or insolvent positions and as a result, these companies would realize debt forgiveness income. In addition, valuation gains and losses on assets are generally non-taxable and non-deductible for Japanese corporate tax purposes. Tax losses can be carried forward to 7 years.

However, if a company's revitalization plan is approved by the court under the Corporate Rehabilitation Law or Civil Revitalization Law or an agreement has been reached for a company revitalization plan similar to that under the Civil Revitalization Law provided that certain conditions are met, the company can recognize revaluation gains or losses on its assets (excluding savings, loan, account receivable) as taxable gains or losses.

To apply the above treatment, all the following requirements should be satisfied:

- a) the revitalization plan is based on the certain procedure rule and reviewed by 3 or more professionals (who have special knowledge and experience in the discharge of debt),
- b) assets and liabilities of the company are evaluated based on the procedures in the above plan
- c) the amounts of debt discharged are determined based on the balance sheet showing an appropriate valuation of assets, and
- d) two or more financial institutions must waive a debt claim, or
- e) government-affiliated financial institutions discharge debt owing by the company.

If the above requirements are met, the company can deduct the valuation loss from certain assets (e.g. fixed assets, land, securities) against the debt forgiveness income arising from the cancellation of the debt. In addition, any tax losses that have expired due to the carryforward period of 7 years having passed may be offset against valuation gains or debt forgiveness income.

#### *Under 2009 Tax Reform*

- Under the proposed amendments, a revitalization plan approved by the local revitalization institution (Chiiki Ryoku Saisei Kikou) may also qualify for the above treatment.
- The requirement of two financial institutions to forgive the debt can be substituted with one local government institution.
- In addition to debt forgiveness, a debt equity swap would also qualify for the above treatment.
- In the case of small or medium-sized revitalization (defined as where the amount of the company's debt with accrued interest is less than JPY 1 billion), two or more professionals should be involved in confirming the revitalization plan.
- The valuation loss deductible as a built-in loss is expanded to include credit (e.g. bond, account receivable and loan etc) which are excluded under the current law.

### 6.2 Appraisal method of inventory at fiscal year-end

#### *Before 2009 Tax Reform*

There are several methods to appraise inventory held by a company at the end of the fiscal year, including FIFO (first in first out), LIFO (last in first out) and simple average method etc.

#### *Under 2009 Tax Reform*

To maintain consistency with recent amendments to Japanese accounting standards, the LIFO and simple average methods are no longer acceptable as inventory appraisal methods. A transitional rule has been also introduced.

### 6.3 Deductibility of foreign penalties under anti-trust laws

#### *Before 2009 Tax Reform*

Penalties and interests paid to foreign governments as a result of action instigated under those countries' anti-trust laws are deductible for Japanese corporate tax purposes.

#### *Under 2009 Tax Reform*

Penalties and interests (and equivalent payments) paid to foreign governments and other international organizations as a result of action instigated under foreign anti-trust laws will no longer be deductible for Japanese corporate tax purposes. This amendment is effective for actions instigated under anti-trust laws on or after April 1, 2009.

### 6.4 Special depreciation or special credit for acquisition of facilities, etc. for promoting reform of energy demand-and-supply structure

In addition to the current special depreciation, the amount equivalent to purchased cost is deductible in a year when the facility is placed in operation if the asset is purchased between April 1, 2009 and March 31, 2011. The current measurement (including tax credit applicable to a small corporation while special depreciation is applicable regardless of size of a corporation) is extended to March 31, 2012.

## **7. Inheritance tax**

In general, inheritance tax is imposed on the transfer of property through inheritance. Inheritance tax is payable by the beneficiary and the scope of property that is subject to inheritance tax depends upon the domicile status of the beneficiary. A beneficiary that has his/her domicile in Japan at the time the property is acquired is subject to inheritance tax on all property irrespective of its location. A beneficiary that has his/her domicile outside Japan at the time the property is acquired is subject to inheritance tax only on property located in Japan, subject to the following rule. A beneficiary who (i) is a Japanese national, (ii) acquires property in Japan through inheritance, (iii) has his/her domicile outside Japan but was domiciled in Japan within five years before acquiring the property, and (iv) the property was received from a person who was domiciled in Japan within five years before his/her death.

Gift tax is imposed where one person gratuitously transfers property to another person. Gift tax is payable by the recipient of the gift.

To encourage the smooth succession of businesses conducted by small and medium sized companies, two amendments relating to the imposition of inheritance tax and gift tax in relation to unlisted shares of small and medium sized companies are introduced. These amendments would be applicable to the inheritance effective from October 2008 or to gift effective from April 2009.

#### 7.1 Tax deferral on inheritance of shares in small and medium sized company

80% of the value of up to two-thirds of the total outstanding voting shares in a small and medium sized company may be temporarily excluded from the inheritance tax base. If the beneficiary retains such shares until his/her death, the exemption will become permanent, provided certain conditions relating to the position of the beneficiary in the company are satisfied.

#### 7.2 Tax deferral on gift of shares in small and medium sized company

If a person receives a gift of shares in a qualifying small and medium sized company from another member of his/her family who is the representative director of the company, up to two-thirds of the value of the total outstanding voting stock is eligible for a deferral from gift tax. If the recipient retains such shares until his/her

death, the exemption will become permanent, provided certain conditions relating to the position of the beneficiary in the company are satisfied.

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

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