

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. Recent Tax Disputes and Changes in The Tax Administration
2. METI Proposes Formation of Japanese Limited Liability Partnership
3. Reform of the R&D Tax Credit Regime

1. Recent Tax Disputes and Changes in The Tax Administration

According to the data released by the Tokyo Regional Tax Bureau ("TRTB"), the number of administrative appeals to the TRTB (including those made to local tax offices under the supervision of the TRTB) by taxpayers during the period from April 1, 2003 to March 31, 2004 ("FY 2004") was 1,596. An administrative appeal (that is the first step of the tax dispute) is made when a taxpayer does not agree with a specific assessment by the tax authorities and asks for a request for reinvestigation of the assessment. Although the total number of appeals made during FY2004 has not yet been released, it is estimated (from past data) that as much as one third of appeals to the tax authorities per year are made to the TRTB.

It should be noted that the number of appeals made to the TRTB during FY2004 dramatically increased from the previous fiscal year. The number of appeals as a whole increased by 29% while income tax increased by 24%, corporate tax increased by 58% and consumption tax increased by 34%.

It is considered that appeals relating to income tax are primarily in relation to stock option income and appeals relating to corporate tax involve several new tax issues that have become targets in recent tax audits.

In the past, major tax issues subject to close scrutiny during the corporate tax audits were entertainment expenses, directors' remuneration and the timing of sales and/or cost recognition. However, due to the increasing awareness by the tax authorities of cross-border transactions involving various entities and financial instruments, and certain business models adopted by foreign-owned subsidiaries, these tax issues have become the focus of recent corporate tax audits. To improve the audit capability of the auditors to deal with these types of transactions adequately, a specialized project team was formed in July of 2002 within each of the Regional Tax Bureaus of Tokyo, Osaka, Nagoya and Kanto-Shinetsu.

PwC Comments

Given the new tax issues being examined during recent tax audits, affected corporate taxpayers may need to assess their potential tax exposure and be prepared for future tax audits. Furthermore, it will be necessary to consider whether it is worth making administrative appeals if an aggressive assessment is issued.

2. METI Proposes Formation of Japanese Limited Liability Partnership

The Ministry of Economy, Trade and Industry ("METI") has proposed the creation of a *Yugen Sekinin Jigyo Kumiai* (Limited Liability Partnerships or "LLPs") as a special form of *Nin-i Kumiai* ("NK") under the Japanese Civil Code. METI intends to submit the relevant legislation to the next regular Diet session, and has also included the creation of LLPs in its proposals for the 2005 tax reform.

From a business law perspective, business entities are classified into two categories; a corporation and a Kumiai (partnership). A corporation includes a Kabushiki-Kaisha, a Yugen-Kaisha, Gomei-Kaisha, Goshi-kaisha, Sougo-kaisha and a Kumiai is either in the form of a TK (Tokumei Kumiai, a silent partnership) or a NK. A Kumiai is afforded pass-through treatment for Japanese income tax purposes, while corporations other than TMK (a special purpose corporation) are not.

A NK is a partnership formed under the Japanese Civil Code and a TK is formed under the Japanese Commercial Code. As noted above, the primary advantage of pass-through taxation is that the profits or losses incurred by the entity are allocated to investors, thereby avoiding the double taxation that occurs at the entity level and investors level that in the case of a corporation. However, as the investors' liability in the NK is unlimited, they must assume all the risks arising from the NK's business. The investors' liability in the TK may be limited to the extent of their investment depending on the agreement. The new LLP structure will be based on NK regulations, but it is proposed that special rules will be put in place to limit the investors' liabilities to the extent of their investment. At present, it is not certain whether the limitation of liability will be applicable to all investors.

A form of LLP known as a "Venture Capital Investment Limited Partnership" ("VCILP") already exists under the Limited Partnership Act for Venture Capital Investment. A VCILP consists of general partners and limited partners and is treated as a pass-through entity for Japanese tax purposes. However, as a VCILP's business activities are limited to investment activities, it has not been widely used so far.

PwC Comments

To the extent that the issue is not resolved under a relevant tax treaty, the introduction of a Japanese LLP and corresponding amendments to the corporation tax law could assist with resolving any doubt as to whether a LLP formed in another country should also be treated as a pass-through entity under Japanese tax law.

3. Reform of the R&D Tax Credit Regime

Japan's long-established R&D tax relief system for large companies was originally designed to incentivize individual companies to keep on increasing their levels of R&D expenditure. In practice, however, this "incremental" approach has meant that comparatively few large companies were able to claim the tax credit, especially in recent years when the Japanese economy has continued to be slow.

As the incremental approach was no longer achieving the desired levels of investment in R&D, the Japanese government has introduced an alternative R&D tax credit system which rewards R&D spend simply in proportion to the amount spent on R&D. The new "proportional" regime was introduced in the FY2003 tax reform, and is running alongside the older incremental regime; taxpayers can choose which system to claim under. Prior to the FY2003 tax reform, the "proportional" regime was applicable only to small and medium-sized corporations (which were not owned by large corporations).

Under the incremental tax credit regime, a tax credit is available if there has been incremental growth in R&D spend (based on the criteria in the tax law). The tax credit would be equal to the lower of 15% of the increase in the R&D spend or 12% of the corporation tax liability.

Under the new proportional tax credit regime, a tax credit is available in direct proportion to the amount spent on R&D. For years beginning from 1 January 2003 until 31 March 2006, the rates of the tax credit are 15% of the R&D spend for small and medium sized companies, and in the range of 10% to 12% for large companies (depending on the overall amount spent on R&D as a ratio of sales). For all companies the maximum tax credit is limited to 20% of the corporate tax liability, although if conditions are met it may be possible to carry forward unused credits to the next business year.

PwC Comments

The new proportional regime is likely to be far more beneficial for most corporations than the existing incremental system, and is leading to increased interest into making R&D relief claims. The Japanese government expects the regime to create the effect of a ¥600 billion annual tax cut and to stimulate companies in Japan to invest an additional ¥1.2 trillion per annum in R&D.

The increased uptake of the tax credit is likely to lead to increased vigilance by the Japanese National Tax Authority ("NTA"). R&D tax credit claims under the incremental system were comparatively infrequent and usually did not involve substantial amounts, and as a consequence were rarely challenged. Since the introduction of the new regime, however, the NTA has issued a several bulletins providing guidance on matters such as the definition of R&D expenditure for tax purposes, qualifying costs and the calculation of the tax credit. The first claims under the new proportional system (e.g. for years ending 31 December 2003) are now beginning to be subjected to tax audits and claimants can expect increased scrutiny by the NTA. Supporting documentation will be the key for companies making successful claims.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the October 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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