

Japan Tax Update

Monthly tax update

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As we all know, the only thing constant is change. And the only way to stay successful is to keep on top of changes - in the economy, the industry, and with regulation.

"Japan Tax Update" seeks to update you on the latest developments in Japanese tax law that affect Japanese and foreign multinationals having operations in Japan. In addition to providing information on Japanese tax issues, the purpose of this newsletter is to make management aware of changes in the regulatory environment that may have an impact on their business.

Included in this issue are the following articles:

1. New Revaluation Loss Accounting Standard to Take Effect Soon
2. Latest High Court Ruling on Stock Option Income
3. Streamlined Taxation of Income from Financial Assets

1. New Revaluation Loss Accounting Standard to Take Effect Soon

A new accounting standard for the impairment of fixed assets will be applicable for fiscal years commencing on or after April 1, 2005. Under the practical guidelines ("Guidelines") for the application of the "Asset-impairment Accounting Standards" issued on October 31, 2003 by the Accounting Standard Board ("ASB"), a company will be required to write-down the carrying value of tangible and intangible fixed assets if certain conditions are satisfied. Under the current accounting standard, it is not mandatory for a company to recognize revaluation losses on fixed assets.

Under current tax laws, a revaluation loss relating to a fixed asset is not deductible for tax purposes (although in limited circumstances, a write-off of the asset may be allowed as a deduction if specified conditions are met). This will not change after the new accounting standard becomes effective.

In the amended Corporate Tax Law Basic Circular ("Tax Circular") on December 16, 2003, it was clarified that the

revaluation loss on the impaired assets would be treated as depreciation expense of assets. Accordingly, the revaluation loss on the impaired assets would be tax deductible subject to the limitation of the statutory depreciation.

However, the application of the new accounting standard could result in situations where the carrying value of an asset for book purposes is different from its carrying value for tax purposes. Although book depreciation should be based on the carrying value for book purposes, the depreciable tax basis of the asset will not be affected by the application of the new accounting standard.

PwC Comments

The new accounting standard could result in increased administration for companies that are required to maintain fixed asset ledgers for both book purposes and tax purposes and make the necessary tax adjustments on their tax returns.

2. Latest High Court Ruling on Stock Option Income

On August 4, 2004, the Tokyo High Court reversed an earlier judgment of the Tokyo Regional Court (issued on November 26, 2002) and held in favor of the National Tax Agency ("NTA") to the effect that stock option income, in the case where the stock options were issued to an individual in connection with their employment and were for shares of a foreign company that was related to their employer (i.e. Japanese subsidiary), should be treated as employment income rather than occasional income.

This is the third ruling this year from the Tokyo High Court that has held in favor of the NTA, thus reversing a prior Tokyo District Court decision that had ruled in favor of the taxpayer.

The first judgment by the Tokyo High Court was issued on February 19, 2004 followed by the second one on February 25, 2004. Both of these judgments have since been appealed by the individual taxpayers to the Supreme Court. Until the Supreme Court has ruled on the matter, thereby providing definitive guidance as to the correct treatment to be adopted, there will therefore remain some uncertainty as to the correct tax treatment of stock option income.

PwC Comments

It is difficult to foresee the Supreme Court reversing the judgments of the Tokyo High Court and ruling in favor of the taxpayers under the circumstances since three different judges have concluded that stock option income should be treated as employment income. Furthermore, penalty tax may be assessed if the income is reported as occasional income in the tax return and the Supreme Court ultimately holds in favor of the NTA. Therefore, taxpayers who filed their tax returns and reported the income as occasional income need to monitor this situation and consider their specific facts and circumstances to determine if they need to file an amended tax return to avoid penalty taxes, if any.

3. Streamlined Taxation of Income from Financial Assets

On June 15, 2004, the Japanese government's Tax Committee released a report outlining a new taxation regime for income derived from financial assets. Under the current tax regime, the taxation of income from financial assets is complex and varies depending upon the financial asset from which the income was derived. According to the report, it is expected that the new tax regime will revitalize the economy by (1) providing more incentives for individuals to invest in financial assets, and (2) improving investment efficiency from a tax perspective. The specific objectives of the new tax regime are simplicity and neutrality; the taxation mechanism is easy to understand for individuals and neutral among financial assets to provide a wider range of selection for investment.

Under the new tax regime, investment income (interest, dividends and capital gains) will be subject to a 20% flat rate of tax separate from other individual income. In addition, losses from one type of investment asset can be offset against income from another type of investment asset. Financial products covered by the new tax regime include stocks, investment trust units and bonds but do not include real estate for

investment purposes, golf club memberships or precious metals. The stock valuation loss (due to company bankruptcy and etc.) is not deductible from investment income under the current tax regime, however, the report proposed that the loss would be deductible and offset against investment income.

Under the new tax regime, income and losses from several financial assets can be offset and should be reported by individuals. In order to ensure the new tax regime can be properly managed, certain tax administration reforms such as the introduction of an individual taxpayers' numbering system (Tax Identification Numbers (TINs)) and the protection of privacy will be critical.

On August 9, 2004, study team of Financial Review Committee (advisory committee of the Prime Minister) further proposed that the flat 20% tax rate should be reduced to 10%. Financial Agency of the government is planning to summarize their final proposal of the above investment income treatment towards 2005.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments about our current issue or ideas for what you'd like to see covered in future issues.

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