

Japan Tax Update

Monthly tax update



August 2005, Issue 12

PricewaterhouseCoopers Tax (Zeirishi-Hojin ChuoAoyama) is the largest professional tax corporation in Japan with more than 300 staff. PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services for public and private clients. More than 120,000 people in 144 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

This Update is provided for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, or professional consulting of any kind. Before making any decision or taking any action, you should consult a professional adviser who has been provided with all pertinent facts relevant to your particular situation.

PricewaterhouseCoopers
Kasumigaseki Bldg., 15F
2-5 Kasumigaseki 3-chome
Chiyoda-ku, Tokyo 100-6015
Telephone: 03-5251-2400
<http://www.pwc.com/jp/tax>

© 2005 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Included in this issue are the following articles:

1. **Japanese Corporate Law Promulgated on July 26, 2005**
2. **Transfer Pricing Update**
3. **Individual Income Tax Changes**

1. **Japanese Corporate Law Promulgated on July 26, 2005**

On July 26, 2005, both the Corporate Law and the Law Concerning Coordination, Etc. of Related Laws in Connection with the Enforcement of the Corporate Law (the "Coordination Law") were promulgated. Both laws will generally take effect around April 2006, but certain provisions, including those related to corporate reorganizations have later effective dates.

At present, all provisions relating to corporate governance are prescribed in Section 2 of the Japanese Commercial Code. The Yugen Kaisha Law (the "YK Law") and the Special Measurement Law Concerning the Audit of Kabushiki Kaisha (the "Special Measurement Law") will be repealed when the Corporate Law and the Coordination Law take effect.

Among those changes of particular interest are changes to the share capitalization requirements, rules for corporate mergers and reorganizations, and the creation of a new form of Japanese limited liability company called a "Godo Kaisha". Since the new rules for corporate mergers and reorganizations are supposed to have a significant effect on foreign acquirers who will invest in Japan, these provisions will take effect one year after the enactment of the Corporate Law.

Japan Branches

Article 821, which seemingly restricts foreign corporations from doing business solely in Japan, is a very controversial provision. Prior to its promulgation, Article 821 was subject to an intense lobbying effort by those who sought to highlight to the Diet Members the consequences of this provision to foreign

investors in Japan and to encourage the Diet Members to limit the scope of the new provisions to prevent unintended consequences. As a result of these efforts, the upper house of the Diet indicated that Article 821 was not intended to affect the business activities of existing as well as future foreign corporations in Japan. Accordingly, it attached a rider to the legislation that suggested that the Corporation Law should not generally require most foreign corporations to restructure their Japan branch businesses. Although the rider was passed only by one house, and there remains questions as to how the rider and law will be interpreted, commentators think that existing corporations with branches may continue in their present form. The impact on newly formed branches is unclear.

The rider further suggests that the legislation may be revised as necessary, prior to its effective date.

Repeal of the Yugen Kaisha Law

Pursuant to Article 1 of the Coordination Law, the Yugen Kaisha Law will be repealed in connection with the enactment of the Corporation Law. YKs that exist at the time that the Coordination Law becomes effective will automatically be converted to Special YKs, though the legal form is a Kabushiki Kaisha with the characteristics of a YK. This will raise technical uncertainties for U.S. and foreign corporations that have made elections under the U.S. check-the-box regulations to treat their Yugen Kaisha corporations as disregarded entities or partnerships for U.S. tax purposes. Commentators have expressed concerns that the post-enactment status of Special Yugen Kaishas for U.S. tax purposes will change from eligible entities to per se entities under the U.S. entity classification regulations, since the Special YK that continues post-enactment will be dealt with exclusively under the articles of the new Corporation Law that apply to the per se ineligible Kabushiki Kaisha corporations.

Note that we believe that a conversion of a YK to a Special YK will not trigger a taxable event for Japanese tax purposes.

Godo Kaisha

The new law creates a new juridical limited liability company in Japan, the Godo Kaisha. The tax character of this entity – as tax transparent or taxable entity – has not yet been determined.

2. Transfer Pricing Update

The Japanese National Tax Agency (NTA) issued partially revised Transfer Pricing Administrative Guidelines (Guidelines) relating to transfer pricing on June 14, 2005.

Below is a summary of several items that are covered by the new Guidelines.

First, the Guidelines provide a change in the administrative procedures by covering Japanese companies that are members of a consolidated tax group.

Additionally, the following paragraphs were added to Section 3. "Points to Note in Calculating Arm's Length Prices":

- If there is more than one comparable transaction that has the same level of comparability, the average of those transactions can be used as the arm's length price/profitability.
- Under the TNMM, indirect SG&A expenses should be reasonably allocated between related party transactions and other transactions (if any) taking into consideration both the contents of the transactions and the nature of such expenses, using factors such as sales, cost of sales, value of assets, and head-count.

The Guidelines also provide information regarding the Terms of Advanced Pricing Agreements (APA). Previously, the Term of an APA was for three years in principle, but the taxpayer was allowed to propose a different Term in its APA request. As a result, taxpayers typically filed an APA request with Terms of up to

five years being proposed. Such five year Terms were generally accepted by the NTA. The Guidelines formalize this prior practice and state that the Term of an APA can be between three to five years.

The Guidelines also change the rules relating to the filing of an APA request. Previously, a taxpayer was required to file the APA request by the date prescribed by law for filing its final corporate tax return for the first business year to be covered by the APA. Under the Guidelines, in the case of a renewal of an APA, a taxpayer must file the APA request before the beginning of the first year that will be covered by the APA. Since this change may affect many taxpayers, the NTA has provided a transition rule. Under the transition rule, for APA requests whose first year of renewal begins prior to April 2006, the prior rules regarding APA requests will apply. Note this transition rule is not explicitly stated in the Guidelines.

3. Individual Income Tax Changes

The Japanese Tax Commission, an independent government advisory body consisting of members from the business and academic areas, issued its report on recommended individual income tax changes.

While the report contained several specific individual tax recommendations, it did not provide any specific reform proposals with respect to retirement income taxation. Currently, retirement income is taxed preferentially: the tax on lump sum payments of retirement income is calculated after subtracting a fixed amount per year (the amount varies depending on the number of years of service) with only 50% of the balance being subject to tax. The Tax Commission indicated that the deduction permitted in calculating the retirement income for more than 20 years of service (currently JPY700,000 per year) and the 50% retirement income exclusion should be reviewed for possible changes in the future.

The reason for such proposals is that the Tax Commission does not consider the retirement system to be suited to the current environment, as a result of the shift from lifetime employment to people working for many employers. It appears that any reform of the retirement tax system is likely to draw a distinction between short term and long periods of employment service.

The Tax Commission also raised a concern about the potential abuse of the retirement income system as some companies may be paying a larger amount of compensation in the form of retirement payments rather than employment income such that its employees are paying less overall tax.

It does not seem likely that the government will review this issue prior to the end of this year due to the sensitivity of this matter and the Tax Commission's desire to review the issues in more detail before arriving at a recommendation.

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 or ideas for what you'd like to see covered in future issues.

If you have any questions, please contact:

Takuro Tagai	03-5251-2413	takuro.tagai@jp.pwc.com
Alfred Zencak	03-5251-2431	alfred.zencak@jp.pwc.com
Ken Leong	03-5251-2945	ken.leong@jp.pwc.com
Yumiko Arai	03-5251-2475	yumiko.arai@jp.pwc.com