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# Japan I

## 2009 Tax Reform

2009 tax reform bill (Bill of amendment of Income tax law and other) has been passed into law in the diet on March 27, 2009, and it is effective on April 1, 2009 unless expressly stated otherwise. Under this tax reform, land and building tax system, corporation tax system, small and medium sized enterprises' (SME's) tax system, inheritance tax system, finance and securities tax system and international tax system have been amended from the perspective of providing a safe and vibrant society based on the present economic situation. In this article, we will introduce the main points of the tax reform and future tax reform plan and the directions described in the supplementary

provision of the bill.

### 1. Corporation tax system

#### (1) Introduction of instant depreciation of the acquisition cost of facilities, etc. for promoting reform of energy demand-and-supply structure.

When a corporation acquires the facilities, etc. for promoting reform of energy demand-and supply structure in the period from April 1, 2009 to March 31, 2011, the corporation can deduct all of the acquisition cost in the accounting period including the day on which the assets are in use for

### <Summary of tax credit for residential mortgages>

#### Standard housing

Year of inhabitation	Creditable period	Maximum Qualified amount of outstanding loan	Amount of tax credit %	Maximum tax credit amount per year	Maximum accumulated tax credit amount (10 years accumulation)
2009	10years	JPY 50 million	1.0%	JPY500,000	JPY 5 million
2010	10years	JPY 50 million	1.0%	JPY500,000	JPY 5 million
2011	10years	JPY 40 million	1.0%	JPY400,000	JPY 4 million
2012	10years	JPY 30 million	1.0%	JPY300,000	JPY 3 million
2013	10years	JPY 20 million	1.0%	JPY200,000	JPY 2 million

#### Qualified long-term high quality housing (so called "200 years residence")

Year of inhabitation	Creditable period	Maximum Qualified amount of outstanding loan	Amount of tax credit %	Maximum tax credit amount per year	Maximum accumulated tax credit amount (10 years accumulation)
2009	10years	JPY 50 million	1.2%	JPY600,000	JPY 6 million
2010	10years	JPY 50 million	1.2%	JPY600,000	JPY 6 million
2011	10years	JPY 50 million	1.2%	JPY600,000	JPY 6 million
2012	10years	JPY 40 million	1.0%	JPY400,000	JPY 4 million
2013	10years	JPY 30 million	1.0%	JPY300,000	JPY 3 million

business. These assets include photovoltaic facility, natural gas vehicle and super-insulated window, etc.

## **(2) Introduction of tax incentive on improvement of resource utilization**

When a corporation obtains equipments to improve the resource utilization or production equipments for high energy-saving home electric appliances based on certain authorized plan by March 31, 2009, the corporation can deduct all of the acquisition cost in the accounting period including the day on which the assets are in use for business.

## **2. Land and building tax system**

### **(1) Extension and/or expansion of tax credit for residential mortgage**

Application period of individual tax credit for residential mortgage is extended for 5 years, and the maximum credit amount for 10 years is raised to JPY 5 million. If the Japanese resident is qualified for long-term high quality housing (so called "200 years residence"), the maximum credit amount for 10 years would be JPY 6 million. In addition to above, individual residence tax credit system of the excess credit amount from individual tax was also introduced.

### **(2) Introduction of tax credit for acquisition of qualified long-term housing**

When the Japanese resident acquires qualified long-term housing (so called "200 years residence") and is used for residential purpose for the period between June 4, 2009 and December 31, 2011, a 10% of standard performance-enhanced costs for long-term housing is credited from the income tax for the year with limit of JPY 1 million.

### **(3) Introduction of special tax credit for improvement of an existing residence**

When the Japanese resident makes additional energy-saving and/or barrier-free improvement on an existing residence between April 1, 2009 and December 31, 2010, 10% of the actual cost or

standardized construction cost, whichever is less, would be credited from the income tax for the year with limit of JPY 200,000 (for photovoltaic power generation the limit would be increased to JPY 300,000).

### **(4) Introduction of special deduction for long-term capital gain on land**

When an individual or a corporation sells land possessed for a period of more than 5 years that is acquired between 2009 and 2010, a special deduction of JPY 10 million would be allowed for the capital gain.

### **(5) Introduction of deferral of tax on capital gain from sale of land by reduction of tax basis of land acquired between January 1, 2009 and December 31, 2010.**

When an individual business enterprise or corporate taxpayer acquires land (Land A) in Japan between January 1, 2009 and December 31, 2010 and files a tax report to apply the special tax deferral of capital gain by the filing due date of the tax return in the year of acquisition and sell another piece of land (Land B) within 10 years after the end of the fiscal year in which Land A has been acquired, 80% of the capital gain derived from the sale of Land B can be deferred by reducing the tax basis of Land A (compressed value entry) by the same amount (60% if the land is acquired during the period from January 1, 2010 to December 31, 2010).

### **(6) Suspension of tax rates increase for registration tax**

Although relieved registration tax rate of land sale or entrustment of land is planned to increase gradually from April 1, 2009, the application period for the relieved rate is extended for 2 years and the registration tax would increase gradually from April 1, 2011.

The application period for the relieved registration tax rate for residential building sales is also extended by 2 years.

### **3. Finance and Securities tax system**

#### **(1) Extension of the application period for the reduced withholding tax rate on dividend or capital gain on listed stocks**

The application period for the reduced tax rate on dividend or capital gain on listed stocks for Japanese residents (income tax 7%, individual residence tax 3%) is extended until December 31, 2011. In addition, the application period for the reduced withholding tax rate (WHT rate 7%) on dividend on listed stocks is also extended until December 31, 2011 for non-Japanese residents with no PE in Japan, Japanese companies, and foreign companies.

### **4. International tax system**

#### **(1) Introduction of foreign dividend exemption**

95% of a dividend received by a corporation in Japan from a foreign subsidiary (foreign subsidiary means that the corporation in Japan holds at least 25% of the outstanding shares for a continuous period of six months or more ending on the date on which the dividend is declared) can be excluded from the corporation's taxable income.

Due to the introduction of this exemption system, indirect foreign tax credit system would be terminated with interim rules for transition period.

### **5. Small and Medium sized Enterprises tax system**

#### **(1) Tax rate relief**

A small and medium sized Enterprise (SME) is eligible for reduced tax rate of 22% on its first JPY 8 million of taxable income, and the tax rate would be reduced to 18% for fiscal years ending from April 1, 2009 to March 31, 2011.

#### **(2) Tax loss carry-back for SME**

Tax loss carry back system which has been suspended except for certain companies becomes available for SME for tax losses recognized by a SME for fiscal years ending on or after February 1, 2009.

### **6. Inheritance tax system**

#### **(1) Introduction of Smooth succession for SMEs tax system**

##### **1) Deferral of inheritance tax payment**

If the heir as the business successor inherits the unlisted shares from the deceased and continues to manage the company, 80 percent of total value of SME shares inherited of up to 2/3 of the total voting shares outstanding in SME would be temporarily excluded from the inheritance tax base and it becomes permanently exempted upon death of the heir as business successor of the SME, subject to certain conditions.

##### **2) Deferral of gift tax payment**

If the potential heir recipient as business successor who receives unlisted shares from current owner and the potential heir continue to manage the company, all of the gift tax amount corresponding to the gift of unlisted shares of the company would be deferred under certain conditions. However, if the recipient's total shareholding of the company exceeds 2/3 of the company's total issued shares; the deferral tax amount would be the tax amount on the difference between 2/3 of the total issued shares and the shares which the recipient held prior to the gift.

When the giver passes away, the gifted shares which were deferred for gift tax would be treated as taxable asset of the inheritance and compute inheritance tax; however, the inheritance tax amount corresponding to the shares would be suspended (under the tax deferral is calculated similar to the inheritance tax deferral system described in 1).

#### **(2) Revision of deferral of inheritance tax payment on farm land**

Some conditions to apply the deferral of inheritance tax payment on farm land are revised.

## 7. Other

### (1) Tax rate relief on automobile tonnage tax

Automobile tonnage tax is levied when automobile owners receive regulatory automobile inspection. For certain qualified automobile with clean emission gas and/or with good fuel consumption, the automobile tonnage tax would be exempted for the first regulatory automobile inspection which would be held between fiscal year of 2009 and 2011.

### (2) Tax rate relief on automobile acquisition tax

Automobile acquisition tax on qualified automobile with certain clean emission gas and/or with good fuel consumption purchased between fiscal year of 2009 and 2011 would be applicable for the tax rate relief.

## 8. Steps of drastic tax system restructuring and its basic directionality

In the supplementary provision of 2009 tax reform bill, execution of drastic tax system restructuring including consumption tax system by fiscal year 2011, considering the status of economic recovery or the status of global economy is defined. Main points of the tax system restructuring are described as follows.

(1) Revising various tax deductions and the tax rate structure for individual tax by revising the maximum tax rate and employment income deduction, increase the tax rates of upper-income earner, and reduce the tax rates for middle and low income earner (including

assessment of tax deduction with cash incentives).

(2) For corporation tax, the expansion of tax base and reduction of tax rate to be in consistent with global trend and enhance international competitiveness for Japanese corporation.

(3) For consumption tax area, studying appropriate tax rate under the prerequisite condition that full amount of consumption tax income would be used for security benefit payment and as a counter measure to the birthrate decline. In addition, analyze the introduction of multiple tax rates for considering the low-income earner.

(4) As of automobile related tax area, consider to simplify the tax scheme and tax relief by revising temporary high tax rate.

(5) As of property related tax area, by revising taxable income and tax rate scheme of inheritance tax, study appropriate tax incidence.

(6) As of local tax area, by studying of enriching local consumption tax and revising local corporate related tax, advance the local tax structure with less uneven tax sources and stable tax revenue.

(7) Driving green taxation plan

(8) Preparation for introduction of taxpayer identification number system to improve convenience of tax payer and adequate taxation.

## Asia I

### New Transfer Pricing Guideline in China and its Implications for Japanese MNEs

On January 9, 2009, the State Administration of Taxation in China (“SAT”) formally approved a

circular entitled Guo Shui Fa [2009] No.2 “ Implementation Measures for Special Tax

Adjustments (Trial Version)” (“New Guideline”). The New Guideline is an enforcement guideline for administration of the new “Corporate Income Tax Law of the People’s Republic of China” (“CIT Law”) and related regulations concerning implementation. From a technical perspective, the New Guideline lays out detailed rules for the disclosure of information about related party transactions and contemporaneous documentation. From the tax authorities’ perspective, it develops infrastructure for the enforcement of China’s transfer pricing taxation system. However, from the taxpayers’ perspective, it significantly increases the compliance requirements with transfer pricing laws and regulations.

In this article we provide an overview of the transfer pricing regulations contained in the New Guideline. We also consider the implications of the New Guideline for Japanese multinational enterprises (MNEs) with related parties in China, and suggest some measures those MNEs may use to manage the additional compliance requirements introduced by the New Guidelines.

## 1. Overview of the New Guideline

The New Guideline contains 13 chapters with a total of 118 articles providing comprehensive regulations for transfer pricing, advance pricing arrangements (“APAs”), cost sharing agreements, controlled foreign corporations, thin capitalization, general anti-avoidance rules, etc.

- Chapter 1. General Provisions (Articles 1-8)
- Chapter 2. Reporting of Related Party Transactions (Articles 9-12)
- Chapter 3. Administration of Contemporaneous Documentation (Articles 13-20)
- Chapter 4. Transfer Pricing Methods (Articles 21-27)
- Chapter 5. Transfer Pricing Investigations and Adjustments (Articles 28-45)
- Chapter 6. Administration of Advance Pricing Arrangements (Articles 46-63)

- Chapter 7. Cost Sharing Agreements (Articles 64-75)
- Chapter 8. Administration of Controlled Foreign Corporations (Articles 76-84)
- Chapter 9. Administration of Thin Capitalization (Articles 85-91)
- Chapter 10. Administration of General Anti-Avoidance (Articles 92-97)
- Chapter 11. Corresponding Adjustments and International Consultations (Articles 98-104)
- Chapter 12. Legal Obligations (Articles 105-109)
- Chapter 13. Supplementary Provisions (Articles 110-118)

Chapters 2 to 6 in the New Guideline contain regulations directly related to transfer pricing. Chapter 2 “Reporting of Related Party Transactions” (Articles 9-12) requires the disclosure of information regarding related party transactions, while Chapter 3 “Administration of Contemporaneous Documentation ” (Articles 13-20) establishes contemporaneous transfer pricing documentation requirements as part of the enhancement of the transfer pricing compliance framework. A brief overview of Chapters 2 and 3 is provided below.

## 2. Chapter 2 - Disclosure of Information about Related Party Transactions

Article 43 of the CIT Law states that “when a company files its annual CIT Law return with the tax authority, it must also submit reports about its related party transactions for the year”<sup>1</sup>. To that end, Article 11 of the New Guideline provides that a resident taxpayer should submit the “People’s Republic of China Enterprise Annual Reporting Forms for Related Party Transactions” along with its annual CIT return. In other words, all taxpayers are required to disclose information regarding their related party transactions by attaching the relevant reporting forms to their annual CIT Law return. Prior to issuing the New Guideline, the SAT approved and distributed a circular entitled Guo Shui Fa [2008] No.114 in December 2008

<sup>1</sup> Under Article 54 of the CIT law, taxpayers shall submit to the tax authorities their annual declaration of corporate income tax within 5 months after year end.

(“Circular No. 114”), which sets out the annual reporting forms. Circular No.114 prescribes 9 forms for information disclosure regarding related party transactions, as follows:

Form 1 “Related party relationships”
Form 2 “Related party transactions”
Form 3 “Purchases and sales”
Form 4 “Services”
Form 5 “Intangible assets”
Form 6 “Fixed assets”
Form 7 “Financing”
Form 8 “Outbound investment status”
Form 9 “Outbound payments status”

At the time of filing a tax return under the Japanese transfer pricing legislation, a taxpayer engaged in transactions with overseas related parties must attach a form entitled “Detailed

statements of transactions with overseas related parties”, Schedule 17(3) to the corporate income tax return. However, a comparison of the information to be disclosed under both the Japanese and Chinese transfer pricing regulations shows that the New Guideline requires disclosure of far more information than under the Japanese Schedule 17(3).

Taxpayers should pay careful attention when completing the Chinese disclosure forms since Form 2 “Related party transactions” contains a space to confirm if the taxpayer has prepared contemporaneous documentation. In addition, the transfer Pricing methods selected for each related party transaction must be declared on Form 3 “Purchase and sales” and Form 4 “Services”. This provides the Chinese tax authorities with more information than ever to assist in selecting companies to target for audit. Consequently,

(1) Organization structure	<ol style="list-style-type: none"> <li>1. Relevant organizational structure and ownership structure of the group of companies to which the enterprise belongs;</li> <li>2. Description of the changes in the relationship between the enterprise and its related parties in the tax year;</li> <li>3. Description of the related parties with whom the enterprise has transactions, including the name, legal representative, composition of high level management such as directors and managers, registered address and address of business operations of related parties; the name, nationality, country of residence, and composition of family members of related individuals; and identification of related parties with direct influence over the pricing of related party transactions of the enterprise; and</li> <li>4. Description of the types of relevant income tax, applicable tax rates and the applicable preferential tax treatments of each related party.</li> </ol>
(2) Description of business operations	<ol style="list-style-type: none"> <li>1. Business overview of the enterprise, including a summary of the enterprise’s development and changes, a summary of the industry in which the enterprise operates and development of that industry, major economic and legal issues affecting the enterprise and the relevant industry such as business strategy, industrial policy, and restrictions facing the industry, etc., industry channel of the group, and the enterprise’s position within the industry channel;</li> <li>2. Composition of the principal business operations of the enterprise, revenue from principal business operations and its proportion of total revenues, profit from principal business operations and its proportion of total profits;</li> <li>3. Analysis of the enterprise’s market position and relevant competitive environment of the market;</li> <li>4. The internal organizational structure of the enterprise, relevant information of the functions performed, risks borne and assets employed by the enterprise and its related parties involved in the related party transactions;<sup>2</sup> and</li> <li>5. Consolidated financial statements of the group.<sup>3</sup></li> </ol>
(3) Description of related party transactions	<ol style="list-style-type: none"> <li>1. Description of the type of related party transactions, relevant parties engaged in those transactions, timing, amount, currency of settlement, and terms and conditions of the transactions, etc.;</li> <li>2. Description of the trading model for related party transactions, changes in the tax year, and reasons for the change;</li> <li>3. Description of the transaction flow, including information flow, physical flow and cash flow, at each level, and discussion of similarities to and differences from transactions with unrelated parties;</li> <li>4. Description of intangible assets involved in the related party transactions and their effect on pricing;</li> <li>5. Copies of contracts or agreements relating to the related party transactions, and descriptions of the implementation of those contracts or agreements;</li> <li>6. Analysis of the major economic and legal factors influencing the pricing of related party transactions; and</li> <li>7. Segmentation of sales, costs, expenses, and profits between transactions with related parties and transactions with unrelated parties.<sup>4</sup></li> </ol>

<sup>2</sup> To provide this information, the enterprise shall use “Form for an Enterprise’s Function and Risk Analysis”, Appendix 1 of the New Guideline.

<sup>3</sup> The enterprise may extend the preparation of this information depending on the fiscal year end of the group. However, such information has to be prepared no later than 31 December of the year following the year in which the related party transactions occur.

<sup>4</sup> If these items cannot be segmented directly, they must be segmented based on certain reasonable allocation key(s) together with an explanation of the allocation key(s) selected. To provide this information, the enterprise shall use “Form for an Enterprise’s Annual Related Party Transaction Financial Analysis”, Appendix 2 of the New Guideline.

(4) Comparability analysis	<ol style="list-style-type: none"> <li>1. Considerations for the comparability analysis, including the characteristics of the assets or services involved in the transactions, functions and risks of the parties engaged in the transactions, contractual terms, economic environment, and business strategies, etc.;</li> <li>2. Relevant information regarding functions performed, risks borne, and assets employed by comparable companies;</li> <li>3. Description of comparable transactions, such as the physical attributes, quality and efficacy of tangible assets; normal interest rate, amount, currency, term, guarantee, credit standing of the lender, term of repayment, and interest calculation method, etc. under financing arrangements; nature and level of services; type of intangible assets and the form of intangible asset transactions, right to use the intangible assets obtained from the transactions, and income from using the intangible assets;</li> <li>4. Source of comparable company information, selection criteria and the reason for setting those criteria; and</li> <li>5. Adjustments made to comparable company data and the reason for those adjustments.</li> </ol>
(5) Selection and application of Transfer Pricing method	<ol style="list-style-type: none"> <li>1. Selection of transfer pricing method and the reason for selection. If the profit split method is selected, contribution to the overall group profits or the level of residual profits should be explained;</li> <li>2. Description of how comparable company information supports the selected transfer pricing method;</li> <li>3. Assumptions and decisions made in the process of determining comparable uncontrolled price or profit;</li> <li>4. Determination of comparable uncontrolled price or profit based on application of the proper transfer pricing method and the result of the comparability analysis, and confirmation of compliance with the arm's length principle; and</li> <li>5. Other information supporting the application of the selected transfer pricing method and so on.</li> </ol>

taxpayers will need to review the information disclosed on Forms 1 to 9 carefully from the transfer pricing perspective, and will need to prepare supporting data and documents.

### 3. Chapter 3 - Contemporaneous Documentation Requirement

Article 43 of the CIT Law and Article 114 of the CIT Law implementation regulations stipulate the information taxpayers are required to submit to the tax authorities during transfer pricing audits. Referring to Article 114 of the CIT Law implementation regulations, Article 13 of the New Guideline states “for each tax year, enterprises must prepare, maintain and submit upon request by the tax authorities, contemporaneous documentation regarding their related party transactions in accordance with Article 114 of the implementation regulations of the CIT Law”. Hence, taxpayers should have completed the preparation or maintenance of contemporaneous transfer pricing documentation by the time of filing their corporate tax return each year. However, it is not necessary to attach the contemporaneous documentation to the corporate tax return. Instead, the contemporaneous documentation needs to be submitted to the tax authorities upon their request.

The contents of contemporaneous documentation

provided in Article 14 of the New Guideline are as follows.

As noted above, contemporaneous documentation must contain significant amounts of detailed information and analyses. Meanwhile, under Article 16 of the New Guideline, taxpayers must complete preparation of contemporaneous documentation by 31 May of the year following the year in which their related party transactions occur, and must submit that documentation within 20 days of a request from the tax authorities.<sup>5</sup> In other words, by requiring that documentation containing the information listed above must be submitted within 20 days of a request by the tax authorities, the tax authorities have imposed a de facto obligation to prepare and maintain contemporaneous documentation by the time of filing of the corporate tax return.

However, unlike the disclosure of information about related party transactions, not all taxpayers need to prepare contemporaneous documentation. Article 15 of the New Guideline provides an exemption from the documentation obligation for taxpayers which meet either condition listed below.

1. The annual amount of related party transactions for the purchase or sale of tangible assets is below RMB 200 million, and the annual amount of all other types of related party transactions is

<sup>5</sup> The deadline is extended to December 12, 2009 for preparation of FY 2008 contemporaneous documentation. However, other than for FY 2008, the deadline is May 31 of the following year.

below RMB 40 million<sup>6,7</sup>.

2. The related party transactions are covered by the scope of advance pricing arrangements; or
3. The foreign shareholding of the taxpayer is below 50%, and the taxpayer only transacts with domestic related parties.

Taxpayers that do not satisfy these conditions are uniformly obliged to prepare contemporaneous documentation, and there are punitive clauses to encourage taxpayers to perform that obligation. Where a taxpayer refuses to submit requested documents during a tax audit, or files false/deficient documents, Article 44 of the CIT Law grants the tax authorities the power to estimate the taxpayer's taxable income. With this power the tax authorities can impose additional taxes on the taxpayer, which must then also pay default interest under Article 48 of the CIT Law. Based on Article 122 of the CIT Law implementation regulations, the default interest rate is calculated as the RMB base lending rate of the People's Bank of China plus 5%. According to Article 122, however, the 5% additional amount will be waived if the taxpayer submits relevant documents in a timely manner. Articles 106 and 107 of the New Guideline also provide similar punitive clauses.

#### **4. Implications of the Contemporaneous Documentation Requirement**

Due to the issuance of the New Guideline, taxpayers will inevitably face increased risk of an estimated tax assessment by the tax authorities, based on non-compliance with the contemporaneous documentation requirements. Taxpayers therefore need to prepare contemporaneous documentation which fulfills the requirements of the New Guideline to reduce these risks, which is likely to increase the burden of transfer pricing work from both a time and cost perspective. Therefore, this is an issue which requires prompt action in order to reduce the risks arising from transfer pricing and to strengthen corporate compliance.

In addition, during transfer pricing audits in Japan, Japanese MNEs with overseas affiliates in China will probably be asked to provide any documents which have been prepared in accordance with the Chinese regulations. Accordingly, contemporaneous documentation must be consistent with the transfer pricing policy established in Japan. For this reason, close attention needs to be paid to the New Guideline not only from the perspective of the local Chinese affiliate, but also from the perspective of the group as a whole. The Japanese headquarters should take the initiative to establish a consistent global transfer pricing policy for the group, and should ensure that transfer pricing policy is applied appropriately, so as to manage the expectations of the tax authorities in each country in which the MNE operates.

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<sup>6</sup> The benchmark for exemption is the total amount paid and received in transactions with related parties.

<sup>7</sup> If a taxpayer is subject to a transfer pricing adjustment, the taxpayer cannot avoid penalties if the annual amount of related party transactions exceeds the limit set under 1 as a result of the adjustment.

### Social Security for International Workers in India

The Indian Social security scheme has been modified in October 2008. The modifications have increased the scope of the applicability of the social security scheme for International workers. The purpose of this modification is to encourage the other countries to enter into social security agreement (SSA) with India to avoid contribution losses in other countries in respect of international workers working abroad.

#### 1. Outline of the modifications

The modifications have increased the scope of the applicability of the social security scheme for 'International workers'. The 'International workers' would be subject to the Indian social security scheme on and after 1 November 2008.

'International workers' are defined as follows;

- An Indian Employee going to work in a country which India has SSA and the employee is eligible for the Social Security benefits under the SSA.<sup>1</sup>
- A non Indian employee, holding passport of a foreign country and working for an establishment in India which the Social Security scheme applies.

Since there is no social security agreement (SSA) enters between Japan and India, the Indian social security scheme (PF act) would not be applicable to the Indians working in Japan as an employee. Therefore, in this text, the application of the new social security scheme to Japanese, who seconded to India, is mainly subjected.

#### 2. Indian Social Security System

Indian Social security system is consisted of 'Provident fund' and 'Pension fund'. Provident

fund is a system for paying lump-sum money to member when he/she fulfilled the prescribed conditions such as a retirement, etc. Pension fund is a system that if a member meets the prescribed condition, the member can receive payment from the pension.

#### (1) Member of the social security

Any organization employs 20 persons or more or an organization voluntarily registered for the Social security system when the number of employees is less than 20 should be subject to the Indian social security system and hence all employees of these entities shall be a member of the system. However, an international worker, who is contributing to the social security of his home country either as a citizen or resident with which India has entered with a SSA on reciprocity basis and enjoying the status of detached worker for a period and terms as specified in such SSA, should be treated as an excluded employee. At present, as the social security agreement between Japan and India has not been concluded, no Japanese employee working in India shall be treated as an excluded employee under the circumstance.

Beside, there is no any minimum period of employment in India is required to be eligible for the membership. Every eligible International worker has to be enrolled from the first date of his/her employment in India.

#### (2) Contribution

The employee is required to contribute at the rate of 12% of contribution base. The employer is mandatorily required to match the employee's contribution along with administrative charges as applicable.

<sup>1</sup> India has presently signed SSA with Belgium, France and Germany only but these SSAs have not yet been notified by the Government.

The contribution base for calculating contributions to be paid is the sum of the following:

- Basic wages (all employment compensation paid or payable in cash while on duty or on leave / holiday except Dearness allowance, House rent allowance, overtime allowance, bonus, commission or any other similar allowance payable in respect of employment and any presents made by the employer)
- Dearness allowance (all cash payments by whatever name called paid to an employee on account of a rise in the cost of living)
- Retained allowance
- Cash value of any food concession

The salary payment for the services rendered in India which is included in the contribution base, should include the salary paid both in and out of India, such as salary payment in Japan.

Employers' contribution is allocated as 8.33% of salary (ceiling cap of INR 6,500 p.m. for salary) to Pension fund and the remaining balance to Provident fund. However, employees' entire contribution of 12% salary goes to the Provident fund only. As a result, most part of the contribution, especially for an International worker, would go to the Provident Fund. There is no cap on the contribution of salary made by both the employer as well as the employee. The contribution should increase when the salary increases.

### **(3) Withdrawal**

Once a member meets prescribed conditions, the fund can be withdrawn. The prescribed conditions for the Provident fund and the Pension fund are as follows.

#### **- Provident Fund**

International workers can withdraw the accumulated fund balance (including the interest on the balance) when one of the following conditions is satisfied:

- Normal retirement at age of 55 or above,
- Mandatory retirement due to permanent and total incapacity to work,

- Immediately before migration from India to other countries for permanent residence or taking employment abroad,
- Termination of mass services or individual retrenchment or in accordance with voluntary retirement scheme, or
- 2 months after resignation, if not re-employed.

For Japanese assignees working in India, they may withdraw from the fund when their assignment is over and they return to Japan.

#### **- Pension Fund**

It is followed on principle of reciprocity available to Indian employees in that country. For Japanese assignees, they would receive the withdrawal money based on the Japanese public social security system's treatment for Indian employees.

### **(4) Tax Implications from the employees' perspective**

In the year of contribution, employee contribution is eligible for deduction from taxable income subject to the maximum of INR100, 000 annually and employer's contribution is exempt from taxable income. Interest accumulated on both employer's and employee's contributions are also not taxable.

In the year of Withdrawal, the withdrawal money is basically exempt from taxable income. If the withdrawal happens before five years of continuous service, the employer's contribution and interest accumulated on both employer's and employee's contributions would be taxable. In addition, employee's contribution claimed prior to 5 years of continuous service (i.e. up to INR 100,000) would be taxable in the year of withdrawal. As a result, the total contributions from both employer and employee are taxed as salary income.

### **(5) Penalties for non compliance**

Non compliance with the provisions of the social security attract penalty.

- failure to remit timely payment for the contributions is charged a penalty of interest

17%-37% and Imprisonment, etc.

As the contribution is a large part of salary, the penalty interest would have a significant impact.

### 3. Issues to be considered

As noted above, the SSA scheme brings a costly impact to companies and non compliance would result in huge penalties. Companies should carefully analyze the situation and their positions.

#### (1) Optimization of Contribution base

Following the Indian Social Security scheme, it is required that an employer and its employee to make a contribution of 24% of salary. Further, in the case where the salary for the employee is determined by Net salary basis, the employee's portion which borne by the employer should be included the taxable income of the employee and hence it is necessary to be grossed up. As a result of the gross-up calculation, the level of the increasing cost would be more than 30% of the contribution base.

It may be common that all salary of a Japanese assignee is basic salary and they don't have any break-downs. As noted above, certain allowances would be exempt from the contribution base. It is advised for the entities to re-consider the salary scheme to achieve the optimization of the

contribution base.

#### (2) Treatment at withdrawal amounts

Even if an employer bears the entire contributions, the withdrawal money must be paid back to the employee from the funds, because this is employee's public social security scheme. In the case where the employer has borne the all contributions, it should consider how the treatment of the withdrawal amounts. In other words, the employer should consider whether the employee can keep the amounts or the employee has to pay the amounts back to the employer because the contributions were paid by the employer. Consideration should be made for the position of the withdrawal amounts in the International worker's salary scheme, how the employer get reimbursed, and the impact on the employee's individual tax calculation, etc. It is advised that these issues should be considered by the employer in advance.

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## North America

### U.S. Federal Tax Reform under the Obama Administration

Under the Obama Administration, fundamental reforms of the U.S. federal tax rules are expected. These would mark a major turning point in U.S. tax policy since the latest major revision of the Internal Revenue Code in 1986 under the legacy Reagan Administration. The tax reform includes a possible change of the statutory tax rate, a more stringent oversight on multinational corporation's alleged tax avoidance schemes, tax relief opportunities, and a

continuing evolution of new tax laws. However, these developments are in the initial stages, and the impact these tax reforms will have are yet to be seen. This article will present the recent updates and outline (i) the tax reforms by the American Recovery and Reinvestment Act of 2009 ("ARRA") which was signed into law on February 17th, 2009, and (ii) President Obama's plan to revamp international tax rules that was rolled out on May

4th, 2009.

## **1. American Recovery and Reinvestment Act of 2009 ("ARRA")**

The US\$787 billion American Recovery and Reinvestment Act signed by President Obama on February 17th is an attempt to invigorate a faltering economy marked by rising job losses, falling GDP, continuing uncertainty in the capital markets, and a weak global economy. The stimulus provisions are divided between spending US\$575 billion and tax reliefs of US\$212 billion, according to the Congressional Budget Office ("CBO"). Nearly three-quarters of the package is intended to be implemented into the economy by the end of September, 2010.

The Administration hopes to make both short- and long-term investments that not only create jobs and stem the decline of the economy, but also build the future of the U.S. through building infrastructure, promoting science, innovation and education, improving healthcare, and spurring clean energy. All public agencies receiving monies and businesses receiving government aid will face strict oversight, such as transparency of expenditures and accountability.

The tax provisions within the package primarily benefit individuals, however there also proposals that target businesses such as the following:

### **(1) Deferral of Cancellation of Indebtedness Income**

Companies are allowed to reacquire or modify outstanding corporate debt trading at a discount in 2009 or 2010 to defer recognition of taxable income for the 5 years from 2014 through 2018. This action is planned to give businesses with difficulty in repaying outstanding debt an increased opportunity to shore up balance sheets and avert bankruptcy.

### **(2) Bonus Depreciation**

In an effort to improve liquidity, companies can

continue to use "bonus depreciation" enacted in 2008 to accelerate recovery of the cost of capital expenditures for new 2009 investments. Bonus depreciation allows an immediate deduction for 50% of the cost of certain fixed assets plus accelerated depreciation on the remaining 50% of cost.

### **(3) Section 179 Deduction**

Qualifying businesses can continue to expense up to US\$250,000 of section 179 property for tax years beginning in 2009. (Without ARRA, the 2009 expensing limit for section 179 properties would have been US\$133,000.)

### **(4) 5-year carryback of 2008 NOLs for eligible small businesses**

For 2008, eligible small businesses ("ESB") can choose a 3, 4, 5-year carryback period for the part of the 2008 NOL, instead of the regular 2-year carryback period. The statutory definition of ESB includes a corporation or partnership that satisfies a US\$15 million average gross receipts test for the three taxable-year period ending with the taxable year of the 2008 NOL (Gross Receipts Test).

### **(5) Tax incentives to invest in energy-efficient products**

Investing in energy-efficient products such as installation of energy efficient windows, doors, heating and cooling equipment, and as well as funding for renewable energy power plants will qualify a taxpayer for a certain tax credits.

## **2. President Obama's Plan to Revamp International Tax Rules**

On May 4th, 2009, President Obama unveiled far-reaching international tax proposals which would expand the scope of the taxable bases of U.S. multinational corporations. Initial estimates for these tax proposals would raise approximately US\$210 billion over 10 years, and would be incorporated as part of the fiscal year 2010 budget.

The President's background analysis concluded

the U.S. tax code provided a competitive advantage to companies that invest and create jobs overseas as compared to those that invest and create those same jobs in the U.S.; the President believes this has created opportunities to evade and avoid taxes through offshore tax havens. It has been reported that U.S. multinational corporations paid only about US\$16 billion of U.S. tax on approximately US\$700 billion of foreign active earnings - an effective U.S. tax rate of about 2.3%, in 2004, the most recent year for which data is available.

The proposals include the following:

**(1) Reforming deferral rules**

The proposal would require a company to defer any deductions - such as interest expense and royalties associated with untaxed overseas investment until the company repatriates its earnings back to the U.S. This proposal would go into effect in 2011, and is estimated to raise approximately US\$60.1 billion from 2011 to 2019.

**(2) Closing foreign tax credit loopholes**

Under the proposal, a company would determine its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which it can claim a deemed paid foreign tax credit (including lower tier subsidiaries described section 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year. These reforms would go into effect in 2011, and are expected to raise approximately US\$43.0 billion from 2011 to 2019.

**(3) Eliminating loopholes that allow "disappearing" offshore subsidiaries**

The proposals seek to take an aggressive position against overseas tax havens by abolishing a range of tax-avoidance techniques. It would now require U.S. businesses that establish certain corporations

overseas to report them on their U.S. tax returns. As a result, U.S. firms that invest overseas would no longer be able to shift their income to tax havens. This would level the playing field between those corporations that invest overseas and those that invest within their domicile. This proposal would go into effect in 2011, and raise approximately US\$86.5 billion from 2011 to 2019.

The proposals encourage new investments and innovation within the U.S. by making the Research and Experimentation ("R&E") Tax Credit permanent. Only domestic R&E activities are eligible for the R&E tax credit, which has been extended on a temporary basis 13 times since it was first enacted in 1981 and is set to expire on December 31, 2009. This change would cost about US\$74.5 billion over 10 years, which will be paid for by reforming the treatment of deferred income and the use of the foreign tax credit.

These are still proposals that are not certain to be enacted into law. However, The Wall Street Journal on May 5th, 2009 reported, "President Barack Obama's plan to revamp international tax rules stirred opposition from many multinational businesses and questions among a few leading lawmakers. But even if the proposal doesn't advance rapidly, policy makers said a broader corporate-tax overhaul is becoming increasingly likely over the next two years."

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## The Chancellor's Budget 2009 - Budget Summary

This year, there has been a large amount of very specific and detailed measures announced within this year's Budget, with 93 notes across 221 pages and draft legislation. The purpose of this summary is to provide a snap-shot of the main points within the Chancellor's 2009 Budget. There remain a number of areas where the Government will continue to consult and review.

### 1. Outlook for the economy and the public finances

As expected, the Treasury has slashed its Pre-Budget Report (PBR) forecasts for economic growth. It now expects the economy to shrink by around 3.25-3.75% in 2009 (compared to 0.75-1.25% in the PBR), which is broadly in line with our own view. We are, however, more cautious about the Treasury forecast of growth of around 1-1.5% in 2010, which looks optimistic. The Treasury also takes a relatively optimistic view of medium-term prospects, projecting that GDP growth will rebound to an average of 3.5% per annum in the following three years.

Public sector net borrowing is now estimated to be around £175 billion in 2009/10 and £173 billion in 2010/11. These are way above earlier Treasury forecasts due to the effects of the deep recession and the fiscal stimulus measures announced in the PBR (around £20 billion) and the Budget (around £5 billion).

The Treasury expects that economic growth will bounce back quickly from 2010 onwards, boosting tax revenues and returning public borrowing in 2013/14 to around £97 billion (5.5% of GDP). This is possible, but the economic risks are weighted to the downside at present, so borrowing may well remain higher than the Treasury expects.

The Treasury forecasts that net public debt will rise to around 79% of GDP in 2013/14, including the potential losses related to financial sector interventions, before stabilising. The current budget deficit will not return to balance now until 2017/2018, which would be a long time for the bond markets to wait. The risk is that financial market worries about this rise in public debt (to around £1.4 trillion by March 2014) could lead to higher long-term UK gilt yields in the medium-term.

The Treasury forecasts that total public sector revenues will drop from 38.6% of GDP in 2007/8 to a low of 35.1% of GDP in 2009/10. But this downward trend in tax revenues is assumed to be reversed from 2010/11 onwards due to a combination of economic recovery, fiscal drag and discretionary tax rises focused on high earners. By 2013/14, tax revenues are projected to rebound to around 38% of GDP, although this may prove relatively optimistic.

Public spending is expected to be slightly above previously budgeted levels in the short-term, but is assumed to grow significantly more slowly in the three years to 2013/14 at an average real rate of just 0.7% per annum. But we consider that even tighter public spending constraint and possibly also additional tax rises are likely to be needed to restore the public finances to health in the medium-term. This will certainly be a long and painful process: the Budget is just the first step along this road.

### 2. Personal taxes

#### (1) Tax rates

There have been changes to the announcement made at the 2008 Pre-Budget report, with the following changes taking effect from 6 April 2010:

- An additional higher rate of 50% (compared with the previously announced 45% rate) on taxable income above £150,000 - given the capital gains tax rate for individuals will be unchanged at 18%, the differential between income and capital gains will increase to 32%
- The basic personal allowance will be gradually reduced to nil for those with “adjusted net incomes” above £100,000
- A new 42.5% tax rate on dividends where they represent the “top slice” of taxable income above £150,000
- Increases to trust rate to 50% and dividend trust rate to 42.5% to align with income tax

Personal allowances have been increased as previously announced. For 2009/10 the basic rate of income tax will be 20% on taxable income up to £37,400.

## **(2) Pensions**

From 2011, people with taxable income of £150,000 or more will have their tax relief on pension contributions reduced to basic rate.

To forestall large pension payments in the current year, there will be a special tax charge for payments made after budget day if the payments exceed £20,000 and they are a change from normal pension accruals or regular payments (quarterly or more regularly).

## **(3) Savings**

The ISA limit will be raised to £10,200, of which £5,100 can be invested in cash. The new limits will apply from 6 October 2009 for people aged 50 and from 6 April 2010 for all other ISA investors.

## **(4) Venture capital schemes**

For the Enterprise Investment Scheme (EIS), the Corporate Venturing Scheme (CVS) and the Venture Capital Trust (VCT) scheme, the rules concerning the employment of the money invested have been relaxed. For EIS, there has also been a relaxation of the restriction on the carry back of income tax relief to the previous year.

## **(5) Employment taxes**

In many cases employees, mostly ex-pats, are provided with living accommodation through the payment of a lease premium. This gives a lower tax benefit than straight forward rental payments. Legislation will be introduced to reduce this advantage for all new leases or extensions to leases on or after 22 April 2009 where the lease is less than 10 years. If the lease is less than 10 years the lease premium will be treated as rent spread over the lease period.

## **(6) Cars**

From 2011-12, the cap on car benefits for expensive cars will be removed. Currently the list price of a car for calculating the car benefit is capped at £80,000. The starting point for calculations of car benefits will reduce from 130g/km (2010-11) to 125g/km. At this level, the benefit is 15% of list price, which increases by 1% per 5g/km up to 35%.

Electrically propelled cars registered after 1998 will have a percentage (to calculate the benefit) of 9%. It is currently 9% but only reduced from 15% due to a special provision, which will no longer be needed.

## **3. Corporate taxes**

### **(1) Tax rates**

The Chancellor confirmed that the main corporation tax rate and small companies rates will remain unchanged at 28% and 21% respectively.

### **(2) Taxation of foreign profits**

The combined foreign profits package proposed consists of four elements:

#### 1) Dividends

All companies receiving distributions from UK and overseas companies on or after 1 July 2009 will be exempt from corporate tax if they fall into an exempt class and anti-avoidance provisions do not apply. The vast majority of distributions are expected to be exempt from corporate tax.

## 2) Worldwide debt cap

The debt cap applies to limit the tax deduction for finance expense payable by UK group companies to the consolidated worldwide gross finance expense of that group. There are a number of exclusions, for example: financial services; short-term debt; and group treasury. The debt cap will apply for accounting periods beginning on or after 1 January 2010.

## 3) Controlled foreign companies (CFC)

The existing acceptable distribution policy exemption and the exemption for superior and non-local holding companies will be removed for accounting periods starting on or after 1 July 2009. The relevant holding company exemptions will still be available in a transitional form until 1 July 2011. The exemption for local holding companies will be retained. The consultation will continue in relation to the proposed wholesale changes to the CFC rules with reform proposed in July 2011.

## 4) Treasury consent

The existing Treasury consent regime is repealed from 1 July 2009 and a new post-transaction information reporting regime applies from that date to transactions with a value of £100 million or more. There are a number of exclusions that include several of the existing general consent rules. Companies must make a report within six months of the transaction.

### **(3) Capital allowances**

A 40% first year allowance for expenditure on general plant and machinery will be available to businesses on qualifying expenditure incurred in the 12 month period beginning 1 April 2009 (6 April 2009 for businesses carried out by individuals).

### **(4) Carry back of trade losses**

Finance Bill 2009 will extend the carry back of

trading losses incurred in accounting periods ending in the 12 months to 23 November 2009 from the current one year entitlement to a period of three years up to a maximum of £50,000.

### **(5) Loan relationship rules**

Changes have been made to the taxation of loan relationships, in line with expectations:

- Amendments, effective from 22 April 2009, to the rules covering release of trade debts within a group to ensure these are tax neutral.
- Interest payable to overseas connected parties and discounts accrued on deeply discounted securities will be allowable on an accruals basis unless the lender company is resident in a tax haven. These rules will be effective for accounting periods beginning on or after 1 April 2009, but companies can elect to remain on the "paid" basis for the first accounting period beginning on or after that date.

### **(6) Group relief provisions**

Rules have also been introduced to make it easier for groups to match gains and losses that arise on disposals of chargeable assets without the need to transfer ownership of assets within the group.

### **(7) Transfer of income streams**

Receipts arising from the disposals of rights to receive future income streams without disposing of any underlying asset may be treated as trading income with effect from 22 April 2009.

## **4. Anti-avoidance**

### **(1) Finance and treasury**

Legislation will be introduced to target particular intragroup financing structures and will apply to related debits and credits arising on or after 22 April 2009.

A specific measure aims to ensure debits and credits are brought into tax equally for both lender and borrower, regardless of whether or not they are recognised in a company's accounts. Particular structures affected are:

- those involving convertible bonds where there is a high likelihood of the debt converting into shares; and
- those where a company seeks to create a tax free gain in respect of derivative contracts.

Another set of measures targets two specific types of intra-group financing structures that use the foreign currency matching rules to create a tax advantage. Specific measures are to be introduced to prevent companies exploiting asymmetries within these rules to create 'one-way bets' on the matching of share capital and claiming deductions on the forward points element of currency contracts.

## **(2) Other anti-avoidance measures**

The Chancellor has announced a number of anti-avoidance measures to close down perceived existing loopholes, including:

- countering avoidance involving leasing of plant and machinery in order to obtain more relief than would otherwise have been available; and
- countering a number of structures around finance and treasury.

## **5. Indirect taxes**

### **(1) VAT**

#### 1) Change of standard rate

The current rate of 15% VAT will be retained until the end of this year, increasing to 17.5% from 1 January 2010.

Anti-forestalling legislation has also been introduced to counter schemes that purport to apply the 15% rate to goods and services supplied on or after 1 January 2010 if certain conditions are met.

#### 2) Cross-border VAT changes 2010

A package of changes is being introduced in order to simplify and modernise the VAT system for cross-border trading around the EU that will come into effect on 1 January 2010.

The new rules aim to ensure that, as far as possible, VAT is due in the country in which the service is consumed. The current rule is that VAT is due where the supplier has established its business, but from 1 January 2010, the new basic rule will result in VAT being accounted for in the place the customer is established. There are also amendments to the rules on the time of supply and when the VAT must be brought to account.

In conjunction with the above, there will be a requirement for businesses that supply goods and services to customers in other EU countries to complete an EC Sales List for each calendar quarter.

Changes will also be introduced to the current VAT refund system for VAT incurred by UK businesses overseas. The new system will be an electronic based system, which aims to speed up and standardise the process.

#### 3) Increased turnover thresholds

The taxable turnover threshold which determines whether a person must be registered for VAT, will increase to £68,000 from 1 May 2009.

### **(2) Stamp duty land tax (SDLT)**

The Chancellor announced that the current increase in the SDLT threshold will be extended - purchases of residential property costing no more than £175K will remain free from SDLT until 31 December 2009. On the corporate side, additional measures have been introduced to support land-backed securities under alternative finance arrangements.

### **(3) Other indirect taxes**

The Chancellor announced changes to other indirect taxes with the aim of increasing amounts raised from these duties and levies. They include: 2% increase on duty rates on alcohol and tobacco; changes to landfill tax; the climate change levy and aggregates levy; gaming duties; and the

amusement machine licence duty.

## **6. Other measures introduced by the Budget**

### **(1) Tax administration**

Rules covering repayments of overpaid tax are to be relaxed to assist taxpayers in the quick recovery of these amounts. The time limits for making such claims will be reduced from six to four years.

Further measures allowing for business to make flexible payments of tax liabilities have been announced. From April 2011, taxpayers will be able to agree Managed Payment Plans (MPP) with HMRC to structure payment of tax liabilities outside the normal statutory due dates.

The Government has announced changes to the penalty regime to late filing of tax returns and late payment of taxes. The measures will replace the existing varied regimes with a more aligned regime covering all taxes. The new rates proposed are likely to result in higher penalties for certain situations, for example daily penalties for returns over three months late. Penalties will now be charged for late payment of monthly PAYE and NIC liabilities. New measures are also being introduced that aim to harmonise the rates of interest on over- and under-payments across the taxes.

Following recent consultation, the Government has announced it will introduce measures requiring HMRC to prepare and maintain a taxpayers Charter, which HMRC plans to launch this autumn.

Large companies will be required to notify HMRC of the identity of their senior accounting officers. These officers will be responsible for ensuring their companies have adequate accounting systems for the purposes of accurate tax reporting, and will have to certify this annually.

### **(2) Publishing names of tax defaulters**

HMRC will have the power to publish the names of

individuals and companies who are penalised for deliberate defaults leading to a loss of tax of more than £25,000.

### **(3) Real Estate Investment Trusts (REIT)**

Following consultation with industry, the Government has announced amendments to clarify certain aspects of the REIT legislation. In addition, powers have been announced aimed at preventing groups from restructuring their activities to benefit from the REIT regime in circumstances not envisaged by the rules. In particular, the REIT legislation will be amended to prevent owner-occupiers from being able to qualify for REIT status.

### **(4) Offshore funds**

There are changes to the rules for investors in transparent offshore funds, as well as changes to the definition of offshore funds.

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## 2009 Japanese Tax Reforms regarding Investment Fund

### 1. Introduction

The 2009 Tax reform proposals, which were passed by the Diet on March 27, 2009 (“2009 Tax Law”), included certain amendments that may significantly affect the taxation of foreign private equity and other investment funds investing in Japan. As expected, the 2009 Tax Law introduced provisions that liberalize the application of the 25/5 Rule (as defined below) for certain transactions, and provides a safe harbor rule to allow foreign investors to directly invest in certain Japanese domestic partnerships without creating a permanent establishment (“PE”). The 2009 Tax Law applies to transactions or PE determinations which take place on or after April 1, 2009.

This article provides a summary of the above changes and, following the release of the Cabinet Orders and Enforcement Orders on March 31, 2008, highlights certain aspects in respect of the practical application of these rules.

### 2. Tax treatment before 2009 Tax Law

#### (1) 25/5 Rule

Under Japanese tax law, gains realized by a nonresident individual or a foreign corporate investor (“Foreign Investor”) without a PE in Japan from the sale of shares in a Japanese corporation are subject to tax if the Foreign Investor (together with specially related persons) sells 5% or more of the shares of such corporation during a fiscal year and such Foreign Investor (together with specially related persons) owned or has owned 25% or more of the shares in such company at any time during a specified lookback period (“25/5 Rule”).

Under legislation introduced as part of the 2005

tax reforms, the interests of foreign partners in a foreign partnership were aggregated under the concept of “specially related persons” for purposes of testing the 25/5 Rule. Under these rules, and in the absence of an applicable tax treaty, it was very difficult for unrelated Foreign Investors to substantially invest in Japanese companies via a foreign partnership without significant Japanese tax cost.

#### (2) Foreign investment in certain Japanese partnerships (PE determination)

Under previous Japanese tax law, as the general partner of a Japanese investment business limited partnership (toushi jigyo yugen sekinin kumiai, or IBLP) is viewed as carrying on the business of the partnership on behalf of the partners, where the general partner carried on business in Japan there was a risk that foreign partners investing in the IBLP were viewed to have a PE in Japan. This was the case even if the foreign partner was not actively involved in the management or operation of the IBLP. Where the foreign partner was determined to have a PE in Japan, the foreign partner was subject to Japanese corporation or individual tax at the effective rate of approximately 40% or up to 50%, respectively.

### 3. Outline of 2009 Tax Law

#### (1) Application of the 25/5 Rule to certain foreign partners

The 2009 Tax Law effectively “rolls back” the changes implemented in 2005 by testing the application of the 25/5 Rule at the foreign partner level for transactions where investing via IBLP or other foreign partnership fund similar to an IBLP (“Foreign Limited Partnership”) that satisfies the following: 1) a 1-year holding period criteria is met; and 2) the transaction does not involve a

shareholding in certain distressed financial institutions (“Covered Transaction”).

For a Covered Transaction involving an IBLP, the foreign partner must:

- A. Have limited liability with respect to the IBLP;
- B. Not be involved in the management or operation of the IBLP;
- C. Together with specially related partners, have an investment ratio in the IBLP that is less than 25%;
- D. Not be specially related to the general partner of the IBLP; and
- E. Not otherwise have a PE in Japan.

For a Covered Transaction involving a Foreign Limited Partnership, the foreign partner must:

- A. Have limited liability with respect to the Foreign Limited Partnership;
- B. Not be involved in the management or operation of the Foreign Limited Partnership.
- C. Not own, together with specially related shareholders, 25% or more of the shares of the corporation sold at any time during a specified lookback period; and
- D. Not otherwise have a PE in Japan.

Please note that the 2009 Tax Law does not liberalize the taxation of transactions involving the transfer of shares in a real estate holding company.

However, to claim benefits under this new rule, the Cabinet Orders and Enforcement Orders require the foreign partner file certain documentation. The scope of information required by the Cabinet Orders and Enforcement Orders may make it practically difficult, in some circumstances, for certain foreign partners to claim the exemption.

For foreign partners in a Foreign Limited Partnership, the foreign partners are required to provide documentation which verifies that the foreign partner has limited liability with respect to the Foreign Limited Partnership and that the foreign partner is not involving in the management or operation of the Foreign Limited Partnership

(e.g., a copy of the Foreign Limited Partnership agreement). Where this documentation is not in Japanese, the foreign partner is required to file translations.

## **(2) Foreign investment in certain Japanese partnerships (PE determination)**

Under 2009 Tax Law, a foreign partner may invest in an IBLP without risk of a PE in Japan on account of such investment provided certain requirements are met. These requirements are similar to those for foreign partners in an IBLP as outlined above.

Similar to the 25/5 Rule exemption, certain documentation requirements were included in the Cabinet Orders and Enforcement Orders, including the requirement for the foreign partner to file documentation which verifies that the foreign partner has limited liability with respect to the Foreign Limited Partnership, that the foreign partner is not involved in the management or operation of the Foreign Limited Partnership and that the foreign partner does not own 25% or more of the limited partnership interests in the Foreign Limited Partnership together with specially related partners. Where the documentation is not in Japanese, the foreign partner is required to file translations. In addition, the foreign partner is required to show a documentation which verifies the limited partner is a foreign partner upon filing the documentation.

Detailed documentation regarding the Japanese sourced income derived from the partnership business is required to be filed as well.

When any of the information contained in the filed documentation changes, the foreign partner is required to re-file the documentation.

## **4. Conclusion**

The 2009 Tax Law was designed to bring the taxation of foreign investment into Japanese venture companies in line with international

standards, revitalize domestic industries, and facilitate further foreign direct investment in Japan through IBLP or Foreign Limited Partnerships. We

understand that further details are expected to be released later this year to seek to clarify some of the documentation requirements.

## Transfer Pricing

### First Taxpayer Success in Japanese Transfer Pricing Litigation

#### 1. Introduction

On October 30, 2008, the Tokyo High Court upheld an appeal by Company A (“Appellant”), which primarily performs sales support activities related to computer software products, against a decision of the Tokyo District Court, and entered judgment to overturn certain corporation tax assessments made by the Tokyo Regional Taxation Bureau (“TRTB”) pursuant to the Japanese transfer pricing legislation.<sup>1</sup>

We are aware of only three previous cases considering the appropriateness of transfer pricing tax assessments, other than this case and its related lower court decision.<sup>2</sup> In the earlier three cases, the relevant Japanese courts upheld the tax assessments made by the tax authorities. Consequently, the decision relating to the Appellant is the first by a Japanese court to overturn a transfer pricing tax assessment. Moreover, this decision is particularly noteworthy in the sense that the judgments made by the courts of first and second instance differ in their conclusions as to the appropriateness of the transfer pricing method, despite the fact that both judgments are based on the same set of facts and circumstances. It is also expected that the

appellate decision will affect future enforcement of the transfer pricing legislation by the Japanese tax authorities.<sup>3</sup>

#### 2. Overview of the case

Pursuant to certain Subcontracting Service Agreements with foreign-related parties, the Appellant provided services in support of software product sales activities conducted by those foreign-related parties in Japan (“Foreign-related Transactions”). In consideration of these services, the Appellant received a payment (“Service Fee”), which was equivalent to the total of 1.5% of net sales of the software products in Japan, plus all direct and indirect expenses incurred by the Appellant in providing the services.

The TRTB judged that the Service Fee was less than the arm’s length price, and made tax assessments to increase the amount of taxable income earned in certain years by the difference between the Service Fee and the TRTB’s estimated arm’s length price. For this purpose, the TRTB exercised its authority to inquire into and inspect information on third party transactions not disclosed to the Appellant<sup>4</sup>. Based on this information, the TRTB selected certain comparable

<sup>1</sup> Since the Respondent has abandoned its right to appeal, the judgment of the Tokyo High Court should be considered binding.

<sup>2</sup> These earlier cases were:

(i) a case concerning the price of vessels transferred to a foreign-related party (judgment rendered by the Takamatsu High Court on October 13, 2006);

(ii) a case concerning interest on loans made to a foreign-related party (judgment rendered by the Tokyo District Court on October 26, 2006); and

(iii) a case concerning the price of electronic components transferred to a foreign-related party (judgment rendered by the Osaka District Court on July 11, 2008).

<sup>3</sup> In Japan, a final and conclusive judgment rendered by a court is only binding on the parties to the particular case. In practice, however, the judgment is also likely to affect other taxpayers and the tax authorities.

<sup>4</sup> Authority granted pursuant to paragraph 9, *Special Taxation Measures Law 66-4* (the Japanese transfer pricing legislation under which the Appellant was assessed).

transactions involving a Japanese company (so-called “Secret Comparable”) engaged in the importation of graphic software products from overseas manufacturers and the distribution of those products to retailers and end-users in Japan on a sale-to-order basis (“Comparable Transaction”). The TRTB calculated the purported arm’s length price based on the gross margins of the Comparable Transaction. The transfer pricing method used by the TRTB (“TPM”) is reported as “a method equivalent to methods consistent with the resale price (“RP”) method<sup>5</sup>.”

### 3. Comparison with the Tokyo District Court’s judgment

A comparison between the key aspects of the judgment of the Tokyo High Court and that of the Tokyo District Court is as follows:

#### (1) Burden of proof when determining that a method equivalent to the three traditional transaction methods cannot be used.

Under the Japanese transfer pricing legislation, a method equivalent to methods *consistent with* the three traditional transaction methods (paragraph 2(ii)(b), *Special Taxation Measures Law 66-4*) can be used only if a method equivalent to the three traditional transaction methods cannot be used (paragraph 2(ii)(a), *Special Taxation Measures Law 66-4*). The Tokyo District Court stated its interpretation of the burden of proof in this matter as “if the tax authorities have asserted and initially proved that a method equivalent to the three traditional transaction methods cannot be used despite a thorough and reasonable tax examination, in order to overcome this position the taxpayer will need to more clearly assert and prove that a method equivalent to the three traditional transaction methods can be used”, obviously taking into account the information already put forward by the tax authorities. The Tokyo District Court decided that the Appellant had not met

this standard. Since the Tokyo High Court followed the Tokyo District Court’s interpretation on this point, it can be assumed that the position of the Japanese courts on this particular issue has been established.

#### (2) Level of Comparability of the Comparable Transaction

The Tokyo District Court took the position that, since emphasis is placed on functions performed and risks assumed by the parties engaged in a transaction under the RP method, it is necessary to focus on functions and risks in evaluating the suitability of potential comparable transactions. The Tokyo District Court then identified certain similarities between the Foreign-related Transactions and the Comparable Transaction, including: both the Appellant and the Secret Comparable were engaged in sales promotion activities, advertising activities and end-user support activities (similarity in functions); and neither the Appellant nor the Secret Comparable assumed inventory or credit risks (similarity in risks).

In contrast, the Tokyo High Court did not identify sufficient comparability between the Appellant and the Secret Comparable. Instead, the Tokyo High Court held that the functions and risks of the Appellant were significantly different from those of the Secret Comparable:

- The Comparable Transaction was a resale transaction, while the Foreign-related Transactions were transactions related to the provision of services both legally and in (economic) substance, and the Appellant did not perform a sales function (difference in functions); and
- The Secret Comparable assumed the risk that it would earn profits only if its sales revenues were greater than breakeven, and that it would suffer losses if sales revenues were lower than breakeven. On the other hand, the Appellant

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<sup>5</sup> Paragraph 2(ii)(b), *Special Taxation Measures Law 66-4*.

was guaranteed a level of remuneration that exceeded any expenses it incurred to provide those services (difference in risks).

Given the differences in comparability, the Tokyo High Court determined that the TPM used by the TRTB did not fall under “a method equivalent to a method consistent with the RP method,” as described in the Japanese transfer pricing legislation.

### **(3) Exercising the authority to inquire into and inspect information on third party transactions**

The Tokyo District Court stated its position that “since procedural requirements for inquiry and inspection are not requirements for the making of a tax assessment, it is not possible to determine the illegality of the tax assessment solely based on the grounds that the procedures for inquiry and inspection leading up to that assessment are illegal” and that “the tax assessment should only be revoked if there is serious misconduct involved: for example, the relevant inquiry and inspection violates punitive laws.” The Tokyo District Court also rejected an assertion made by the Appellant that misconduct had occurred on the basis that “even if the taxpayer submitted all accounting books and records required for calculation of the arm’s length price without delay, it is not possible to determine that there has been serious misconduct in the procedures for inquiry and inspection.”

The Tokyo High Court was expected to provide comments on this issue. However, as a result of its decision on the lack of comparability stated in (2) above, the Tokyo High Court reached the conclusion that the tax assessments made by the TRTB were illegal. Accordingly, it was not necessary to reach a decision on the legitimacy of the TRTB’s exercise of the authority to inquire into and inspect information about third party transactions.

## **4. Impact of the judgment rendered by the Tokyo High Court**

It is clear that if the tax authorities initially prove it is not possible to use the three traditional transaction methods (or methods equivalent thereto) in spite of a thorough and reasonable tax examination, the burden of proof will be transferred to the taxpayer to prove otherwise. In this particular case, both courts determined that the Appellant did not satisfy this requirement. Therefore, it will be more important in the future for taxpayers to prepare transfer pricing analyses and documentation in advance of a tax examination in order to clearly and strongly justify and support the use of the taxpayer’s selected TPM.

It is also clear that more emphasis will be placed on the contents of agreements with foreign-related parties when functions and risks are analyzed. Therefore, as long as a taxpayer providing support for the sales activities of foreign-related parties has concluded a substantive service agreement with those foreign-related parties, as did the Appellant, it will be more difficult for the Japanese tax authorities to use the gross margins (i.e., the RP method) of companies engaged in buy and sell transactions to determine an arm’s length price for those services. Going forward, we anticipate that the Japanese tax authorities will be more likely to use a markup on costs as the profit level indicator for transactions involving the provision of support for the sales activities of foreign-related parties (either the cost plus method or the transactional net margin method using a full-cost markup). However, given there is likely to be a lack of comparable companies engaged in the provision of such services, it will be difficult in practice to identify the comparable companies that should be used to set the target range, or how the “plus” component of such methodologies should be determined.

Finally, although the position of the Japanese courts remains unclear as to whether tax assessments based on information from secret

comparables are reasonable or not, it seems unlikely that the Japanese tax authorities will refrain from making such assessments simply

because the Tokyo District Court judgment in this case was overturned by the Tokyo High Court on other grounds.

## Customs

### Overview of the Revision to the Government Ordinance and the Guidelines Concerning the Special Tariff

#### 1. Introduction

The FY2009 (from April 1, 2009 to March 31, 2010) Customs and Tariff Policy Amendment was implemented based on the framework discussed and agreed on 12 December 2008 by the Council on Customs, Tariff, Foreign Exchange and other Transactions (“CCTFT”). This eighth installment of Customs Issues for Tax and Accounting Executives outlines the revision of government ordinance (“GO”) and guidelines on special tariff systems and procedures of Japan, which is a major revision since 1994 when Uruguay round had come to a conclusion.

Special tariff is a WTO approved means for a country to relieve the domestic industry from harm caused by certain special circumstances, such as

the unfair trade practices or drastic increase of import of the goods. By determining the goods, supplier, or the supplying country, etc. in accordance with the rules, a country is able to impose within a certain range of Countervailing duty, Anti-dumping duty, Safeguard duty or measure, or Retaliatory duty in addition to the general duty.

#### 2. Overview of CCTFT report in relation to FY2009 Customs and Tariff Policy Amendment

Overview of the CCTFT report is as follows (Source from the website of Ministry of Finance) :

- (1) Strengthening customs enforcement  
 • Prohibition of the import of revenue stamps

**Table 1 - Summary table of the Special Tariffs in Japan**

	WTO Agreements	Law	GO	Guideline
Countervailing Duty	<ul style="list-style-type: none"> <li>• General Agreement on Tariffs and Trade 1994 (GATT), Article 6</li> <li>• Marrakesh Agreement Establishing the World Trade Organization (WTO Agreement), Annex 1 / Agreement on Subsidies and Countervailing Measures (SCM Agreement)</li> </ul>	Customs Tariff Law, Article 7	GO for Countervailing Duty	Countervailing Duty Guidelines
Anti-Dumping Duty	<ul style="list-style-type: none"> <li>• GATT, Article 6</li> <li>• Agreement on Implementation of Article VI of GATT (AD Agreement)</li> </ul>	Customs Tariff Law, Article 8	GO for Anti-Dumping Duty	Anti-Dumping Duty Guidelines
Safeguards	<ul style="list-style-type: none"> <li>• GATT, Article 19</li> <li>• Agreement on Safeguards (SG Agreement)</li> </ul>	Customs Tariff Law, Article 9	GO for Safeguards	Safeguards Guidelines
Retaliatory Duty	<ul style="list-style-type: none"> <li>• GATT, Article 23</li> <li>• WTO Agreement, Annex 2 / Understanding on Rules and Procedures Governing the Settlement Disputes (DSU)</li> </ul>	Customs Tariff Law, Article 6	GO for Retaliatory Duty	-

- and postal stamps which are forged, altered or imitated
- Addition of the provisions that exclude the crime syndicate from getting permission for the Customs Area
- (2) Improvement of the current expedited customs clearance procedure to enhance global competitiveness of Japan
  - Expansion of the coverage of Authorized Economic Operators to manufacturers (Authorized Economic Operators - firms recognized by Customs to excel at security management compliance)
- (3) Revision of special tariff systems and procedures
  - Revision of special tariff system, such as Anti-dumping duty, etc. for the purpose to improve timeline of investigation and transparency of the procedures
- (4) Amendment of the tariff rates
  - Elimination of the tariffs on Yarn spun from silk waste (HS5005.00)
- (5) Extension of the effective periods of temporary tariff rates and measures
  - Extending the effective period of temporary tariff rates and Safeguard measures for specific agricultural products by the end of FY2009
  - Extending the effective period of exceptional treatment of Safeguard measures on imports of beef by the end of FY2009

The first bullet of item (1) is effective on June 1, 2009, and second bullet of (1) and (2) became effective on July 1, 2009 and all others became effective on April 1, 2009. Items (1), (2), (4) and (5) are enacted by the “Act on the Partial Revision of the Customs Tariff Law,” and item (3) is enacted by the “Ordinance for Revising Related Ordinances as a Result of the Enforcement of the Act on the Partial Revision of the Customs Tariff Law.”

### 3. Background for revision of special tariff systems and procedures

So far, Japan has been acting as one of the targeted countries of anti-dumping measures and taking a leading position among a group who requests for tightening disciplines on the application of Anti-dumping investigations (Formed Group for Discipline on AD). In the period from 1995 through June 2008, 105 cases of anti-dumping duties were invoked on Japanese products, while Japan government invoked only 7 special tariff cases. From the perspective of balanced operation of nation’s economy system, CCTFT expresses an opinion toward the future operation of special tariff on the report as follows:

*“At the GATT and WTO round of negotiation, Japan has been advocating the prevention of abuse of the right and tightening of disciplines on Anti-dumping duty from the standpoint of the targeted country. On the other hand, we need to*

**Table 2 - Summary of contents of the Revisions to the GO**

	GO for Countervailing Duty	GO for Anti-Dumping Duty	GO for Safeguards
1) Addition of “a person or an entity approved especially by Minister of Finance as stakeholder to the investigation “ to the direct stakeholders	Article 5	Article 8	—
2) Maintenance of provisions in a case when a stakeholder is failed to submit evidence in substantial time period	Article 7	Article 10	—
3) Maintenance of provisions for the notification of provisional decision	Article 10-2	Article 13-2	Article 9-2
4) Maintenance of provisions for the stakeholders to provide an opportunity to express their opinion	—	Article 12-2	—

*take some means against the loss incurred by domestic industries caused by certain trade circumstances, such as steep growth of import from emerging countries; we need to consider the possibility of increasing invocation of special tariff.”*

#### **4. Contents of revision of special tariff systems and procedures**

During this revision, GOs and Guidelines in relation to Countervailing duty, Anti-dumping duty, and Safeguards are revised for the purpose of improving the timeline for investigation and transparency of the procedures. Main points of revision are as follows:

##### **(1) Government Ordinance**

- 1) Addition of “a person or an entity especially approved by Minister of Finance as stakeholder to the investigation “ to the direct stakeholders

Prior to the revision of GO, Minister of Finance would make notification of commencement of investigation only to “direct stakeholders” defined in the Ordinance. The said direct stakeholders were limitedly stipulated on the Ordinance as supplier, importer, and applicant of investigation in relation to the goods concerned. To improve the transparency of the investigation procedure, “other person or entity Minister of Finance expressly acknowledges that they have interest to the investigation” are added to the definition of the direct stakeholder.

- 2) Maintenance of provisions in a case when a stakeholder failed to submit evidence within the substantial time period

The method to determine the facts for nonconforming stakeholder to the investigation, application of “Facts Available (FA)” procedure, which is acknowledged by SCM Agreement and AD Agreement, is clarified in this revision. In this regard, a stakeholder who was failed to submit the

evidence may bear certain disadvantages, GO clearly stipulates that “at the time when Minister of Finance requested stakeholders to submit evidence, provisional and final decision shall be made after their submission.” FA would be applied after the certain period in case where the stakeholder fails to submit the evidence despite of the provision. Detailed manuals are determined in the Guidelines.

- 3) Maintenance of provisions for the announcement of provisional decision

GO newly stipulates the announcement of “provisional decision” and the facts which supported the decision shall be made in public through official newspaper announcement before providing the final decision. The ability to foresee the final decision for stakeholder would be improved and investigation of additional objection would lead accuracy improvement of the final decision.

- 4) Maintenance of provisions for the stakeholders to provide an opportunity to express their opinion

This revision applies only to the GO in relation to Anti-dumping duty. Opportunities are granted to the person or entity such as industrial user, consumer organizations, etc. to provide opinions.

##### **(2) Guidelines**

In the past, Countervailing duty and Anti-dumping duty were handled by one “Guideline for Countervailing duty and Anti-dumping duty,” but from now on, each special duty has its own guideline for procedures. Existing Guideline on Safeguards has also been revised. In addition to the revision of Guidelines, standard format of questionnaire to be submitted from investigating authorities to stakeholders, revised manuals for enrollment, and standard processing timeline from request of investigation to final decision, are provided to

improve the transparency of procedure in accordance with the revision of GO.

Notable point on the revision of the three Guidelines is a sentence added to the “1. Nature of Guideline” which clearly indicates; “For the application of this guideline, flexible handling of each individual case would not be prevented.” This draws out the meaning that authority is allowed to exercise agile management of special tariffs stipulated in the Customs Tariff Law of Japan, especially Anti-dumping and Countervailing duties.

## **5. Going Forward**

In a statement of G7 Finance Ministers and Central Bank Governors meeting held in Rome, February 2009, for the recovery and future growth of the world economics, avoiding protectionist measures is the most important and immediate assignment for the world to act against severe global economic downturn and financial turmoil, as well as the stabilization of financial market.

The revisions of GOs and Guidelines in relation to Special tariff explained throughout this installment are not aimed to utilize those measures aggressively, but to prepare and maintain management procedure which is compliance with WTO rules for the events that would harm the national interest. Further maintenance and improvement of the procedure, such as administrative review for the exporters to grant exceptional low Anti-dumping duty rate, would be expected.

*Statement of G7 Finance Ministers and Central Bank Governors  
(Rome, Italy, February 14, 2009, source from the website of Ministry of Finance)*

*An open system of global trade and investment is indispensable for global prosperity. The G7 remains committed to avoiding protectionist measure, which would only exacerbate the downturn, to refraining from raising new barriers*

*and to working towards a quick and ambitious conclusion of the Doha Round.*

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