



The tax legislation, Cabinet Orders and Enforcement Orders relating to the 2004 tax reform were enacted as of April 1, 2004. Although this newsletter provides an outline of the new laws, we recommend that you consult with us for specific advice relating to your circumstances and do not take any action based solely on the contents of this Newsletter.

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## 2004 Japanese Tax Reform

The 2004 tax reform legislation was enacted as of April 1, 2004. The Ministry of Finance expects that the amendments contained in this legislation will result in a decrease in tax revenues of approximately 1.5 trillion Japanese yen at the national tax level.

### 1. Corporate tax

- Extension of tax loss carryforward period
- Extension of period for which books and accounting records must be maintained
- Extension of statute of limitations for amendment of tax returns
- Abolition of surtax for companies electing consolidated tax filing

### 2. International taxation

- Ratification of new Japan-US Tax Treaty
- Adoption of Transactional Net Margin Method
- Relaxation of rules regarding comparables for thin capitalization purposes
- Withholding tax exemption procedures

### 3. Finance and securities

- Income tax treatment of publicly offered stock investment contractual funds
- Tax rate reduction on capital gains on unlisted stocks
- Exemption of withholding tax imposed on redemption gains

### 4. Small-and-medium-sized enterprises

- Measures to promote business succession
- Tax incentives to support qualified ventures

### 5. Housing and land - Individuals

- Special tax credit for housing loans
- Capital gains from land and buildings

### 6. Pensions

- Increase of maximum deductible contributions to defined contribution pension
- Public pension allowances and allowances for aged people

### 7. Local taxes

- Size-based taxation - special treatment to deduct capital decrease without compensation from capital
- Abolition of maximum fixed assets tax rate
- Per capita inhabitant tax

## **Corporate tax**

### **1. Extension of tax loss carryforward period**

Previously, the following losses could be carried forward for up to 5 fiscal years:

- loss arising in a fiscal year for which a blue form tax return is filed;
- casualty loss arising in a fiscal year for which a blue form tax return is not filed; and
- a consolidated taxation loss.

The carryforward period has been extended to 7 years for losses incurred in fiscal years starting on or after April 1, 2001. The following table summarizes the previous and new carryforward periods:

Classification of loss	Loss carryforward period	
	Previous	New
Blue form tax return loss	5 years	7 years
Casualty loss	5 years	7 years
Consolidated taxation loss	5 years	7 years

### **2. Extension of period for which books and accounting records must be maintained**

Previously, books and accounting records were required to be maintained for 5 or 7 years. In order to maintain consistency with the extension of the tax loss carryforward period, the period for which books and accounting records must be maintained has been extended to 7 years, applicable to books and accounting records for fiscal years starting on or after April 1, 2001. The 7-year maintenance period commences from the day following the due date for the taxpayer's final tax return.

### **3. Extension of statute of limitations for amendment of tax returns**

- The period during which the tax authorities may make adjustment to a tax loss carried forward has been extended to 7 years, applicable to losses incurred in fiscal years starting on or after April 1, 2001.
- The period during which the tax authorities may adjust a company's reported taxable profit, correcting understatements other than those due to deliberate tax evasion, has been extended from 3 years to 5 years, applicable to corporate tax returns due on or after April 1, 2004. The statute of limitation for local tax returns have similarly been amended.
- The above period during which the tax authorities may adjust a company's reported taxable profit will begin from the day after the original filing due date of the tax return.

### **4. Abolition of surtax for companies electing consolidated tax filing**

The 2% surtax applied to taxable profits reported in a consolidated tax return is abolished for fiscal years starting on or after April 1, 2004.

## **International taxation**

### **1. Ratification of new Japan-US Tax Treaty**

The new Japan-US Tax Treaty ("new treaty") has been ratified by both the US and Japan legislatures and the instruments of ratification were exchanged on March 30, 2004. The new treaty provides for the elimination or reduction of withholding taxes on dividends, interest, and royalties paid or payable on or after July 1, 2004, in general. In respect of other taxes, the new treaty is effective for taxable years beginning on or after January 1, 2005.

(a) Application of new treaty to hybrid entities

Article 4 of the new treaty sets out detailed rules addressing when an item of income derived through hybrid entities is entitled to treaty benefits. In analyzing these hybrid entities, the specific rules of Article 4(6) consider:

- who are the beneficiaries, members or participants in the hybrid entity;
- where the income is derived; and
- how the income is treated by the tax laws of the contracting states or its state of domicile (if not established in either of the contracting states)

(b) Approval of qualification for treaty benefits by Competent Authority

Article 22 of the new treaty imposes conditions to be satisfied in order for treaty benefits to be available. If a taxpayer does not satisfy any of the qualifying conditions, it may as a last resort apply to the Competent Authority of the state from which benefits are claimed for treaty benefit eligibility. In the case of a US resident, an application should be filed with the Commissioner of National Tax Agency via the Kojimachi tax office director. If the application is approved, it will be announced in an official gazette. If the application is not approved, the applicant will be notified accordingly. Detailed procedures for Competent Authority approval are provided under a new Ministry of Finance Cabinet Order issued on March 31, 2004.

(c) Treatment of payments exceeding an arm's length amount

Under the new treaty, if an amount of income within the "other income" articles of the new treaty exceeds the arm's length amount for the transaction in question, the excessive amount may be subject to tax in the source country at a rate not exceeding 5%. The necessary measures will be set out in order to tax at the limited rate of 5%.

(d) Transitional period

To the extent that a taxpayer can obtain greater benefits under the former tax treaty, it may elect for this treaty to continue to apply for up to 1 year from the date on which the new treaty would otherwise be effective.

## **2. Adoption of Transactional Net Margin Method**

The Transactional Net Margin Method ("TNMM") has been introduced as another permissible methodology for determining arm's length prices for cross-border transactions with related parties under the Japanese transfer pricing rules (in addition to the three basic methodologies and the profit split methodology already allowed). The TNMM is permissible for fiscal years beginning on or after April 1, 2004. As with the profit split method, the TNMM is permissible only where one of the three basic methods (the Comparable Uncontrolled Price, Resale Price and Cost Plus methods) cannot be applied.

In brief, the TNMM calculates the arm's length price by reference to the operating profit earned in a comparable transaction between unrelated parties. Thus, the TNMM is the first permissible methodology that uses operating margin as the profitability measure for the comparable transaction. In the context of transfer pricing audits, however, it is reasonable to assume that the use of the TNMM will be restricted to situations where none of the three basic methods are applicable and operating margins of comparable companies are available on a specific transaction (or specific product line) basis. It will be necessary to carefully monitor in what circumstances the Japanese tax authorities will apply the TNMM in practice.

In the context of bilateral APAs, an operating margin based methodology (in which an arm's length gross margin is derived by adding operating expenses to an agreed-upon operating margin) has often been used for many years, although it is called the "Modified Resale Price Method" in order to fit within the requirements of the Japanese transfer pricing legislation. The introduction of the TNMM allows such operating margin based methodologies to be called "TNMM" in the bilateral APA context.

### **3. Relaxation of rules regarding comparables for thin capitalization purposes**

The Japanese thin capitalization rules allow the normal 3:1 debt-equity threshold to be exceeded where it can be demonstrated that a comparable third party has a higher ratio. In lieu of the 3:1 ratio, a taxpayer was previously permitted to consider a comparable company's financial information for the most recent year and use the ratio of indebtedness and capital. This rule has been changed to allow a taxpayer to refer to a single selected fiscal year out of the past 3 years of the comparable company by adopting a ratio of net assets over the net liabilities. This change is applicable to fiscal years ending on or after April 1, 2004.

### **4. Withholding tax exemption procedures**

The procedures for applying for withholding tax exemption for non-residents and foreign corporations with permanent establishments in Japan have been revised. Previously, non-residents and foreign corporations were required to obtain an exemption certificate for each payer and submit it to each payer in order to enjoy the withholding tax exemption. In order to reduce such administrative burden, for domestic source income receivable on or after July 1, 2004, the non-resident recipient is only required to show the exemption certificate to the payer.

## **Finance and securities**

### **1. Income tax treatment of publicly offered stock investment contractual funds**

The following reforms were made in order to align the taxation of publicly offered stock investment contractual funds with that of listed shares.

- (a) Certain capital gains, including sales through securities companies, realized on or after January 1, 2004 are subject to a reduced income tax rate (7% national tax and 3% local tax).
- (b) (i) Publicly offered stock investment contractual funds are added to the list of assets in a "special account" (*Tokuteikouza*) for which the special taxation method for capital gains on transfer may be applied. Tax is withheld from any resultant income incurred by the transfer of such assets, and no further tax liability arises. This treatment will apply to:
  - Foreign publicly offered stock investment contractual funds for capital gains incurred on transfers on or after April 1, 2004; and
  - Domestic publicly offered stock investment contractual funds for capital gains incurred on transfers on or after October 1, 2004.
- (ii) Banks, *Kyodososhiki-kinyukikan* and registered financial institutions are allowed to operate "special account" on or after April 1, 2004.
- (c) Capital losses incurred on the certain sale of publicly offered stock investment contractual fund securities on or after January 1, 2004 can be carried forward for 3 years.
- (d) When certain financial institutions repurchase investments from investors, and then subsequently redeem the investments on or after April 1, 2004, profit distributions from those redemptions are exempt from withholding tax under certain conditions.

### **2. Tax rate reduction on capital gains of unlisted stocks**

The tax rate on capital gains on disposal of unlisted stocks realized on or after January 1, 2004 is reduced from the former rate of 26% (20% national tax, 6% local tax) to 20% (15% national tax, 5% local tax).

### **3. Exemption of withholding tax imposed on redemption gains**

- (a) Redemption gains of short-term bonds held in a paperless trading system (so called "*Denshi CP*") issued by foreign corporations are exempt from withholding tax at the time of issuance. This change

is applied to bonds issued on or after April 1, 2004.

- (b) A system of payment slips for the transfer and redemption of short-term bonds is introduced for transfers of short-term domestic and foreign corporate bonds on or after April 1, 2006.
- (c) A qualified foreign intermediary must notify certain items on its books to certain financial institutions with regard to the paperless transfer of short-term government bonds. Certain financial institutions are required to submit payment slips concerning transfer of short-term government bonds in a paperless trading system. This applies to transfers on or after April 1, 2004.

## **Small-and-medium-sized enterprises**

### **1. *Measures to promote business succession***

- (a) Taxation of capital gains on unlisted stocks used to finance payment of inheritance tax

If a beneficiary of a deceased estate inherits unlisted stocks in respect of which he/she is required to pay inheritance tax, it is common for the beneficiary to sell a portion of the shares to the issuing company in order to finance the payment of such inheritance tax liability. Previously, the capital gain arising from the sale of such shares was subject to deemed dividend taxation (up to a maximum tax rate of 50%) since such sale was regarded as an acquisition of treasury stock via directly negotiated transfer off the market, and not through the stock exchange. This tax liability was generally greater than the tax liability on a capital gain realized from the sale of listed stocks through the stock market. Under the new law, a capital gain realized from the sale of unlisted stocks in the above circumstances will be subject to taxation as a capital gain rather than being subject to deemed dividend taxation. This new law is applicable to the sale on or after April 1, 2004 of unlisted stocks acquired by inheritance.

- (b) Special treatment for family corporation

Where shares in a small or medium-sized family corporation are acquired by inheritance, for the purposes of determining the valuation of these shares for inheritance tax purposes, if certain conditions are satisfied, a 10% discount can be applied to the first 300 million JPY. This amount has been increased to 1 billion JPY for assets acquired by inheritance or bequest on or after January 1, 2004.

- (c) Extension of family corporation surcharge suspension

The surcharge levied on the "excessive" retained earnings of a family corporation is currently suspended for a small and medium-sized corporation. This suspension has been extended for a further 2 years (up to fiscal years ending by March 31, 2006).

- (d) Suspension of ability to carryback tax losses

With the exception of certain small or medium-sized companies, the tax loss carry-back provisions (allowing the carry-back of tax losses for one year for national corporation tax purposes) was suspended until March 31, 2004. This suspension has been extended for a further 2 years up to fiscal years ending on March 31, 2006. The exception that allows certain small-and-medium-sized companies to carryback their tax losses has been extended and is applicable to fiscal years ending on or before March 31, 2006.

### **2. *Tax incentives to support qualified ventures***

The following amendments have been made in order to support funding for qualified ventures:

- (a) The tax rate applicable to capital gains realized from the sale of unlisted stocks is reduced to 20% (as discussed above).
- (b) Expansion of the scope of angel taxation

Under the “angel taxation” system, 50% of a capital gain realized from the sale of certain shares is exempt from tax. The following companies have been added to the list of companies whose shares may qualify for this tax incentive, provided such shares are acquired for consideration on or after April 1, 2004:

- Medium and small companies that have been established for less than 10 years and, issuing shares are classified as “green sheet emerging shares”<sup>\*\*</sup>; and
- Medium and small companies that have been established for less than 10 years, satisfying certain requirements.

\* “Green sheet emerging shares” are shares:

1. which are issued by an unlisted corporation which discloses information necessary for a securities company to make a share offering;
2. which are registered with the Japan Securities Dealers Association (“JSDA”) by the securities company and designated by the JSDA as “green sheet shares”;
3. of which indicative prices are continuously rendered by the securities company; and
4. of which the issuer is examined by the securities company in accordance with the rules of the JSDA and judged as having potential to grow.

## **Housing and land - Individuals**

### **1. Special tax credit for housing loans**

At present, individual taxpayers are entitled to tax credits for housing loans calculated as follows:

$$\text{Tax credit} = \text{Year-end housing loan balance (maximum 50 million yen)} \times 1\%$$

After 2005, the amount of the tax credit will be reduced gradually as indicated in the following table:

Year housing occupation starts:	Period eligible for special deduction	Year-end loan balance	Applicable year, credit rate	Maximum Amount per year (¥ million)
2004	10 years	1st 50 million JPY or less	➤ 1 <sup>st</sup> to 10 <sup>th</sup> year 1%	0.5
2005	10 years	1st 40 million JPY or less	➤ 1 <sup>st</sup> to 8 <sup>th</sup> year 1% ➤ 9 <sup>th</sup> , 10 <sup>th</sup> year 0.5%	0.4 0.2
2006	10 years	1st 30 million JPY or less	➤ 1 <sup>st</sup> to 7 <sup>th</sup> year 1% ➤ 8 <sup>th</sup> to 10 <sup>th</sup> year 0.5%	0.3 0.15
2007	10 years	1st 25 million JPY or less	➤ 1 <sup>st</sup> to 6 <sup>th</sup> year 1% ➤ 7 <sup>th</sup> to 10 <sup>th</sup> year 0.5%	0.25 0.125
2008	10 years	1st 20 million JPY or less	➤ 1 <sup>st</sup> to 6 <sup>th</sup> year 1% ➤ 7 <sup>th</sup> to 10 <sup>th</sup> year 0.5%	0.2 0.1

### **2. Capital gains from land and buildings**

Previously, it was perceived that gains from stock investments were taxed more favourably than gains from land investments. In order to equalize the tax treatment of gains from land and stock investments, the following amendments have been made:

- (a) Reduction of tax rate on capital gains from land and buildings, where transfer occurs on or after January 1, 2004
  - The tax rate on long term capital gains from land and buildings is reduced from 26% (national tax 20%, local tax 6%) to 20% (national tax 15%, local tax 5%); and
  - The tax rate on short term capital gains on land and buildings is reduced from 52% (national tax 40%, local tax 12%) to 39% (national tax 30%, local tax 9%). However, for transfers to

Japanese governmental authorities, the rate will be reduced to 20% (national tax 15%, local tax 5%).

(b) Offset of capital loss from land and buildings against other income

Previously, for income tax purposes, capital losses from land and buildings could be offset against other income (such as business profits and salary income) or carried forward to subsequent years. This offsetting will no longer be allowed for capital losses incurred on or after January 1, 2004 (for national tax purposes) and for capital losses incurred on or after January 1, 2005 (for local inhabitants tax purposes). However, under certain conditions (e.g. the sale of residential property), the offsetting of capital losses against other income will remain possible.

(c) Losses from transfer of certain residential assets

Currently, capital losses from the transfer of certain residential assets can be carried forward for up to 3 years if the following conditions are satisfied:

- a residential asset (land and buildings) is sold during the period from January 1 1998 to December 31, 2003;
- such asset has been held for more than 5 years prior to its disposal and other residential assets are purchased; and
- the annual income of the vendor is 30 million yen or less and the vendor has a housing loan.

The applicable period for this measure has been extended to December 31, 2006. In addition, the requirement that the vendor has a housing loan has been abolished.

(d) Carryover of capital loss from disposal of certain residential assets where no re-investment into residential assets occurs

Capital losses incurred from the transfer of residential assets which are held for more than 5 years and transferred between January 1, 2004 and December 31, 2006 may be carried forward for 3 years provided certain conditions are satisfied.

(e) Abolition of the special deduction of 1 million JPY

Consistent with the reduction of the tax rate applicable to capital gains on land and buildings, the 1 million JPY special deduction against total long term capital gains from the transfer of land and buildings is abolished. The 1 million JPY special deduction will not be available for income tax purposes for 2004 and thereafter and for local tax purposes for 2005 and thereafter.

## **Pensions**

### **1. Increase of maximum deductible contributions to defined contribution pension**

Due to the declining benefits provided by the national pension system, the maximum deductible contributions to defined contribution pensions have been raised as indicated in the following table:

(Unit: Thousand JPY)

Type of pensions	Current (Monthly limitation)	Proposal ( Monthly limitation )
Corporate type		
(1) If no other corporate pension is provided	36	46
(2) If some other corporate pension is provided also	18	23
Individual type		
If a corporate pension is not provided	15	18

## **2. Public pension allowances and allowances for aged people**

The following principle amendments have been made:

- The preferred tax treatment for persons aged 65 or more will be abolished, from 2005 onwards.
- Abolition of allowance for senior citizens: The tax credit of 500,000 JPY for national tax (480,000 yen for local tax) given to persons aged 65 or more provided that their annual total income is 10 million JPY or less, will be abolished with effect from 2005 for national tax and 2006 for local tax purposes.

## **Local taxes**

### **1. Size-based taxation - special treatment to deduct capital decrease without compensation from capital**

The size-based taxation system, under which tax is imposed based on factors such as personnel expenses and amount of capital, is applied from fiscal years starting on or after April 1, 2004. The new system, which was introduced under the 2003 tax reform, applies to corporations whose capital amount exceeds 100 million JPY.

Under an amendment to the size-based taxation rule, 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 size-based enterprise tax system, the pre-offset capital surplus amount is taken into account. However, 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 size-based taxation system will be reduced accordingly.

### **2. Abolition of maximum fixed assets tax rate**

Fixed assets tax is a local tax, however currently a national limit prevents the tax rate being set higher than 2.1%. This limit will be abolished, allowing local governments to decide the tax rate.

### **3. Per capita inhabitant tax**

Currently the per capita inhabitant tax is charged at varying rates, between 2,000 JPY and 3,000 JPY per annum per person, depending on the size of the municipality. In 2004 and later years a uniform rate of 3,000 JPY per annum per person will apply, regardless of the size of the municipality.