

ASG tax news

ASG Tax Corporation
Quarterly Newsletter
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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.

New Company Law

In our last newsletter, we provided some information on the proposed commercial code reform here in Japan. The Ministry of Economy, Trade and Industry has submitted the Limited Liability Partnerships Bill to the Diet and this new commercial code proposes to change the types of entities that can be chosen from. As a result of these legislation changes, foreign investors will have a choice from LLC and LLP as ways of doing business in Japan, along with KK, which will undergo a few changes (namely the introduction of flexible rules previously associated with the now eliminated YK).

Up to now, the types of choices for companies in Japan would not allow for limited liability for Directors with flexibility for management structure, plus pass-through taxation. The new changes plan to allow for these.

Listed here are some changes and details of the various types of companies:

KK (Joint Stock Company)

1. Internal Management Structure

KK is the most popular form of doing business in Japan with both small closely held businesses and large public companies. The same requirements such as appointing at least three directors, setting up the board of directors, appointing at least one statutory auditor, minimum capital of JPY 10M etc. are applied to all KK regardless of their balance sheets. It is widely held that the current requirements for KK are too stringent for small closely held businesses, and are yet too loose for large public companies. Small businesses prefer an internal management structure with stronger control over the

management of the business by shareholders. On the other hand, stringent corporate governance and internal control structure must be put in place for large companies. To accommodate these conflicting demands, the New Company Law differentiates between the internal management structure of a KK in which share transfers are restricted in the articles of incorporation and a KK in which share transfers are not restricted. Generally, the first category is a closely held small company and the second category is a large company. For the first category KK, it is left to the company's decision as to whether or not the board of directors is set up. For the second category KK, it is mandatory to set up the board of directors. Kks in this category are also required to appoint statutory auditors and/or set up various committees.

If a foreign investor sets up a subsidiary in Japan and wants to retain as much control over the management of the subsidiary as possible, the following management structure can be designed:

- Only 1 Director required for establishment (board of directors is not set up.)
- No statutory auditors appointed
- Any business decisions must be subject to shareholder approval.

2. Minimum Capital requirement

The minimum capital requirement, currently at JPY10M, is eliminated. When incorporating a KK, at least JPY10M capital contribution must be made to the KK. The purpose of the minimum capital requirement is to protect the company's creditors. However, once a KK is incorporated, it is not required to keep the minimum capital amount in the KK. Even if the net asset the KK has is below the minimum capital requirement, the KK is allowed to

continue on with its business. Therefore, it has been pointed out that the minimum capital requirement is not useful from a creditor protection standpoint.

3. Profit distributions

Under the current law, a KK is allowed to pay dividends once a year after the close of the business year subject to shareholders' resolution. Under the New Company Law, a KK is allowed to pay dividends at any time during the year subject to shareholders' resolution. As long as a KK has distributable profits, it can pay dividends any number of times. However, if the net asset amount of a KK is JPY 3M or less, the KK is not allowed to pay dividends.

LLC (Godo Kaisha)

A LLC is a company with a more flexible internal management than a KK and limited liability interest holders. The characteristics of a LLC are as follows:

- Can be established by one or more members
- Each member is authorized to engage in the business of the LLC
- Managing members, who are engaged in the business of an LLC, can be appointed, but this is not mandatory.
- Transfer of interests in an LLC must be subject to consent of all members.
- No requirement to publish financial records
- Profits and voting rights can be distributed freely in proportion to personal contribution
- Capital contribution is limited to money and properties (no services)
- Corporate taxation most likely to be used

LLP

The new legislation concerning Limited Liability Partnerships is currently being reviewed and deliberated at the Diet. The main characteristics of a LLP are as follows:

- Liability of partners is limited to their contribution in the partnership (must have more than one partner)
- One partner must be either a Japanese resident or company
- All partners must be involved in the management of the LLP
- Name of the company and partners, addresses and type of business must be registered and LLP must be included in the trade name of the partnership.
- Allocation of profits can be distributed freely depending on the amount of contribution by the partner

- Only property contribution is allowed, no labor contribution
- Disposal or takeover of important assets or borrowing of large sums of money requires the unanimous consent of all partners.
- A Partner can exit the partnership freely.
- Partner level taxation

Restriction on using a branch

The New Company Law includes a provision to restrict using a branch in Japan. This new rule (Article 821) is to prohibit the use of conducting business in Japan in branch form if: 1) the head office/principle place of business for the company is Japan; or 2) the primary purpose of the branch's holding company is to hold the branch conducting business in Japan.

This new law will affect those corporations that are using a corporation under foreign laws to avoid Japanese governance, even though their main business is conducted in Japan. No specific information has been defined with regards to what is required by the corporation outside of Japan.

Therefore, should this legislation pass in the present form, those branch offices that fall under this law would need to transfer the branch into a KK business structure.

This legislation is currently in the Upper House, after having passed through the Lower House in May, and



should it pass will come into effect in April 2006.

2005 Tax Reforms

Tax Credit for Training Expenses

According to the new reforms, companies can now receive a tax credit for training expenses of their employees.

Corporations filing the blue tax return, beginning from the fiscal years on or after April 1, 2005, can receive the following credits:

Corporations with capital of JPY 100,000,000 or more

Credit is limited to the lower of either:

- 25% of the increase of costs compared with the average cost of the past 2 fiscal years OR
- Corporation tax liability of the current year x 10%

Companies with capital of JPY 100,000,000 or less

Total amount of expenditures for training * rate (the increase of this year / avg. for past 2 years) * 50% (Maximum credit of 20%).

This training expense credit is a temporary measure that can be utilized for 3 years.

Not all expenses can be qualified for as training expenses. Training expenses can be thought of as those expenses that are needed for employees to acquire or improve their skills in order to complete the duties required for their job. Some examples of types of training expenditures that can be used are:

- Payments for external instructors
- Participation expenses for external training
- Training materials
- Rental fees used for training including: facility, equipment, other assets

In order to assist companies in taking advantage of this credit, it is advisable to set up a new account such as “training expenses” to help keep track of these costs.

Foreign Related Parties - Transfer Pricing Rule

There have been some recent changes to the definition of foreign related parties, which fall under the Japanese transfer pricing regime.

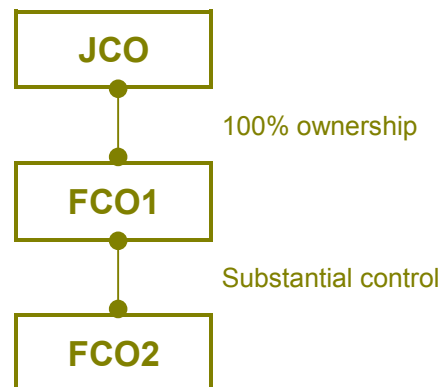
In the past, parties which were covered under foreign related parties, were defined as foreign corporations with which a Japanese corporation has one of the following relationships:

- A relationship in which either of the two corporations owns directly or indirectly 50% or more of the stocks in the other
- A relationship in which 50% or more of the stocks of each of 2 corporations are owned directly or indirectly by the same person
- A relationship in which either of the 2 corporations controls the other by determining their business policies or controls their decision making



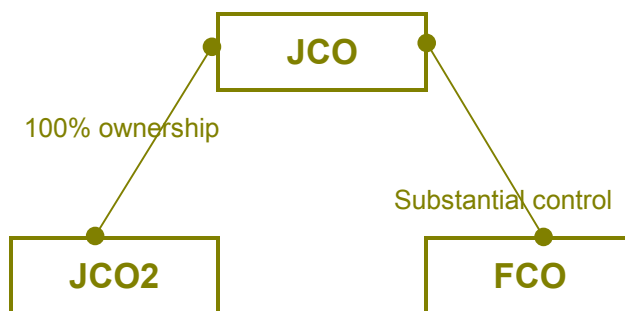
The following 2 classifications will be added to this definition:

- Foreign Corporations (Japanese Corporations) which are directly or indirectly controlled by a Japanese corporation (foreign corporation) through substantial control in relationships and shareholding or substantial control in relationships only



*FCO2 is a foreign related party for JCO under the new rule.

- Foreign corporations and Japanese corporations are directly or indirectly controlled by the same person through shareholding or substantial control.



*FCO is a foreign related party for JCO2 as well as for JCO1

With these additions, those corporations controlled by a company that is associated with a Japanese corporation will be classified as “Foreign Related Parties.”

Capital Gains

Transfer of shares owned by partnership

A new reform in this area specifies that non-residents or foreign corporations owning 25% or more of a Japanese company’s shares, including those stocks owned through partnerships (kumiai) or related companies, will be subject to tax on capital gains from transfers of 5% or more shares during the same fiscal year.

Before this reform, this 25% rule only included ownerships through family members and companies related to the foreign corporations and not those through partnerships.

Non-residents or foreign corporations in a country with which Japan has an OECD model based tax treaty are exempt from this taxation.

Capital gain on transfer of shares in a real property holding company

Non-residents and foreign corporations transferring shares of a corporation, in which 50% or more of the corporation's assets is in real estate, will be subject to tax as source income on the capital gain from this transaction.

Both of these Capital Gains rules will come into effect for fiscal years starting on or after April 1, 2005 for foreign companies and from 2006 for individuals not residing in Japan.

Withholding tax on profit allocation partnerships

Non-residents and foreign corporate partners of a partnership are required to file tax returns for profit allocation from a partnership doing business in Japan if they have a PE in Japan. They will now be subject to withholding tax for profit allocated to them. "Partnership" includes not only those organized under the Japanese laws but also foreign partnerships. As partners conduct business jointly under a partnership agreement, foreign partners are sometimes treated to have a fixed place of business if the GP of the partnership has an office in Japan. Further, there is a possibility that the Japan resident GP is regarded as an agent to foreign partners.

The withholding tax rate will be 20% of the profit allocation. The payer of the allocation will be required to withhold the tax at the time of distribution or 2 months from the date of profit allocation. Since the taxes are withheld, the nonresident or foreign corporation could credit withholding tax against the tax liability on their returns.

Partnership restrictions on deductions

Corporate partners in a NK (Ninni Kumiai: Civil Code Partnership), a TK (Tokumei Kumiai: Silent Partnership under the Commercial Code), Limited Liability Investment Partnership or foreign partnerships similar to those that suffer losses in these partnerships will be restricted in tax deduction of the amount that can be lost, similar to the At-Risk Rule in the United States.

The losses in such cases will be treated in the following manner:

- If a partner in a partnership has no liability in the partnership, due to specific arrangements in their

contract, they will only be able to claim a deduction less than or equal to their actual contribution in the partnership.

- If an arrangement has been made in a partnership to ensure a partner a profit, then the partner is not able to deduct any losses that may occur in the partnership.

The intention of these restrictions is to limit the amount to which a partner can deduct for tax purposes dependent on the amount invested and risk level.

A corporate partner who is involved in contract negotiations and important business of the partnership is not subject to these rules/deductions.

Fixed Rate Tax Credit

Starting from January 1, 2006, fixed rate tax credit for personal income tax will be reduced to one-half of the current amount. Currently the National Income Tax rate is 20% (maximum of JPY250,000) and this will be amended to 10% (maximum of JPY125,000).

Local inhabitants tax will also be reduced in half starting from June 1, 2006. The current law allows for 15% (maximum of JPY40,000) and this will be decreased to 7.5% (maximum of JPY20,000)

CFC (Controlled Foreign Company) legislations

There are a couple of changes in the CFC legislation.

Personnel cost deduction

In the past a Japanese parent company did not have to include their CFC's undistributed profit in its taxable income if the CFC met all of the following tests:

- Business purpose test**
The business purposes of the CFC must not be holding of shares or bonds, holding of industrial property rights, copyright or other intangibles, or leasing of vessel or aircraft
- Substance test**
The CFC must have an office, a shop, a factory or other physical presence in a host country or jurisdiction
- Management test**
Business conducted by the CFC must be managed, controlled and administrated by itself in a host country or a jurisdiction
- Unrelated party or Location test**
In the case the CFC engages in wholesale, bank, trust, insurance, securities dealing, water transportation, air transportation, more than 50% of its business must be



conducted with unrelated parties (Unrelated party transaction test). In cases where the CFC engages in businesses other than the above, its business must be conducted predominantly in the host country or related jurisdiction.

With this reform, the CFC only has to meet (i) – (iii) for the Japanese company to be allowed to deduct 10% of its personnel expenses from the subsidiary's undistributed profits that will be included in its filing.

Deduction period extension

A Japanese corporation that receives dividends from a CFC that has already been included in its taxable income and taxed on its earnings, can deduct this amount from its taxable income in order to avoid being double taxed. The period for this has been extended from 5 years to 10 years.

This ruling can be applied to undistributed profits of the CFC included in the Japanese company's taxable income in business years starting from fiscal years ending on or after April 1, 2000.

Carry-forward Extension

Tax losses can be carried-forward for 7 years (from 5 years) when calculating the undistributed income of a CFC. This extension will apply to those losses from fiscal years ending on or after April 1, 2005.

Director held shares

Shares in a foreign subsidiary held by directors/officers (including non-resident directors/officers) will be included when determining (1) if the foreign subsidiary is qualified as a CFC (50% test) and (2) who are shareholders subject to income inclusion of the CFC (5% test).

Tax Treaty: Japan-US

In order to simplify the procedures for an application of a tax treaty, the new reform will allow non-residents and foreign corporations to show proof of certain facts to the withholding tax agent at the time of application in place of attaching the certificate of residency to the application.

In the past the applicant was required to submit the certificate of residency that was issued by the U.S. Internal Revenue Services.

Transfer Pricing Court Case

Matsuyama (Ehime Prefecture) District Court

In a precedent setting move, the Matsuyama District Court, in April 2004, ruled against a ship building company upholding the corrections of the tax returns in 1991 and 1993 made by the tax office.

According to records, the tax office corrected the company's tax returns in 1991 and 1993 arguing that the sales prices of ships to foreign related companies were lower than arm's length prices as calculated by the transfer pricing rules. The tax office employed Comparable Uncontrolled Price Method (CUP) and selected transactions the company made with unrelated persons as comparable transactions (internal comparables). Although the company argued that ship building sales is a unique transaction and comparable transactions cannot be identified, the court dismissed this argument. The company also argued that adjustments to comparable transactions should be made for business strategy, sales volume and total costs including negotiation costs for transactions. However, the court dismissed this argument as well because the reasons for the adjustments were not reasonable with reference to OECD Transfer Pricing Guidelines or NTA's internal guideline for transfer pricing audit, which is released to the public.

The management of the company appears to have not completely understood the concept of the transfer pricing rules as some parts of their arguments are off point with reference to interpretation of the transfer pricing rules. It is recommended that the management of companies conducting business internationally be fully aware of transfer pricing rules.

In April, Grant Thornton Japan/ASG Tax Corporation held a seminar on Tax Reforms, Issues and other topics with regards to companies doing business here in Japan. Should you be interested in attending future seminars, please let us know and we will keep you updated on future seminars and topic(s). We look forward to hearing back from you.

Grant Thornton 
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We welcome your feedback and suggestions. Please contact:

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