

Japan Announces Proposed Deregulation to Allow a Foreign Law Firm to operate through a Legal Professional Corporation in Japan

On April 13, 2010, Nikkei reported that the Japan Ministry of Justice has decided to revise the Practicing Attorney Law to allow a foreign law firm to conduct its law practice in Japan through a Legal Professional Corporation ("LPC"). The revisions may be submitted to the Extraordinary Diet session this autumn for introduction in the year 2012.

Effective April 1, 2002, Japanese law firms were permitted to practice through an LPC. However, most medium and large sized Japanese law firms located in Tokyo have not opted to use an LPC, and instead have remained Partnerships (Nin-i-Kumiai). In many of these cases, tax considerations have been, and continue to be, a significant aspect in this decision-making process.

Our colleagues at PwC Japan have provided a summary of the main points to be considered when deciding between operating as a Partnership and an LPC from a Japan tax viewpoint:

A. Partnership (Nin-i-Kumiai)

- As a Japan partnership, all partners, including non-resident partners, are taxed on their share of income attributable to the Japan office. However, if they qualify each partner can take a 1,030,000 yen personal exemption¹ (380,000 yen basic plus 650,000 yen blue form deduction if applicable), which would reduce their overall taxable income. All partners, including non-resident partners, must file returns in Japan.
- Income generated by the Japan office is spread over many individuals, including non-resident partners, resulting in a lower tax (often about 5% for non-residents), than if computed on income attributable to one entity or only a few individuals (i.e. only partners resident in Japan).
- The business enterprise tax, which is calculated at a flat rate of 5 percent, could be reduced after applying a statutory deduction of 2.9 million² yen per partner after allocation.
- Consumption Tax could be reduced due to the application of the 10 million³ yen threshold per partner. The more partners there are in the partnership, the greater the decrease in tax overall.⁴

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¹ Roughly \$11,500 USD per partner.

² Approximately \$32,250 USD deduction per partner.

³ Approximately \$111,220 USD deduction per partner.

⁴ Business entities, whose taxable supplies during the base period (generally the year beginning 2 years before the tax year concerned) are 10 million yen or less, are generally exempt from filing a Consumption Tax return and paying net Consumption Tax. However, a corporation with paid-in capital of 10 million yen or more would automatically become a taxable enterprise for its initial 2 accounting years period from its establishment.

B. Legal Professional Corporation

1. Advantages

- Assuming fees are locally billed by the LPC to Japanese clients, the LPC may avoid revenue withholding tax liabilities. Please note, however, that this is merely a cash flow timing issue and does not provide permanent tax savings.
- A 20% withholding tax on dividends is required only when remitted to Shareholders (assuming Shareholders are Resident Partners registered with the Japanese Bar Association).
- Salaries and fringe benefits paid to resident partners are tax deductible (except for certain director's bonuses).
- Fee costs for non-resident partners and associates (including those who are on temporary assignment in Japan) are tax deductible on an arm's length basis.
- The period of tax loss carry-forward is 7 years rather than 3 years.
- Ability to establish branch offices is available.
- Various tax benefits can become available for directors, such as company housing (shataku), home leave and scholarship programs.
- Eliminates the requirement of a personal guarantee from the managing partner when signing-off on company housing (shataku) or other contracts.
- As compared to a partnership, non-resident law firm partners need not file in Japan (as long as they are not Shareholders).

2. Disadvantages

- The effective corporate tax rate is approximately 42% (in the case of an LPC with a paid-in-capital of 100 million Yen or less) and the corporate tax on net worldwide income for the LPC would be assessed on the LPC, rather than spread over the individual partners.
- Consumption Tax is more likely to be fully payable by the LPC (when compared to 10 million Yen exemption per partner under partnership form).
- Japanese tax costs for resident partners may increase since Foreign Tax Credit relief is generally not available.

- Comparatively higher costs, relating to the payment of mandatory health and welfare pension insurance premiums under the LPC, are summarized as follows:

	Partnership (Nin-i-Kumiai)	Legal Professional Corporation (LPC)
Health Insurance Premiums	Lawyer's National Health Insurance: 14,000 yen (or 16,800 yen for 40 ages or older) plus 7,000 yen per dependent (No firm portion)	9.32% (or 10.82% for 40 ages or older) of standard monthly salary and standard bonus (each LPC's and Employee's portion is 50%, respectively). LPC may be allowed to continue "Lawyer's National Health Insurance" in practice.
Pension Premiums	15,100 yen per month (no firm portion)	15.704% of standard monthly salary and standard bonus (LPC and Employee portion is 50% each)

C. Conclusion

In general, the use of a Partnership (Nin-i-Kumiai) structure for international laws firms operating in Japan can be substantially more tax efficient than an LPC if the Japan practice is profitable. However, an LPC also has certain non-tax advantages that would make it an attractive option under certain circumstances.

A thorough and detailed analysis of the two different structures, including an examination of cross-border issues, should be conducted by each international law firm to determine which structure would be most beneficial. PricewaterhouseCoopers' team of professionals is ready to assist its law firm clients in determining whether such an analysis should be performed for your firm. Please contact Stanley Kolodziejczak (646) 471-3160, Gregg Sincoff (646) 471-1335 or Nancy Regan (646) 471-6104 in New York; or Nasir Majid +813 3539 6310, Kojiro Endo +813 52 51 2443 or Joni Edwards +813 3539 6407 in Tokyo.

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