

Japan Tax Update

Monthly tax update



August 2006, Issue 22

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

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Included in this issue are the following articles:

1. **Update on Japanese consumption tax discussions**
2. **Tax Treaty update**
3. **Transfer pricing update**

1. Update on Japanese consumption tax discussions

The Japanese government’s tax panel recommended an overhaul to the nation’s tax system in three stages. The panel recommended that the first stage of the tax reform process be a corporate tax cut in 2007. This would be followed by a review of the overall tax system in 2008. The third and final stage recommended by the tax panel is a proposed consumption tax increase of three percentage points that would be introduced in fiscal 2009 at the earliest to offset expenses associated with pensions and healthcare.

It is expected that the possible increase in the consumption tax will be a key issue in the upcoming LDP presidential elections in September 2006 as candidates take different approaches to the potential increase in consumption tax. One view is to increase the consumption tax rate to at least 10% while another view is to wait and review the government’s spending to determine whether additional revenue can be obtained via spending cuts.

2. Treaty Update

a. Japan and India Treaty

On February 24, 2006, Japan and India signed a Protocol that amended the current income tax treaty that was signed on March 7, 1989. Both governments exchanged diplomatic notes on May 29, 2006 and the Protocol and will now enter into force on June 28, 2006.

The primary changes are the elimination of the tax sparing credit system and a reduction in the withholding tax rate for dividends, interest, and royalties or fees for technical services.

A summary of the primary changes to withholding taxes is as follows:

Type of income	Old Treaty	New Treaty
Dividends (Article 10)	15%	10%
Interest (Article 11)	10% (in the case of banks) 15% (all others)	10%
Royalties or fees for technical services (Article 12)	20%	10%

The Protocol will be applicable is as follows:

Japan

- For taxes withheld at source - amounts taxable on or after July 1, 2006.
- For taxes on income which are not withheld at source, on income for any taxable year beginning on or after January 1, 2007.

India

- For taxes withheld at source - amounts paid or credited on or after April 1, 2007.
- For taxes on income for any taxable year beginning on or after April 1, 2007.

b. Other Treaty developments

According to a press release by the Ministry of Finance on July 18, 2006, Japan and the Philippines agreed to conclude a Protocol to revise the current income tax treaty that was signed in 1980. The purpose for the revision to the treaty is to increase investment between both countries. Both sides have agreed to reduce withholding tax rates on dividends, interest, and royalties, but the revised rates have not been determined.

According to a press release by the Ministry of Finance on July 18, 2006, Japan and France agreed to revise their 1995 income tax treaty. It is expected that the revised treaty will reduce the withholding tax rates on dividends and interest and eliminate the withholding tax on royalty payments. The revised treaty is expected to take effect in 2008.

3. Transfer pricing update

On March 20, 2006, the National Tax Agency of Japan ("NTA") released additional provisions to the Commissioner's Directive on the Operation of Transfer Pricing, originally issued June 1, 2001 ("the 2001 Directive"). As the purpose of the 2001 Directive is to provide guidance to auditors when conducting transfer pricing examinations, the release of new provisions may be seen as an indication of issues currently under focus by the NTA. For example, the release of provisions relating to intra-group services on June 20, 2002 coincided with more detailed scrutiny of that category of related party transaction.

The latest provisions deal with intangible properties and cost contribution arrangements.

Intangible Properties

It should be clarified that the new provisions are not an amendment to the transfer pricing law, nor an extension to the definition of intangible properties under the corporate tax law. Moreover, although the 2001 Directive generally provides guidance to the examiners (as noted above), these particular provisions appear to be a clarification of the current audit practice of the examiners rather than guidance for a change in policy going forward.

Specifically, the provisions state:

- (1) When evaluating the contribution of intangible assets to generation of income earned by the taxpayer or its foreign related party, take into account not only intangible assets created in traditional ways (such as patents and trade secrets), but also those created through employees' knowledge and abilities; or those created through systems, such as processes or networks.
- (2) Not only legal ownership, but also contribution to the creation, maintenance or development of an intangible asset should be taken into account when evaluating licensing transactions. Moreover, the contribution of a party that only bears costs (for creation, maintenance or development) of an asset is likely to be low in comparison to the contribution of a party that makes decisions, provides services, or manages risks in relation to that asset.
- (3) Where no royalty is paid for the use of an intangible asset, the examiners may deem a royalty to be payable.

Cost Contribution Arrangements

In contrast to the provisions for intangible properties, the new provisions relating to Cost Contribution Arrangements (CCA) should be seen as clear guidance to the examiners. This arises from the fact that there have been fewer audits of CCA in Japan and therefore less practical experience, as well as the need to provide guidance in light of the proposed IRS provisions in this area.

Specifically, the CCA provisions clarify:

- (1) That CCA are agreements between parties to bear the costs of developing a particular intangible asset based on the ratio of anticipated income generated or costs saved as a result of creation of that asset. [It is important to note that, despite OECD commentary to the contrary, the provisions deal specifically with CCA for creation of intangible properties only.]
- (2) That CCA between a taxpayer and its foreign related parties are a transfer pricing issue, and therefore must be conducted on an arm's length basis.
- (3) The factors that should be taken into consideration by the examiners when reviewing a CCA, including scope of activities; how benefits accruing will be received (directly or indirectly); allocation of relevant costs; and the calculation of buy in or exit payments from the CCA.
- (4) That consideration should also be given to whether the owner of pre-existing intangible properties should be remunerated by the other participants to the CCA, and if so, whether the remuneration was at arm's length or not.
- (5) The documents that may be inspected at the time of examination of a CCA.

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:

Jack Bird	813-5251-2577	jack.bird@jp.pwc.com
Alfred Zencak	813-5251-2431	alfred.zencak@jp.pwc.com
Ken Leong	813-5251-2945	ken.leong@jp.pwc.com
Takuro Tagai	813-5251-2413	takuro.tagai@jp.pwc.com
Yumiko Arai	813-5251-2475	yumiko.arai@jp.pwc.com