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## JAPAN

### In Brief

The Japan Tax Commission issues comments regarding the taxation of retirement income but does not recommend immediate changes.

### Retirement Income Taxation – Future Reform

As part of continuing Japan tax reform, the Tax Commission on June 21, 2005 released its report on recommended changes for individual taxation. The Tax Commission is an independent government advisory body consisting of 19 members mostly from the business and academic arenas, and is currently chaired by Mr. Hiromitsu Ishi (Professor emeritus Hitotsubashi University).

While the report contained several specific individual tax recommendations, it was incomplete as to tax reform in the area of **retirement income**. This is an area of much concern to many employees, ever since the Tax Commission hinted last August that perhaps some favorable aspects of the retirement tax system may require adjustment and would therefore take-up a review of this matter.

Perhaps aware that any reduction or elimination of the existing preferential tax treatment would likely be highly contentious, the Tax Commission did not make any specific recommendations on retirement taxation in its June report. Instead, they merely provided commentary on some features of the current retirement taxing system which should be further studied for possible changes, which they acknowledge are likely to be controversial. In this regard, the Commission noted two items for future review; (1) the deduction amount currently allowable for more than 20 years of service (ie, 700,000 yen per year), and (2) the 50% retirement

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income exclusion, but primarily with respect to shorter term retirements.

Currently retirement income enjoys preferential tax treatment, even when “retirement” occurs merely as a result of changing employers. Tax on lump-sum payouts of retirement income is calculated by subtracting 400,000 yen per year of service with that employer (increasing to 700,000 yen for each year of service over 20 years) with only 50% of the remainder income being subject to taxation. Furthermore, such income is taxed separately from other income, thereby also benefiting from the lower progressive tax rates. The net effect is that retirement taxation provides an effective tax rate below 25%, even for highly taxed individuals.

In general, the Commission considers that the retirement system is no longer suited to the realities of modern Japan, arguing that with a shift away from lifetime employment to careers where individuals work with multiple employers, it is time to review the way that retirement taxation operates. In-line with this perspective, it appears based on the report and previous comments by individual members of the Commission that any reform of the retirement tax system is likely to draw distinctions between short and long term periods of employment service. Currently, the length of the employment does not affect the application of the favorable 50% retirement income exclusion.

The Commission also made reference to what it considered to be possible tax avoidance by some companies who may be paying a greater share of compensation as retirement income rather than employment income, thereby providing a lower overall taxation to their employees. This situation is evidently a concern to the Commission and presumably will be addressed by them within the context of future reform recommendations.

**“The Bottom Line”**

There is no change to retirement taxation in Japan at the moment, and any future changes are likely to be applied over a period of several years, if done in conjunction with the Commission’s overall recommended timeline for reform implementation.

It seems reasonable, based on the Committee’s comments, to anticipate that any future reform would likely include at a minimum a limitation on the preferential treatment for short-term employment periods (yet to be defined), and also some reduction to the deduction amounts allowed for service periods over 20 years.

While it is possible that retirement tax reform could still be taken-up by the official LDP tax commission before year-end, this would seem unlikely considering the overall sensitivity of the matter and the fact that the advisory Committee intends to further study the issues before providing any specific recommendations. Assuming any legislation is introduced next year in 2006, it may not be until 2007 before such changes become effective, based on past historical legislative practices.

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