

Japan Tax Update

Monthly tax update



March 18, 2005 Issue 8

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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.

The "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. **Supreme Court Decision on stock options: classification as salary income**
2. **Size-based taxation: applicability for Japan branch of foreign corporations**
3. **Proposed 2005 tax reform – effects on leverage lease**
4. **Social Security Agreement with Korea, France and Belgium**

1. Supreme Court Decision on stock options: classification as salary income

On January 25, 2005, in a case involving the issue of stock options by a US corporation to a director of its Japanese subsidiary, the Supreme Court held that profits arising from the exercise of such options should be classified as employment income rather than occasional income for individual income tax purposes. The decision follows a number of lower court decisions on similar cases which in some cases were contrary to the Supreme Court decision.

PwC Comment

As occasional income is taxed on a concessional basis, the Supreme Court's decision represents a blow for taxpayers and has a significant impact on the more than 100 pending lower court cases on the same issue. Although the facts of these cases vary, it can be expected that the Supreme Court decision will be used as the ultimate authority for the appropriate

individual income tax treatment of foreign stock option plan profits.

During the time that this issue was being litigated in the lower courts, PwC recommended that the income from stock options be treated as salary income. Therefore, this Supreme Court decision should not impact those tax returns filed in the prior years reporting salary income in accordance with this advice. However, to the extent that original tax returns have been filed treating the income as occasional income, action may need to be taken.

2. Size-based taxation: applicability for Japan branch of foreign corporations

The size-based taxation system for calculating corporation enterprise tax for a corporation with paid-in capital of more than Yen 100 million was introduced for fiscal years commencing on or after April 1, 2004. In relation to a Japanese branch of a foreign corporation, the applicability of the new system is determined by converting the paid-in capital of the foreign corporation to Yen at the end of the fiscal year. The amount of capital remitted to Japan or allocated to the Japanese branch is not relevant for determining the applicability of the new system.

The tax base of capital basis for a Japan branch of a foreign corporation is the total amount of paid-in capital and capital reserve appropriated to the Japan branch based on the head count.

PwC Comment

In the case of a branch that is incurring losses, the size-based taxation system may still result in an enterprise tax liability. In order to avoid this, one alternative may be for the foreign corporation to transfer the business of its Japanese branch to a corporation with paid-in capital of Yen 100 million or less.

3. Proposed 2005 tax reform – effects on leverage lease

Under the proposed 2005 tax reform, loss restriction rules will be introduced for passive individual partners (who is not involved in the business operation of the partnership business) of a NK or passive corporate partners of a NK or TK type partnership (for further details see January/February Tax Update).

PwC Comment

It is assumed that the loss restriction rules will also apply to leveraged lease transactions involving the leasing of real properties including aircraft and ships. Since the draft bill for the proposed introduction of a Limited Liability Partnership (LLP) as previously announced by the Ministry of Economy, Trade and Industry provides for certain restriction rules for the investment loss from the real properties, we believe that the LLP may not be suitable for the tax driven real estate investment vehicle.

4. Social Security Agreement with Korea, France and Belgium

The Social Security Agreement between Japan and Korea will become effective as of April 1, 2005, as the formal ratification procedures by both countries have now been completed. The Agreement provides for the elimination of double social security taxation and allows for the combination of the work coverage periods under both the Japanese and Korean systems in determining eligibility for pensions. For example, under the new agreement, a Japanese employee assigned by his/her Japanese employer to work temporarily (in principle up to 5 years) at its Korean affiliate will remain subject to the Japanese social security system and exempt from paying Korean social security taxes.

In an effort to expand its Agreement network, Japan has also signed social security agreements with France and Belgium in February 2005. The Agreements with Belgium and France will become effective after the

respective governments have ratified the Agreements.

Following ratification of the agreements with Belgium and France, Japan will have social security agreements in place with six countries, namely Germany, the UK, US, Korea, Belgium and France. Although the agreement with the U.S. was signed in February 2004 and ratified by Japan, ratification procedures are yet to be completed by the US Congress.

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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