

ASG tax news

ASG Tax Corporation
Quarterly Newsletter
December 2004

Grant Thornton 



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

Termination Payments ---- “Retirement Pay” or “Bonus”?

A recent tax audit by the Tokyo Tax Bureau resulted in approximately 185 former expatriate employees of securities firms in Japan being assessed taxes and penalties on underreported income. The amount of the underreported income ranged from tens of millions to hundreds of millions of yen per person. At issue were amounts received as “retirement pay” from former employers after the expatriates had returned to their home countries.

Traditional business practice in Japan includes the practice of paying “retirement pay” when an employee in good standing leaves a company. The term “retirement pay” is perhaps misleading, as such payments are made regardless of whether the employee is retiring from the workforce or simply changing jobs. However, with the “lifetime employment” system that has been in place in Japan for most of the post-war period, leaving a company effectively meant that you were retiring from the workforce, and this lump-sum “retirement” payment served as part of your nest egg to support you and your family during your retirement years.

In order to allow retired workers to make the most of this “nest egg”, Japanese tax law provides for preferential tax treatment of such payments. Firstly, retirement payments are eligible for the “retirement payment deduction”, which is calculated as follows:

<Years of service = 20 years or less>
Retirement income deduction = ¥400,000 * years of service, or ¥800,000, whichever is greater

<Years of service = more than 20 years>
Retirement income deduction = ((Years of service - 20) * ¥700,000) + ¥8,000,000

Additionally, any amount remaining after the retirement payment deduction is only 50% taxable. The effect of the deduction and 50% tax treatment is that the vast majority of employees receiving retirement pay do so on a virtually tax-free basis. Almost all Japanese companies have provisions for payments of retirement pay in their employee compensation policies. A typical retirement pay policy would provide for no retirement pay if an employee left the company within the first three years of employment, and then a retirement payment based on some multiple of monthly salary, with that multiple rising at an increasing rate as the employee’s years of service increase. It would not be uncommon for a person with 30 years of service to receive a lump sum payment upon retirement of ¥20,000,000. Because of the preferential tax treatment of retirement income, only ¥2,500,000 of that income is subject to personal income taxes. At a top marginal tax rate of 37%, the tax difference is ¥7.4 million vs. ¥925,000, a savings of ¥6,475,000.

Because of the preferential tax treatment of retirement income, it is clear that it would be in the interests of the employee to maximize the amount of income that can be classified as “retirement pay” in the year that they leave an employer. Generally speaking, there is no restriction on the amount of retirement payments. No matter how high the payment, the retirement pay deduction may be applied and 50% of any remaining income is exempt from the income tax. However, payment must be contingent upon the employee leaving the company, and the determination method of the retirement pay amount must be consistent across all employees.



In this case, the tax authorities looked at the employee compensation policies of the various employers and concluded that the amounts paid after

termination to these expatriates was excessive compared to the amounts paid to other employees of these same firms after termination. Furthermore, these expatriates had not received “bonus” payments during their period of employment, despite the fact that in their industry variable compensation based on performance was standard practice, and the payment of such bonuses was stipulated in their employment contracts. Therefore, it was deemed that the bulk of the “retirement payments” made to these expatriate employees were actually “bonus” payments. Because bonus payments are treated as salary income for tax purposes, these expatriates were assessed additional taxes on amounts reported as retirement payments, plus penalties.

Note that although the individuals involved in this case were non-Japanese, this fact should not have had any bearing on the outcome of the case. As a result of these findings, the tax authorities can be expected to step up their scrutiny of amounts reported as “retirement income” by both expatriates and Japanese employees.

2005 Tax Reform

The Government study committee for tax reform has issued their proposals for tax reform measures to be implemented for the government fiscal year starting April 1, 2005. The committee stated in its report that the proposed tax reforms were needed to reduce the government’s dependence on the issuance of bonds in order to finance the continuing budget deficit, and to deal with the aging society and the additional costs that will result in terms of health care and pensions. There is a need to deal with the current budget deficit situation by both increasing revenues and decreasing costs. The goal is to eliminate the budget deficit by the fiscal year beginning in April 2006.

1. Gradual Elimination of the “Fixed Rate Tax Deduction”

The “Fixed Rate Tax Deduction” was implemented in 1999 as a temporary measure to deal with the serious economic slowdown at that time. This measure reduced the national income taxes payable by an individual by the lower of 20% or JPY250,000, and reduced local inhabitant tax by the lower of 15% or JPY40,000.

The effect of the Fixed Rate Tax Deduction was to reduce individuals’ taxes payable by over 3 trillion yen per year. However, economic restructuring efforts over the past few years has made the current economic situation significantly better compared to 1999, and

continuing economic reforms can be expected to improve the economic situation further. The study committee recommended that the Fixed Rate Tax Deduction be progressively eliminated by 2006. Therefore, it is expected that the rate of the Deduction will be reduced for the 2005 tax year.

2. Simplification of the Taxation of Financial (Investment) Income

Japanese families have traditionally had a very high rate of savings. However, the rate of savings has gone down dramatically in recent years, and the interest received from banks on savings is almost nil. Therefore, Japan is moving from a “saving” to an “investing” culture, as people try to improve the return on their accumulated funds. The study committee recommended that in order to encourage such investment activity, that the taxation of investment income be simplified by taxing various types of investment income in the same manner.

At present, investment income such as interest, dividends, gain/loss on sale of securities, etc. all have different tax treatment. This is confusing for the investor/taxpayer and may discourage them from investing their financial resources. This situation arose over time as the range of income sources subject to income taxation were expanded. At the same time,

the committee cautioned that care must be taken not to develop a system that would lead to a sharp drop in tax revenues or lead to further confusion among investors.

The details of investment income tax reform have not yet been announced. One major policy that may be implemented is the introduction of a “Taxpayer Identification Number” (TIN) to assist in tracking the income that should be reported by taxpayers. Japan has to date not had a unique taxpayer identification system, such as the Social Security Number used in the U.S.

3. International Taxation

The study committee acknowledged that the Japanese economy has become more complex over the years, as the number, type, and complexity of international transactions has increased. It stressed the need to continue to encourage international economic activities, while at the same time evolving the Japanese tax system to ensure that it maintains its ability to collect taxes on such activities. The study committee recommended



continuing with the process of proactively pursuing revisions of international tax treaties, as was done with the US-Japan tax treaty in 2004, as such treaties are valuable in reducing international tax avoidance by those who exploit gaps in the tax laws of various countries. It also recommended moving forward with tax reform that would expand the taxation of undistributed profits of Japanese subsidiaries located in foreign tax havens, place appropriate restrictions on the deductibility of foreign tax credits, and better identify and tax non-resident investors in Japanese pass-through entities, specifically “Nin-i Kumiai” (NK: Civil Code Partnerships). At present, investors who receive income from Japanese NK are required to file an income tax return in Japan. However, as many foreign individual and corporate investors in such entities are not fulfilling this requirement, the Japanese government is considering the imposition of withholding taxes on income from NK.



4. Other Recommendations

With regards to the consumption tax rate, the study committee recommended that this rate be increased from the current level of 5%, and that adoption of the “Invoice System” used in some other countries, whereby input tax credits must be supported by vendor invoices, be considered. In raising the consumption tax rate, the effect that the tax increase would have on the price of necessary goods should be considered and appropriate measures taken to alleviate the burden on consumers. Also, when formulating future tax policy, consideration should be given to the issue of global warming and tax measures to encourage a decrease in emissions of greenhouse gasses should be formulated.

Commercial Code Reform

Several changes to the Japanese Commercial Code are currently being proposed and, if accepted into law, will become effective as of April 1, 2006. Three measures being considered are the elimination of “Yugen Kaisha”, introduction of the LLC form of business entity, as well as the lifting of restrictions on foreign companies engaging in share-for-share exchanges in acquisition transactions.

1. Elimination of the “Yugen Kaisha”

The “Yugen Kaisha” (YK) is a type of corporate entity that is similar to a “Kabushiki Kaisha” (KK) but operates under slightly different rules. For example, the

minimum capital requirement to set up a KK is ¥10 million, while for a YK the minimum requirement is ¥3 million. A KK is required to have a Board of Directors, with a minimum of three directors, at least one of whom is a Representative Director, while a YK is required only to have one director. Also, a KK is required to hold shareholders’ meetings no later than 3-months after each year-end, while there is no such requirement for a YK. Both types of corporation provide limited liability protection to their investors. As part of the reform of the Commercial Code, it has been proposed that the YK type of corporate entity be eliminated, and some of the more flexible rules associated with YKs be incorporated into the law governing KKs. If this reform takes place, then transitional provisions will be required for existing YKs.

Under the proposed reforms, there will be no minimum capital requirement for establishing a KK. All KKs will be required to have at least one director. However, the establishment of a Board of Directors will be optional for KKs that have in their Articles of Corporation a provision restricting the sale of shares by any investor to outside parties without approval of the other shareholders. If a Board of Directors is established, then either the “Statutory Auditor” system or the “Three Committees” system of corporate governance can be selected. If the “Three Committees” system is selected, then an external auditor must be appointed, while the appointment of an external auditor is optional under the “Statutory Auditor” system unless the company is defined as “Large”. “Large” companies are those that have liabilities in excess of ¥20 billion and/or paid-in capital in excess of ¥500 million. “Large” companies are required to appoint an external auditor.



Term of service for Directors will be two years, and the Statutory Auditor will serve for up to four years. However, KK’s that have restrictions on the sale of shares to outside parties may extend the term of service of directors by up to 10 years after the initial two year term has been completed.

2. Introduction of LLC Legislation in Japan

The LLC (Limited Liability Company) and the LLP (Limited Liability Partnership) type of business entities have become widely adopted in the United States and other industrialized countries. Such company structures enable owners to limit their liability to the amount of

their investments in such entities, and at the same time to avoid taxation at both the company and the personal level (double-taxation), as profits/losses “pass-through” the company and are taxed directly in the hands of the owners. Such “hybrid entities” are not provided for under Japanese laws. However, the Ministry of Economy, Trade and Industry (METI) has announced that it has formed committees to study the adoption of the LLC type of company under the Commercial Code, as well as the LLP type of company under the Civil Code section regarding cooperatives. METI has expressed its goal of introducing legislation allowing the creation of such business entities in Japan starting in 2006.

At present, Kabushiki Kaisha (“KK”) and Yugen Kaisha (“YK”) are the types of business entity generally used in Japan. As stated above, it has been proposed that the YK type of business entity be eliminated and that some of the more flexible characteristics of YKs be incorporated into KK legislation. While a YK can be treated as a pass-through entity for US tax purposes under the “check the box” rule (beneficial if the parent is a U.S. resident), in Japan taxation occurs at the company level. NK, while offering the benefit of pass-through taxation, do not provide limited liability to the partners.

The LLC business structure has proved to be very popular in countries where it has been introduced, such as the United States, for joint ventures, venture capital start-ups, and knowledge-based industries. Such businesses want to limit their liability, but at the same time desire flexibility in terms of decision-making and profit distribution. In knowledge-based industries, where the contribution of a partner/investor may be in terms of know-how rather than cash, the ability to distribute profits based on something other than the monetary contribution of the owners is necessary to attract the talent required to succeed.

One reason for the creation of the LLC type of company in Japan is the hope that this will encourage more investment, from both domestic and foreign sources, in the Japanese economy. However, Japan has no “check the box” tax system, and it is still unclear whether Japanese LLC’s will enjoy pass-through taxation. With pass-through taxation, investors would be able to apply any loss from their LLC investment to their income from other sources, thus realizing an immediate tax benefit. As losses are often incurred in the early stages of any investment, this pass-through taxation acts as an

incentive for investors. Therefore, if it is ultimately decided that Japanese LLC’s will be taxed at the company level, then the popularity of the Japanese LLC business structure will likely be low. In such a case, the Japanese LLP business structure may be more attractive to investors.

3. Share-for-Share Exchanges in Merger Transactions

Under proposed Commercial Code reforms, the restriction on foreign companies being involved in certain share-for-share transactions will be lifted.

Foreign companies will be allowed to engage in “triangular mergers”, whereby a Japanese subsidiary is set up and that subsidiary merged with another Japanese company by exchanging the shares of the foreign parent for shares of the target Japanese company.

However, in order for this revision of the Commercial Code to be effective in increasing the amount of foreign investment in Japan, Japanese tax laws must be revised as well. Current tax law requires that when shares of a third party company are involved in share-for-share exchange transactions,

as is the case in a triangular merger, then the recipients of the shares are deemed to have disposed of their existing shares and then purchased the shares of the other company at the cost of their disposed shares. Therefore, a taxable gain on sale of the original shares may be triggered at the time of exchange. As the current tax law would counteract the effect of the Commercial Code revision to encourage such transactions, it is expected that the relevant sections of Japanese tax laws will be revised accordingly as part of the tax reform measures for the government fiscal year beginning in 2006.



Court Ruling on NK Investments Used for Tax Sheltering Purposes

There have been several court cases in Japan in recent months regarding the use of “Kumiai” business structures as a means to defer and reduce the amount of personal tax paid by investors. NK are pass-through entities, and so any losses incurred by a Kumiai are allocated to the individual investors in the NK and can be used to offset taxable income from other sources. The judgments in these cases have largely been in favour of the government’s position that these investments are for no other reason than tax avoidance, and the taxes and

penalties assessed on the taxpayers have been upheld. However the Nagoya District Court on October 28th, 2004 ruled on a similar case in favour of the taxpayers and canceled over JPY330 million in taxes and penalties assessed by the National Tax Agency (NTA). At issue in these court cases was the validity of the NK contract as a business activity, rather than as a tax shelter product. If the contract was deemed to be for the sole purpose of tax avoidance, then the individual investors would not be able to deduct the losses of the NK against their personal income.



The basic structure of the NK investment in the latest court case is as follows:

- 1) Individual taxpayers invest in a Japanese NK. The NK purchases aircraft and then leases those aircraft to other companies.
- 2) The depreciation expense exceeds lease revenue, and the Kumiai reports losses each year. Because the NK is a pass-through entity these losses flow to the individual investors, who can use the losses to reduce the amount of their taxable income from other sources.
- 3) After several years, the aircraft are sold. The proceeds of the sale go to the investors as a return of their initial investment and profit. Any capital gain realized on sale of the aircraft is taxable in the hands of the investors. However, as the transaction qualifies as a "long term capital gain", only half of the capital gain is taxable.

In this way, investors can reduce their current taxable income by netting depreciation expense with their other income, and any profit that ultimately results from the investment is taxed at only half the rate of other income.

The Nagoya District Court acknowledged that an attractive feature of the NK investment in question was the tax component. However, although the structure of the investment resulted in considerable tax savings to the investors, this alone was not enough to conclude that the NK was not involved in a valid business enterprise. The judge stated in his remarks that it was only natural for reasonable businessmen to consider potential tax benefits as part of their investment decisions. The tax benefits provided by this particular business structure resulted from the way Japanese tax law has been drafted and not from any illegal activity by the taxpayers themselves. The Civil Code states that such pass-through "NK" are legal, and tax laws state that losses from business that pass through to individuals can be offset against other taxable income (Aggregate Taxation) of the individual. Tax laws also give favorable tax treatment to



disposals of assets held long term. The taxpayers were simply utilizing these legal measures, therefore, the NTA erred in its assessment of the NK as having no business purpose and disallowing the pass through of losses to the individuals. The judge criticized the NTA's actions, saying that they had no basis in law.



On November 25th the Tax Committee of the Ministry of Finance announced that it would introduce legal measures to stop tax avoidance by the use of pass-through entities. These measures will likely be placed in effect with the 2005 tax reforms for the government fiscal year beginning on April 1, 2005. Such legislation should help to reduce the confusion about the validity of tax losses from NK investments that exists today as a result of these conflicting court rulings.

Other Matters

Japan – UK Tax Treaty Update


Discussions to revise the Japan – UK tax treaty have begun, with the first meeting of the first round of discussions held in November, 2004, in Tokyo. It is expected that the treatment of royalty payments, interest received by financial institutions, dividends between parent and subsidiary, limitation of the time period for transfer pricing reassessments, limitation of tax treaty benefits, and other issues will be discussed. At present, it is not known when the revised tax treaty will be ready to be signed.

Definition of a Tax Haven

Special Tax Law 66-6-1 requires that undistributed profits of a company controlled directly or indirectly by a Japanese company that is located in an off-shore tax haven must be included in the taxable income of the Japanese parent, to the extent of the parent's proportion of ownership. Elsewhere in the tax law, a "tax haven" is defined as a region where the corporate tax rate is 25% or less. The Isle of Guernsey has a tax system that allows a company to specify its own tax rate, between 0% and 30%. There was uncertainty as to whether this tax system met the definition of a tax haven under Japanese law.

In a recent ruling, the Tokyo National Tax Tribunal determined that the Isle of Guernsey did indeed fall under the definition of a tax haven under Japanese Law. The reason given was that, although nominally the tax rate chosen by a company could exceed 25%, the fact that the payment of tax on Guernsey is entirely

voluntary means that any “taxes” paid do not have the same characteristics of Japanese corporate tax, and therefore cannot be said to meet the definition of “corporate tax” under Japanese law. A key characteristic of corporate tax under the Japanese system is that similar companies involved in similar activities should be subject to the same corporate tax rate. This is not a characteristic of the Guernsey tax system, and so any profits earned in a Guernsey-registered company by a subsidiary of a Japanese company fall under the tax haven provisions of Japanese tax law.

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