

# ASG tax news

ASG Tax Corporation  
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**Our news letter provides information on Japanese tax and business which we believe is of interest to international companies doing business in Japan**

## =Updates=

### Employee Stock Options

In our 2004 No I newsletter, we discussed recent court decisions by the Tokyo District Court (TDC) regarding the tax treatment of income realized as the result of the exercise of stock options received from the parent company by an employee of a Japanese subsidiary. The courts had ruled that such income should be treated as “occasional income” as opposed to “employment income”, resulting in favorable tax treatment for the taxpayers. There are currently dozens of similar cases before the courts, as taxpayers challenge reassessments by tax authorities of such income as employment income. The most recent rulings in this group of cases go against the TDC decisions.

On February 19<sup>th</sup> and February 25<sup>th</sup>, 2004, the Tokyo High Court (THC), hearing appeals brought by the National Tax Agency, ruled that such income should be treated as employment income. The reasons given for these rulings included that the parent company that granted these stock options to the employees of the subsidiaries in Japan surely did so in expectation that it would motivate the recipients to work harder in their capacity as employees of the Japanese subsidiary. Even though the parent company was not the direct employer of the taxpayers, the taxpayers received the stock options as a result of an employee/employer relationship.

These new rulings have added to the confusion that taxpayers face in reporting their benefits realized from the exercise of stock options. More rulings should be coming down on this issue in the near future, and they are being awaited with much interest. It is as yet too early to tell what the appropriate tax treatment for such benefits will ultimately be.

Individuals who have reported stock option gains as “occasional income” on their tax returns for 2003 should be aware of the possibility of reassessment. They should discuss this issue with their tax professional and determine the appropriate course of action.

### New U.S. – Japan Tax Treaty

The new U.S. – Japan tax treaty, which we detailed in the previous edition of ASG Tax News, has been ratified by both nations and will come into force on July 1, 2004. This is earlier than the January 1, 2005 date that was previously expected, showing that Japan and the U.S. are eager for the new provisions of the tax treaty to take effect. Japan has also announced some tax reforms required to implement the provisions of the new treaty. The details of the fiscal 2004 – 2005 tax reform package follow below. For details of the provisions of the new treaty, refer to the 2004 No I edition of ASG Tax News.

## =2004 Tax Reforms=

### Individual Income Tax

#### Taxation of Land and Housing

Individuals owning residential housing may benefit from several provisions of the 2004 tax reforms, such as extensions to the applicability of the tax credit for residential mortgages and to the application of losses carried forward from the replacement of residential housing. Changes regarding taxes on the sale of land are of mixed benefit to taxpayers. While the rate of income tax applied to capital gains realized on the sale of land and housing will be reduced,



from 26% to 20% for long-term capital gains and from 52% to 39% for short term capital gains, the offsetting of losses from the sale of land and housing against other categories of income will be abolished. Long term capital gains refer to capital gains on land and housing held for five years or more before sale, while short term capital gains refer capital gains on land and housing held for less than five years. Note that these new taxation rules regarding land and housing will be applicable to sales completed on or after January 1, 2004.

### SME's (Small and Medium Sized Enterprises)

The tax burden relating to the ownership of SME's has been decreased. Capital gains realized on the sale of unlisted stocks will be taxed at a rate of 20%, as opposed to the previous rate of 26%.

## Corporation Tax

### Loss Carry Forward Corporation Tax

The period over which net operating losses can be carried forward has been increased from five years to seven years. This provision is retroactive to tax years beginning on or after April 1, 2001. Note that the one-year loss carryback provision for net operating losses remains suspended.

### Correction of Tax Reform by the Tax Authorities

Also, starting with tax returns filed on or after April 1, 2004, the power of the tax authorities to retroactively correct taxable income and taxes assessed for corporations will be extended to five years from the current three years.

## Consumption Tax

Changes to consumption tax regulations that were announced as part of the 2003 tax reforms come into affect on April 1, 2004, for corporations. Included in the consumption tax reforms are changes in the requirement to remit interim payments of consumption taxes. The 5% Japanese consumption tax is comprised of a 4% national tax portion and a 1% local tax portion. Business enterprises with a net *national* consumption tax payable (Line 9 of the consumption tax return) of greater than JPY 48 million in the immediately preceding fiscal year are now required to remit interim payments of consumption tax monthly instead of quarterly. The amount of each remittance is to be 1/12 of the preceding year's total consumption tax payable, including both the national tax

and local tax portions. Business enterprises with net national consumption tax payable greater than or equal to JPY 4 million but less than JPY 48 million in the preceding fiscal year must now remit quarterly interim consumption tax payments (1/4 of the preceding year's total consumption tax payable), and business enterprises with net national consumption tax payable greater than or equal to JPY 480,000 but less than JPY 4 million in the preceding fiscal year must remit semi-annual interim consumption tax payments (1/2 of the preceding year's total consumption tax payable).

## International Taxation

The Japanese government has stated its intention to introduce new domestic tax legislation required for the successful implementation of the new Japan – U.S. tax treaty and future bilateral tax treaties with other countries. Areas that are to be included in future legislation are:

- Clarification of the tax treatment in Japan of hybrid entities, whose tax status differs by county.
- Measures to ensure that only individuals and companies that are resident in contracting states benefit from the provisions of bilateral tax treaties.

Also, Japan now recognizes the use of the Transactional Net Margin Method for calculating arms-length prices, as defined in OECD guidelines.

In addition to the above, measures to increase the tax burden of individuals receiving pension income, and measures increasing the amount of taxes received by local governments are included in the 2004 reforms.



## =New Type of Taxation – Gaikei Hyojun Kazei=

When the LDP government led by Prime Minister Junichiro Koizumi was established in 2001, they presented a platform of restructuring the Japanese economy to enable a return to the economic success and growth that Japan had been experiencing up to the early 1990's. Included in this economic restructuring were pledges to reform the tax system, to spread the tax burden "thinly and widely" over the population. Announced as part of the tax reform measures of the government fiscal year 2003-2004, the Gaikei Hyojun Kazei is meant to work towards realizing this goal.

Variously translated as “business scale tax”, “or “size-based tax”, the Gaikei Hyojun Kazei (GHK) is a tax based on a corporation’s capital base and scale of operations, as determined by their taxable income and their payments of salaries, rent, and interest. The Japanese tax system is comprised of taxes at the national level and local (i.e. prefectural, municipal) level. Both levels of taxation have been based primarily on a corporation’s profits. However, since the burst of the “bubble economy” in the early 1990’s, the proportion of Japanese companies earning a profit has declined substantially. For example, in 1998, only 36.7% of Japanese corporations earned any taxable income. Such a sharp drop in corporate profits caused Japanese governments at the national and local level to realize a sharp decline in tax revenues. However, the costs to provide services that benefit corporations remained the same or increased. The result was that an increasing number of corporations were paying almost no taxes, but were still benefiting from the services provided by governments. A shrinking number of profit-generating businesses were supporting these services.

In order to rectify this situation, rather than increase the already high corporate tax rates, the Koizumi government went forward with a strategy of spreading the tax burden “thinly and widely” by requiring that corporations earning no taxable income contribute to the cost of providing government services. This led to the creation of the GHK.

The GHK will replace the existing Enterprise Tax, a local tax, for corporations with paid-in capital (capital stock plus capital reserves) exceeding JPY100,000,000. Not-for-profit and other special corporations are excluded from this tax. This new tax will come into effect for fiscal years beginning on or after April 1, 2004. For corporations with paid-in capital of less than JPY100,000,000 the existing Enterprise Tax will remain in effect with no changes. Details of the GHK are described below.

### Details of the Gaikei Hyojun Kazei

There are three parts to the Gaikei Hyojun Kazei:

1. **Profit-based tax**
2. **Additional Value-based tax**
3. **Capital-based tax**



#### Profit-based tax

The profit-based portion of the GHK is calculated on the same basis that the local Enterprise Tax has been to date, but with a 25% lower standard tax rate. The Enterprise Tax was calculated by applying graduated tax rates, up to a maximum standard rate of 9.6%, against taxable income. The maximum standard rate for the new profit-based tax is

7.2%. Note that local governments can elect to charge up to 20% more than the standard tax rates.

#### Additional Value-based Tax

The Additional Value-based portion of the GHK is determined by taxable income for the year plus “allocated proceeds”, which is defined as the amount of salaries, net rent, and net interest paid during the year. This is considered to be the corporation’s “Additional Value”. Items such as salaries and rent are usually a large part of a corporation’s expenses, and can be expected to be relatively stable from year to year. One of the goals of the GHK is to provide a stable tax base for local governments. By basing a portion of the tax on expenses that are large and do not fluctuate wildly from year to year, the government hopes to come closer to this goal.

#### >>Salaries

The salaries included in the Additional Value calculation are all salaries expensed for financial reporting purposes, plus salaries paid during the year and included in the cost of inventories and fixed assets or other capitalized items. Salaries include monthly salaries, hourly wages, bonuses, termination payments, and allowances insofar as they are considered taxable income to the employees or directors. Items such as the employer portion of statutory benefits are not included, but employer contributions to defined benefit corporate pension plans are included. In the case of outsourced labor, 75% of the outsourcing fee is to be included in this salary calculation.



A high level of salaries will increase the Additional Value portion of the GHK and therefore increase the Corporation’s tax burden. In order to prevent corporations from cutting their employee costs in order to reduce taxes, a Employment Stability Deduction has been made available to deduct from the Additional Value amount when the total of salaries included in the calculation exceeds 70% of “allocated proceeds”. The example below will illustrate this calculation. In this way, a company that has high labor costs in relation to rent and interest expenses will not be required to include the full amount of salaries in the Additional Value calculation.

#### >>Net Rentals

Net rentals is the total expenditure on rentals of land and buildings, less any income received from the rental of land and buildings over the same period, as calculated for tax purposes. If the amount of rental income is greater than the amount of rental expense, then the net rentals amount is deemed to be zero. Only rent derived from contracts

spanning greater than 1-month is included in the net rent calculation. Common area costs and other maintenance or utilities fees are not included in net rentals. Any rent expense included in the overhead cost of inventories would be included in this calculation.

Note that net rentals include rent paid or received for the right to use land and buildings only, and do not include rent payments for such things as the use of machinery and equipment.

**>>Net Interest**

Net interest is the excess of interest paid over interest received during the year. As with net rentals, if the amount of interest received is greater than interest paid, then net interest will be deemed to be zero. The determination of what types of revenues and expenses to include in the net interest calculation can be complex, and the Government has issued guidance on what types of items should be included in this calculation. In addition to interest paid on loans, the discount on promissory notes sold to financial institutions and interest paid and capitalized as part of the cost of construction projects will be included in this calculation. Such things as sales discounts received as a result of early payment of invoices and interest paid to tax authorities for overdue taxes will not be included in the calculation. When uncertainty exists as to the classification of certain payments or receipts as interest, guidance should be consulted to determine whether or not the amounts should be included in the Additional Value Calculation.



**>>Example: Calculation of the Additional Value amount**

Current year Taxable Income	1,000,000
Salaries expense per income statement	5,000,000
Salaries paid to production employees during theyear and included in inventory and cost of goods sold	10,000,000
Net rents paid	2,000,000
Net interest paid	1,000,000
 Allocated proceeds = Total of salaries paid, net rents and net interest	
=	18,000,000

Proportion of Salaries as a % of allocated proceeds  
 = 15,000,000 / 18,000,000 = 83.3%

Employment Stability Deduction  
 = salaries in excess of 70% of allocated proceeds  
 = (15,000,000) - (18,000,000 \* 70%) = 2,400,000

Total Additional Value  
 = Taxable Income + Allocated Proceeds – Employment Stability Deduction  
 = 1,000,000+18,000,000–2,400,000 = 16,600,000



**>>Tax Rate**

The standard tax rate for the Additional Value portion of the GHK is 0.48%. In the example above, the Additional Value portion would result in taxes of:

$$16,600,000 * 0.48\% = \text{JPY}79,680.$$

As with the standard rate for the Profit-based portion of the GHK, local governments may set their own tax rates up to 20% higher than the standard rate.

**Capital-based Tax**

The Capital-based portion of the GHK is calculated on the paid-in capital amount of the corporation at the end of the year. If a corporation has been in existence for less than one year, then the paid-in capital amount is pro-rated for the number of months the corporation has been in existence for that fiscal year. The standard rate of the Capital-based portion of the GHK is 0.2%. As with the Profit-based tax rate and the Additional Value tax rate, local governments may increase the rate for their jurisdiction to a maximum of 20% of the standard rate.

Under this system, corporations with high levels of paid-in capital will pay more taxes. In order to alleviate this tax burden, corporations with paid-in capital greater than JPY100 billion can decrease their taxable paid-in capital by including only 50% of paid-in capital greater than JPY100 billion up to JPY500 billion, and only 25% of paid-in capital greater than JPY500 billion. The maximum taxable paid-in capital amount is JPY1 trillion.

To avoid double-taxation of the capital portion of the GHK, corporations that hold greater than 50% of the shares of a Japanese company, either directly or indirectly, can decrease their taxable paid-in capital by the book value of the shares in these “specified subsidiaries”.

## Foreign Corporations

Foreign corporations with a permanent establishment in Japan will also be subject to the GHK if the paid-in capital of their head office is greater than JPY100,000,000. The calculation of the Profit-based portion and the Additional Value-portion will be based on revenues and expenditures earned and incurred as part of the Japanese operations. As for the Capital-based portion of the tax, paid-in capital for foreign corporations will be pro-rated based on the number of employees in Japan versus worldwide in order to determine the taxable paid-in capital amount. The taxable paid-in capital amount is calculated at the end of each year, and the TTM exchange rate at each year end is to be used in this calculation.


## Accounting for the GHK

In terms of financial accounting for the GHK, the Japanese Accounting Standards Board has issued guidance on this matter. The Additional Value and Capital portions of the tax should be presented as part of operating expenses, and the Profit-based portion of the tax should be presented as part of income taxes. The rationale behind this accounting treatment is that because the Additional Value and Capital portion of the GHK are not based on income, it would not be appropriate to present them as “income” taxes.

## Conclusion

The GHK will have the effect of raising taxes on corporations who have no taxable income. However, the effect it will have on profit-making corporations will depend on the components of their taxable income and the amount of their paid-in capital. The government has stated that their aim is not to increase tax rates, but to spread the tax burden and achieve more stability in their tax revenues. The GHK is a small step in this direction. It remains to be seen how effective this measure will be in achieving the government’s goals.



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