

Japan Tax Update

Recovering from the Tohoku Disaster – managing related tax issues

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This Newsletter focuses on the
challenging tasks many businesses
face in assessing and managing the
tax consequences arising from the
Tohoku catastrophe.
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We are immensely saddened by the March 11th earthquake and tsunami in the Tohoku region and by the losses suffered by the Tohoku communities. The impact on Japan of these tragedies, which has left over 27,000 people dead or missing and has destroyed 23,600 hectares of farmland in the Tohoku and Kanto regions, will continue for some time. As Japan regroups, two guiding considerations have emerged: (1) rebuilding Japan will be a daunting and expensive task, with a potential 5-year estimated horizon and a cost estimated in excess of US \$300 billion; and (2) Japan's resilience in the face of adversity and the strong social psyche of the Japanese public are key strengths that may accelerate such rebuilding and result in an economically stronger Japan.

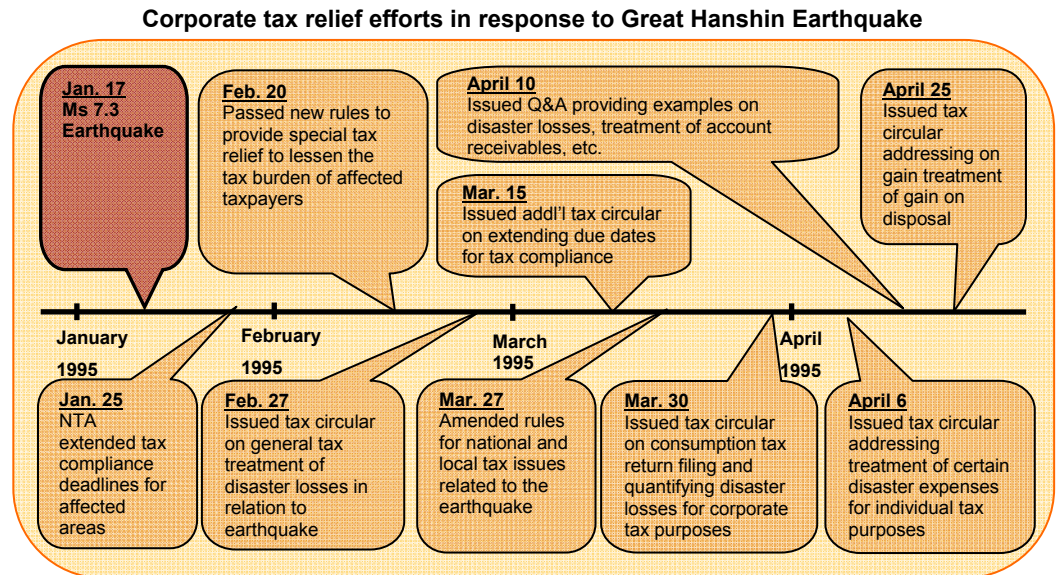
Corporate Japan will need to consider and address consequences far beyond Japan's geographic and economic borders to adjust to the altered circumstances arising from the disaster. While some of the commercial changes made necessary by events (such as repairing earthquake or tsunami damage, temporarily relocating operations, addressing supply chain disruptions, etc.) have been widely discussed, less obvious but critical is the need for tax management to proactively consider and manage the tax risks arising from this type of unexpected eventualities.

The governmental response

The government’s response so far to the Tohoku tragedy in relation to tax matters has been consistent with its response following the 1995 Kobe earthquake (as detailed in our prior Newsletter, which can be found at http://www.pwc.com/jp/en/taxnews/pdf/Tohoku_Earthquake_tax_implications_E.pdf):

- (1) provisional relief to address imminent tax compliance deadlines; and
- (2) an intent to draft more in-depth tax relief (income tax as well as payroll taxes, social security premiums and other non income taxes) without delay (anticipated to come out the end of this month or early next month).

It should also be noted that much of the existing legislation on disaster recovery issues implemented by the government at the time of the 1995 Kobe earthquake may be directly applicable to the Tohoku disaster as well, and in any event may serve as a preview as to what type of tax relief may ultimately be issued by the government this time. A compounding concern this time is the sheer scope of the disaster and required recovery, which is not only unprecedented but is also compounded by the Fukushima nuclear situation and the global public spotlight that is being focused on the government’s aid efforts. Indeed, numerous media reports have alluded to a variety of major tax initiatives to address and fund the recovery effort.



Major tax initiatives being discussed

- Abandon 5% decrease in corporate tax rate as proposed in the 2011 tax reform (2011 Draft Tax Bill)
- Increase income tax rates for residents outside quake-hit regions
- Enact new taxes (i.e., special corporate tax, a “social solidarity tax”, etc.)
- Increase the consumption tax rate (currently 5%)
- Abandon or reduce the current monthly child allowance
- Abandon current toll-free highway system

The government is expected to release a special supplementary budget later this month or early next month to deal with funding the reconstruction effort. The box at left highlights some of the major tax initiatives being publicly discussed. While it is too soon to know which of the initiatives will make their way into the supplementary budget, the scrapping of the planned 5% reduction in the corporate tax rate and a temporary increase in individual income tax rates (for residents outside the quake affected areas) seems likely.

Looking to the future

As Japanese companies consider the rebuilding effort, various tax considerations will need to be carefully considered and can be broadly “bucketed” as follows:

A. Immediate impact of disaster and related taxation

The immediate impact and cost of the triple calamities of the earthquake, tsunami, and nuclear situation includes both direct costs incurred by companies with presences in the Tohoku region as well as indirect costs incurred by companies all over Japan (and indeed, including companies overseas) due to the broader impact of these events on the Japanese and global economies. Solely from a Japanese tax viewpoint however, the following aspects should be considered:

- *Identification of such costs* – costs arising from the Tohoku disaster are likely to qualify for specialized treatment apart from the normal tax rules. Consequently, identification of any such costs outside of normal business expenses will be important to be able to fully take advantage of any specialized treatment offered by the government. For example, while the costs of relocation due to operations being physically destroyed in the disaster may clearly fall within such specialized treatment, the characterization of costs associated with a voluntary relocation of operations not otherwise in the Tohoku area may need to be analyzed in more detail.
- *Quantification of such costs* – company assets will need to be assessed for impairment and/or write off risk. Depending on the assets, the tax rules governing when a write-off or impairment is necessary may differ from the accounting rules, which could be a particular area of concern for Japanese companies.
- *Timing of cost recognition* – while the Tohoku earthquake and tsunami occurred in March 2011 (and thus for many Japanese companies in their fiscal year ending March 31, 2011), the direct costs of the disasters may only be understood and quantifiable in the coming year (i.e., for such companies, in their fiscal year ending March 31, 2012) or even perhaps years later. Determining in what tax year such costs fall has ramifications in terms of the utilization of deductions related to such costs (as tax losses in Japan only carry forward seven years under current rules).
- *Characterization of costs as deductible or capitalizable* – under the general rules, costs incurred to acquire assets must be capitalized and amortized for Japanese tax purposes as opposed to deducted in the year incurred (although various exceptions do narrow the scope of this considerably). For Japanese companies with existing tax losses, having to deduct costs in the year incurred (which would start the 7-year carry forward period ticking) versus being able to amortize and spread that cost out into the future may impact the ability to realize tax savings from such costs.
- *Determination of who should bear such costs* – for corporate or manufacturing groups with more complex intercompany relationships (e.g. related party cost plus service relationships, commissionaire relationships, etc.), determining which company should bear such extraordinary costs will also be a necessary step. For example, if the local Japanese operation is an exclusive limited risk service provider to its offshore parent company on a cost plus basis, and if that Japanese service provider sustained significant damage in the earthquake, should the cost of rebuilding be passed to the offshore parent (on the theory that risks associated with the business are to be borne by the parent)? Or are such costs somehow outside of the costs covered by the cost plus service agreement (and thus should be borne locally)?
- *Impact of costs on transfer pricing* – where it is determined that costs are to be borne by the local Japanese entity, the classification of those costs will also be important from the transfer pricing perspective. For subsidiaries with transfer pricing policies based on net margins (such as a mark up on total costs or a target operating margin approach), it is important to classify those costs as extraordinary losses (i.e., below-the-line items), so that the costs do not distort the net margins.

As has been separately detailed in a previous Newsletter, the JICPA has already published guidance with respect to accounting considerations arising from the Tohoku disaster (including the scope of costs which should be classified as extraordinary losses), and Japanese companies will need to consider where the tax treatment differs from the accounting treatment. Where book-tax differences exist, companies may need to evaluate and record deferred tax assets in their tax provisions, which could impact bottom line earnings.

In addition to the tax issues associated with costs arising from the disaster, a second issue that will need to be considered by tax management is the immediate impact of market uncertainty on transfer pricing policies. Such impact is most obvious in the area of foreign exchange volatility, and thus more likely to have an impact on Japanese operations that are exposed to currency risk, e.g., manufacturers or distributors in Japan that purchase or sell in other than Japanese yen. The treatment of foreign exchange gains or losses arising from sudden swings in exchange rates will need to be factored into existing and future transfer pricing policies.

Less obviously, market uncertainty may also have an impact on a corporation's access to funding (where borrowings are required to fund recovery operations or sustain the ongoing business operations), and thus may lead to an increase in the amount of financing from related parties –all of which will need to be priced on an “arm's length” basis, i.e., as if between third parties. In the same vein, economic forecasts would tend to suggest an increased likelihood of Japanese businesses across a number of industries generating losses, at least in the short term. Whenever and wherever operating losses arise in a multinational group, they place increased stress on the ability of that group to defend its transfer pricing policies under audit, regardless of the legitimacy of the source of the losses. Taxpayers in this situation can improve their ability to manage future audits through document retention policies focused on contemporaneous evidence demonstrating the impact of the disaster on business operations. Turning from the corporate tax viewpoint for a moment, as a result of the disaster many Japanese employees may have received temporary housing or other benefits, special compensation payments for loss of work, or in the most tragic case, bereavement payments from loss of life or loved ones. Such payments could have corporate, withholding tax and individual income tax implications and should be considered as part of the overall tax management function.

In addition, companies may be raising funds to assist with the recovery efforts either by making corporate contributions to charitable or not-for-profit organizations or by pooling its funds with contributions from their employees. Companies could consider the corporate tax deductibility and effectiveness of such contributions (whether the contribution should be made directly to the Japan charity or perhaps by another affiliate through a charitable organization in its home country) and/or whether they could assist their employees in obtaining an individual income tax deduction from the funds collected. Please see our PwC newsletter for more information (http://www.pwc.com/jp/en/taxnews-international-assignment/assets/Japan_charitable_donations.pdf).

B. Looking to recovery

As Japanese companies begin to understand the immediate cost of the disaster and start their rebuilding assessment, they will face challenges unprecedented since World War II, including repairing the largest disruption in the global supply chain in recent years, mammoth reconstruction costs, and even decisions whether to relocate operations and/or headquarters within and without Tokyo, or perhaps even out of Japan. In addition to the commercial factors that need to be weighed when making such decisions, certain tax considerations should also be kept in the forefront of the planning effort:

1. Where “temporary” relocations create “tax nexus” and trigger filing requirements

As the troubles with the Fukushima nuclear reactors escalated a few weeks back, many companies, (with an eye on employee safety first and foremost) relocated employees and operations from Tokyo either to another city within Japan or to another country. Even on a temporary basis, these types of relocations may trigger various filing requirements both for the relocated employees and their employers, depending upon the specific situation.

For the employer, having employees physically present and working in other locations within Japan may create “tax nexus” within that locality and require the employer to file and pay local inhabitants and/or enterprise taxes. While such may largely be viewed as more of a tax compliance management function (i.e., simply allocating local taxes that would otherwise be paid in Tokyo), certain per capita taxes may need to be paid in both locations. This could give rise to paying per capita taxes twice. For Japanese companies that have temporarily relocated large workforces, such taxes may not be immaterial.

In addition, this situation may also give rise to local payroll withholding tax requirements. As the rules are likely to differ locality by locality and based on the length of the relocation, it is recommended that companies in this position build a tax compliance assessment function within their tax management plans to address the requirements.

The rules become even more complicated where such relocations occur cross-border. Many multinational corporations have relocated expatriate staff to Hong Kong, Singapore, or other countries on a temporary basis. Companies need to ensure any necessary visa and immigration papers are obtained. In addition, such

relocations may trigger local country rules with regard to creating “tax nexus” (i.e., so-called “permanent establishments” in tax terminology) and tax filing requirements in those other jurisdictions. Social security taxes in the host location may also need to be considered. Furthermore, the tax laws on reimbursements of temporary relocation costs (i.e., airfare for the employee and his family, temporary accommodations, potentially a per diem) could differ from Japan tax laws. To the extent that this results in a requirement to pay taxes (perhaps because the length and depth of the relocation is viewed to be akin to temporarily operating a business in the other country), then it must also be considered whether those foreign taxes can be credited to reduce Japanese tax liabilities, or whether they are an additional cost of relocation.

Similarly, the relocated employees will need to consider whether the length of such relocation triggers individual income tax filing requirements. For example, U.S. citizen expatriates relocated to Singapore on a temporary basis would need to consider whether under Singapore tax rules the relocation triggers local filing requirements and/or tax payments. If so, those individuals would need to work through the foreign tax credit rules to see whether the Singapore taxes could be offset against their Japan taxes (if they are permanent residents of Japan) and/or their U.S. taxes that would otherwise be due on their income.

2. Relocating more permanently – the choice to change base of operations

Recent media reports have discussed whether the Tohoku triple disaster would prompt companies to consider relocating operations out of Tokyo, or even out of Japan, on a permanent basis. Although many commercial factors will undoubtedly factor into any such decision, this thought process also requires a number of tax considerations to be weighed, some of which are discussed below.

Certainly, any such analysis should be based on a thorough understanding of the overall tax picture of the existing operations. For example, do the existing operations have significant tax losses that could shelter business profits, which would otherwise be taxed if the business operations were moved out of Japan? Moreover, if those losses gave rise to deferred tax assets in Japan for accounting purposes, would an inability to utilize the losses in the future (due to decreased profitability in the remaining Japan-based operations) require the company to write-off the deferred tax assets? On a similar issue, should expenses be capitalized (versus currently deducted) so as to defer recognition of the deduction until the future, when profitability has hopefully recovered?

In addition to understanding the overall tax picture of the existing operations, the tax treatment of the relocation would also need to be considered.

From the individual perspective, in addition to the relocation issues identified above in the temporary relocation section, companies considering permanently relocating may also need to consider that not all employees may be able to or desire to permanently relocate with the company. If these employees leave the company then retirement/ separation payments may need to be made and potentially taxes would need to be withheld.

i. Relocating operations within Japan

Relocating operations within Japan permanently will give rise to the same tax considerations mentioned above in relation to temporary relocations within Japan.

ii. Relocating operations to another country

For companies considering relocating operations to another country on a permanent basis, the taxation of the business migration out of Japan needs to be considered. As a general principle, the transfer of business assets outside of Japan will trigger a taxation of any built-in gain in such assets (as well as allow any built-in losses to be recognized) for Japanese tax purposes. Where the entire business operations are transferred, the goodwill associated with such operations is generally viewed as an asset for this purpose and taxed. Accordingly, companies considering migrating their businesses will need to value such operations and may incur a significant tax cost to move the operations out, depending on the results of the valuation.

Beyond the immediate taxation of the business migration, the relocation of the business will also directly impact the transfer pricing policies in place to govern intercompany transactions among group companies. For example, relocating a manufacturing function from Japan to China, for example, would require an assessment of whether Chinese transfer pricing rules support the same policy to remunerate the manufacturing function as that applied in Japan, or whether the policy will need to be adapted – or even completely changed – to ensure compliance with Chinese law. Particularly within Asia, where there is significant variety both in terms of transfer pricing practice, it is unlikely that the same transfer pricing policy will be able to be applied exactly as it was in Japan – even, for example, for a business as simple as a limited risk service provider. It will also be important for tax

management to check if there are any transfer pricing filing requirements in the relocated jurisdiction, such as contemporaneous documentation requirements, as Japan has a far less onerous compliance burden in this regard than many other countries.

Relocating only part of the business (the raw materials processing part of the manufacturing operations only, for example) creates other transfer pricing issues to consider. In such cases, a new intercompany transaction – between the part of the business remaining in Japan and that relocated overseas – would be created, requiring establishment of a completely new transfer pricing policy. The consequences of a partial relocation are particularly relevant where they result in the conversion of the Japanese business from an entrepreneur to some form of limited risk entity. This will inevitably cause a reduction in the “arm’s length” profit margins that should be recorded by the Japanese entity in the future, as well as an assessment of whether any intangible assets have been transferred outside of Japan. These aspects will certainly require careful consideration, and are likely to increase audit risks going forward. Again, documentation of the changes to the business as a result of the permanent relocation will be critical to managing that risk.

The permutations of any such potential relocation are varied (e.g. moving an entire headquarters, moving a division, solely moving a workforce, moving management, etc.), with an equally wide range of tax issues arising in each case. Thus, the tax consequences of any form of relocation should be carefully considered as part of management’s relocation decision making process.

Addressing the tax function as part of the broader business recovery plan may hopefully ensure that tax risks are identified early and mitigated as far as possible. In turn, this should allow Japanese companies to financially account for the economic consequences of the Tohoku disaster as efficiently as possible.

Zeirishi-Hojin PricewaterhouseCoopers

Kasumigaseki Bldg. 15F, 2-5 Kasumigaseki 3-chome, Chiyoda-ku, Tokyo 100-6015

Telephone: 81-3-5251-2400, <http://www.pwc.com/jp/tax>

For more information, please consult your international tax representative or contact any of the following members listed below:

Partner	Yoko Kawasaki	81-3-5251-2450	yoko.kawasaki@jp.pwc.com
	Akemi Kito	81-3-5251-2461	akemi.kitou@jp.pwc.com
	Jack Bird	81-3-5251-2577	jack.bird@jp.pwc.com
	Marc Lim	81-3-5251-2867	lim.marc@jp.pwc.com
Managing Director	Ken Leong	81-3-5251-2945	ken.leong@jp.pwc.com
	Yumiko Arai	81-3-5251-2475	yumiko.arai@jp.pwc.com

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