

Newsalert

International Tax Services

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Japan

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PwC International Tax Services Network

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U.S. Asia Pacific Tax Group

The Asia Pacific Tax Group ("APTG") prepared this news alert. The APTG is part of PwC International Tax Services in the U.S. The group includes people from overseas offices of PwC – giving it a powerful knowledge base to solve Asia Pacific tax issues and optimize global tax rates. If you would like to contact a member of APTG please speak to Maria Torres at (646) 471 0801.

For issues relating to this news alert please contact your local international tax services advisor or the specialists listed at the end of this article.

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Japan's Ruling Parties Unveil 2006 Tax Reform Legislation Proposals

On December 15, 2005, Japan's ruling parties announced the proposed legislative outline for the 2006 Japanese tax reforms. These proposals are intended to boost tax revenues by fully or partially repealing various tax incentives including the special tax cuts for individual income taxation, IT spending tax credits, the temporary reduction of property registration tax rates, etc. The proposal outlines will be reviewed and discussed at the Japanese Diet in the early part of 2006, and are expected to be enacted by the end of March 2006 and effective generally from April 1, 2006. The proposal includes the following items of interest to U.S. groups:

Thin Capitalization Rules

Under the proposals, Japan's thin capitalization rules would be amended to include loans with related party guarantees and pledges, etc., within the scope of related party borrowings. When the new rules are considered to apply, any fees payable to related parties for providing related party guarantees and pledges, etc., as well as the applicable interest expense on the deemed related party borrowing will be treated as a permanent non-deductible expense.

The new rules would apply to fiscal years commencing on or after April 1, 2006 (i.e., to calendar year 2007 for calendar year taxpayers). The proposals would also apply to certain cross-border financing transactions involving related parties, including certain cross-border repurchase ("repo") transactions. For example, the proposals would apply to cross-border related party repo transactions entered into to hedge a Japanese company's domestic unrelated party repo obligations, although in these cases the statutory safe harbor would be reduced to 2 to 1 from the normal ratio of 3 to 1. This would apply to fiscal years ending on or after April 1, 2006.

These changes will require many U.S. groups to review the capital structure of their Japanese subsidiaries, and to review the implications of their cross-border financing transactions.

New 10-Year Period Applies For Non-Permanent Resident Definition

Non-permanent residents are subject to Japanese income tax only on the total of Japan source income and the offshore income remitted to the total of Japan source income and the offshore income remitted to Japan. Permanent residents are subject to Japanese income tax on worldwide income.

The new proposals change the definition of non-permanent residents. Non-permanent residents are only those individuals who do not have Japanese nationality and who, in total, have lived in Japan for 5 years or less over the previous 10 years. Thus, under the new definition, an individual who completes a first assignment to Japan shorter than 5 years, but who subsequently returns to Japan for a second assignment, may well become a permanent resident of Japan in the second assignment if the combined Japanese residency period exceeds 5 years within a total period of 10 years. This new definition would become effective April 1, 2006.

Alignment with New Corporation Law

The proposals revise various tax definitions and concepts for consistency with the provisions of the Japanese Corporation Law, enacted June 29, 2005, expected to become effective in May 2006. There are no specific proposals regarding the Japanese tax treatment of the new Godo Kaisha entity, which suggests that this new LLC-type entity will likely be treated as a corporation for Japanese tax purposes.

Other Provisions under the Proposals

- Repeal of Certain Tax Incentives: Certain tax incentives, including individual special tax cuts and IT spending tax credits will be repealed.
- Registration Tax: The registration tax rates for most transfers of real property will increase from April 1, 2006, but the 1% concessionary registration tax rate for land sales will continue until March 31, 2008.
- Real Property Acquisition Tax: The tax rate for commercial building acquisitions will go up to 3.5%.
- Non-filing Penalty: The maximum penalty tax rate for non-filing will increase from 15% to 20% for tax returns due on or after January 1, 2007.
- Share Swap, "*Kabushiki-Iten /Kabushiki-Koukan*": The tax free reorganization rules will be extended to include these two types of tax free share swap transactions, which were subject to a separate statutory regime. The new harmonized rule will apply from October 1, 2006.
- Rules Limiting Deductibility of Directors Remuneration: The new provisions relax the limitations on deductibility of certain forms of director compensation.
- New Anti-Tax Avoidance Rules for Acquiring a Company with NOLs: Use of NOLs following the purchase of a loss company may be restricted.

For more detailed information, please do not hesitate to contact

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