Public Safety and Parliamentary Secretaries of Finance and Internal Affairs and Communications. Following the December 2012 election victory by the Liberal Democratic Party (LDP), the Tax Commission will be reverting to the pre-2009 form.

[¶1-121] The Tax Commission's 2002 and 2003 Tax Reform Reports

In reports issued in 2002 and 2003, the Tax Commission concluded that major long-term reforms of the tax system were needed to deal with the large fiscal deficits arising in Japan during a time of falling birth rates, an ageing society and loss of tax bases through globalisation. The main conclusions of the Tax Commission regarding the outlook for Japanese tax reforms are summarised below.

General tax reform principles

- Raising taxes in the short-run is not feasible in the current unfavourable Japanese economy, but current tax reductions should be linked to tax increases over the long term.
- Tax reform should take place within the context of measures which reduce expenditures for social security, public works and financing for the local government.
- The common social costs funded by taxes should be borne fairly.
- Special taxation measures, including tax incentives to corporations, should be used only where they have the most effect.
- The role of the national Government in financing local governments should be cut back and the proportion of individuals and corporations that pay no local taxes should be reduced. Reforms of local taxes should incorporate a "benefit" principle, where the tax burden is not inconsistent with local benefits received by taxpayers. Such reforms include revisions of personal exemptions and tax rates and implementation of an enterprise tax based on the scale of the activities of companies.

Income tax proposals

- Before implementation of a series of rate cuts in the late 1980s, the Income Tax accounted for 30% of national revenues and 25% of local revenues. The Income Tax should be restored to its position as a "main" tax by scaling back tax rate cuts and personal and special deductions and exemptions.
- The fixed rate reduction in Income Tax (see ¶3-280) should be repealed.
- Changes in social and living conditions in Japan have decreased the need for many existing income tax deductions and exemptions. Personal deductions and exemptions, other than the exemptions for the taxpayer, taxpayer's spouse, dependants and the disabled, should be streamlined or discontinued. (See ¶3-259 to ¶3-266.) The special deduction for spouse (see ¶3-265) was terminated beginning in 2005.
- The employment income deduction (see ¶3-235) currently has no upward limit and accounted for about 30% of gross employment income in 2002. This deduction should be revised to a standard deduction of limited amount.

- To equalise the tax treatment between the elderly and working generations, public pension benefits should be included in the income tax base and limits should be put on deductions for public pension premiums (see ¶3-239 and ¶3-254). At the same time, a better framework for deductions for payments into and benefits received from private pensions should be established. (Note: the 2005 tax reforms incorporated these proposals.)
- Currently, only one-half of retirement income is taxed after allowance of a deduction based on years of service (see ¶3-240). This favourable treatment should be made more consistent with the taxation of other forms of compensation.
- Deductions for life and casualty insurance (see ¶3-257) and the special tax credit for home acquisition loan (see ¶3-293) should be eliminated as part of a comprehensive plan to streamline special tax measures and reverse the shrinking of the tax base.
- The local inhabitants tax (see ¶3-510) has the positive characteristics of being closely tied to recognisable benefits received from the Government by taxpayers and providing a stable source of revenue. Because of the close relation between the tax and benefits received, its tax base should be made broader than that of the income tax by allowing fewer deductions and exemptions. The rate of per capita inhabitants tax should be increased and the differing rates based on the size of municipalities should be eliminated. The exemption for a spouse supported by the taxpayer should be eliminated. (Note: the 2005 tax reforms incorporated these proposals.)

Corporation tax proposals

- The corporation tax rate has been reduced to internationally competitive levels and no further cuts in the corporate rate are foreseen (see ¶4-610).
- Taxation of profits of partnerships and other business entities should be considered (see ¶2-400).
- In the future, non-profit organisations of various types, including public interest corporations (see ¶2-340) and cooperatives (see ¶2-350), are expected to provide many of the public welfare services traditionally supplied by the Government. The tax system, particularly the taxation of donations, will have to adjust to accommodate the changing role of these organisations.
- Currently, about 70% of corporations do not pay corporate enterprise tax. Beginning in 2005, the factor tax system for the corporation enterprise tax (see ¶4-930) provides a tax base which includes the scale of corporate activities.

Consumption tax proposals

- Consumption tax will play an increasingly important role in Japan as other tax bases shrink due to falling birth rates, the ageing population and globalisation. While the consumption tax is criticised as regressive in relation to income, it is neutral across economic activities and across generations.
- The rate of the consumption tax needs to be raised from the current 5% (see ¶7-200) to double-digit levels (similar to European value added tax levels) in order to fund increasing expenditures for public pensions and healthcare for the elderly. (Note:

European directives provide a standard rate of 15% or more for value added tax. As of April 2001, the rate was 21% in Belgium, 20% in Italy, 19.6% in France, 17.5% in the UK and 16% in Germany).

- To mitigate the regressive nature of a double-digit percentage consumption tax, lower rates will apply to a limited number of items, such as food.
- When differing rates of consumption tax apply, an invoice system will be needed in order to compute the credit for taxable purchases (see ¶7-611).

Inheritance and gift tax proposals

- The inheritance tax base should be expanded to reflect the diminishing role of families and the increasing role of society in providing care for the aged.
- The burden of the inheritance and gift taxes has been reduced through rate cuts and expanded exemptions (see ¶6-220), but the tax base needs to be broadened.

Proposals for taxation of financial assets

- Taxation of financial assets is expected to provide greater tax revenues in the future as an ageing population earns increasingly more from investments relative to employment income. Also, the Government is adopting various means to divert household savings from deposits to investments. In 2003, tax reforms were implemented to equalise rates on income from interest and dividends or gains from listed shares (see ¶3-231, ¶3-232 and ¶3-236).
- Future reforms will be oriented toward providing tax neutrality to savings, investments and business activities.
- A taxpayer identification number (TIN) system will probably be necessary to implement effective tax collection systems, improve confidence of taxpayers in the fairness of the system and deal with the computerisation and globalisation of financial transactions.

Source: *The Tax Commission: Policy Guidance on the Establishment of a Desirable Tax System (Draft) (June 2002) and A Sustainable Tax System for Japan's Ageing Society (June 2003)*

[¶1-122] The 2005 Tax Commission Subcommittee on Basic Issues Report

The Tax Commission Subcommittee on Basic Issues Report on Structural Change in Japan's Economy and Society

The Subcommittee on Basic Issues issued a report in June 2005 which listed "10 key facts" representing the structural changes in Japan's society and economy since the 1970s that will impact the tax system in the future:

(1) transformation of Japan to a low birth rate and rapidly ageing society

(2) end of the "steadily growing economy", including lower potential growth in the economy and lower household savings rates

(3) diversification of family structures, including an increase in single-person households, and changes away from the "model family" and "standard life course"

(4) changing patterns in Japanese-style employment practices, including less employment security, declining loyalty to a single company, increasing emphasis on expertise and skills, increase in non-standard employment and increasing emphasis on leisure

(5) diversification in lifestyles and values, including greater emphasis on freedom of choice, comfort and present enjoyment instead of deferred gratification

(6) consideration for society and the public, including increased interest in making social contributions, such as volunteer work

(7) less homogeneity in wealth distribution, including an end to the concept that almost everyone belongs to the middle class and an increased desire for equality of opportunity

(8) increase in and diversification of the environmental burden and social costs, including a shift in attention from industrial pollution to the environmental costs of urban living, such as automobile emissions and waste disposal

(9) the progress of globalisation, including the end of the Cold War, progress in trade, advances in telecommunications, increased foreign direct investment and international economic mutual-dependence relations

(10) worsening fiscal management conditions, including an increasing government revenue-expenditures gap, increases in deficit bonds, and expected increases in social security related expenditures, raising questions about the sustainability (*jizoku kanosei*) of the current system of government finance.

Source: *The Tax Commission Subcommittee on Basic Issues: The Real Picture of Structural Change in Japan's Economy and Society — From "Quantity" to "Quality" and "Status Quo" to "Diversity" (June 2005)*

[¶1-123] The Tax Commission's 2005 Tax Reform Report

The Tax Commission's main conclusions regarding the outlook for Japanese tax reforms for 2005 (summarised below) were outlined in their annual report issued in November 2004.

General principles

- Japan is facing a historical turning point of structural changes in the economy and society. The ageing society and declining birth rate will result in Japan's population peaking in 2006 and declining thereafter. At mid-century, about one person in three will be a senior citizen. In addition, structural changes are needed to meet the challenges of the post-Cold War world where global economic competition has increased along with mutual-dependent relations among countries. Changes in the tax system are needed as part of the overall structural reforms.
- As a result of a succession of tax cuts, the tax burden in Japan is at a very low level by international standards (see Tables 5A and 6 at ¶1-110). Tax revenues currently only account for slightly over 50% of expenditures by the national Government (see Table 3 at ¶1-110) and enormous amounts of deficit bonds continue to be issued.

- A goal of reaching a budget surplus by the beginning of the 2010s should be established in order to prepare for the retirement needs of the baby boom generation during the mid 2010s.
- The Trinity Reforms should be implemented to change the system of national subsidies for the local government. The transition to local government financing through the individual Inhabitants Tax rather than by the Income Tax should be accomplished by FY 2006.

> ⇒ **Explanation: The "Trinity" Reforms**
>
> The "Trinity Reforms" are a package of tax reforms created by the Koizumi administration in 2003 to decentralise (1) local taxes, (2) local allocation tax grants, and (3) national Government disbursements. Local taxes are determined under the national *Local Tax Law* rather than by local initiatives. Local allocation tax grants are allocations of national tax revenues to local governments. The amounts of local allocation tax grants are determined at the national level by the Ministry of Internal Affairs, but the uses are left to the local governments. National Government disbursements are subsidies by the national Government for joint projects undertaken by the national and local governments or for other projects designated by the national Government. The local government has little say in determining the nature of national Government disbursements.

- The national tax burden ratio (ratio of taxes and social security contributions to national income) is 35.5%, about the same level it was 20 years ago, while the ratio of government spending as a percentage of national income is 45.1%. (See Table 5A at ¶1-110 for recent figures.) The difference, about 10%, represents the budget deficit which will be a burden on future generations. Tax reforms taking place in the context of structural changes in the economy must be based on balancing the benefits and burdens of taxes and social security contributions and increasing the burdens of the current generation. The relative role of taxes and social security contributions is going to be an important policy concern.

Direction of future tax reforms: Establishing a "desirable tax system" (あるべき税制)

- FY 2005 tax reform proposals were designed to help establish a "desirable tax system" (*arubeki zeisei*) that will implement the Trinity Reform Package, reform the social security system and balance the budget by the beginning of the 2010 decade.
- As part of the Trinity Reforms, a drastic shift in tax revenues from the Income Tax to the local individual Inhabitants Tax should take place by FY 2006.
- The fixed rate reduction in Income Tax should be abolished in stages beginning in FY 2006.

> ⇒ **Explanation: The fixed rate reduction in Income Tax**
>
> The fixed rate reduction in Income Tax was enacted as part of the *Tax Reduction Law of 1999*, which was designed to reduce the tax burden on individuals and corporations in order to stimulate the economy. The reduction is similar to a tax credit and was equal to the lesser of 20% of the income tax before the reduction or ¥250,000 (*Tax Reduction Law of 1999* Art 6(2)). For tax years beginning after 2005, the reduction will be equal to the lesser of 10% of the income tax before the reduction, or ¥125,000 (see ¶3-294).

- In order to eliminate the fiscal deficit, both national and local governments should make concerted efforts to reduce spending while implementing the necessary tax reforms.
- An overall reform of the social security system is inevitable.
- Prior tax reforms have been enacted based on the concept that an increase in the relative weight of the Consumption Tax is contemplated in connection with the overall reductions in the individual Income Tax. Future tax reforms will be based on recovering the original function of the Income Tax while raising the rate of the Consumption Tax.
- Environmental issues, including global warming, must be considered when developing reforms of the taxation of assets, corporations and international taxation based on changes in the economy and society.

Proposed tax reforms

- Due to successive tax rate reductions, the individual Income Tax burden in Japan is very low in relation to other major nations (see Table 6 at ¶1-110). In order to establish a stable revenue structure able to carry out the purposes on which the Income Tax is based, the fixed rate reduction needs to be revised, the tax base needs to be expanded and various deductions need to be reviewed based on principles of matching the benefits and burdens of taxation and reducing misdistributions.
- A transfer of tax source (*zeigen ijo*) from the Income Tax to the Inhabitants Tax should begin in FY 2006 as part of the Trinity Reforms.
- The per capita tax portion of the local Inhabitants Tax (*kintowari*, see ¶3-510) has remained at a low rate compared to changes in national income and expenditure and the rate should be raised. The tax base for the income tax portion of the local Inhabitants Tax (*shotokuwari*) should be expanded by reducing deductions.
- *Taxation of financial assets*. Efficient use of financial assets is essential to sustain the vitality of the economic system in the midst of an ageing of the society, lower birth rates and a downward trend in the savings rate. In June 2005, the Financial Subcommittee recommended an integration of the taxation of financial income of individuals in order to simplify the tax system and mitigate investor risk. For this integration to be possible, a financial numbering system will be needed.
- *Consumption Tax*. A hike in the rate of Consumption Tax is a necessary part of the reform of the tax system. In the future, the Consumption Tax should be considered a source of revenue for the Government's general fund. With a Consumption Tax

rate in the double digits, as is common in Europe, it will be necessary to consider whether a lower rate should apply to items such as foodstuffs. However, from the point of view of economic neutrality, and simplification and minimisation of the cost of tax compliance, a unitary tax structure is preferable. The adoption of an invoice system will also have to be considered.

> ⇒ **Explanation: Consumption tax invoice system**
>
> A credit is allowed to enterprises for the amount paid by the enterprise for taxable goods and services sold to consumers in order to prevent the Consumption Tax from being imposed more than once on the same taxable item. Japan currently requires enterprises to either maintain books and records to support amounts claimed for the credit or to use a simplified system for estimating the credit. An invoice system would require enterprises to maintain copies of tax invoices for all purchased inputs in order to claim the credit. (See ¶7-611.)

- *Inheritance Tax*. The burden of the Inheritance Tax has been reduced through a series of reductions in the tax rates and expansion of exemptions (see ¶6-220). However, Japan has been developing into a "stock-based economy" and an increasing proportion of assets are held by older citizens. Increases in social security benefits have resulted in a shift away from support of elderly people by their families to support by the society in general. An increase in the Inheritance Tax burden on assets remaining at the time of inheritance will be needed to repay society for these costs of providing care for the elderly.

> ⇒ **Explanation: Stock-based economy *(keizei no sutokku-ka)***
>
> The development of Japan into a stock-based economy refers to the increase in national wealth represented by financial assets.
>
> *% of nominal GDP consisting of:*

	1965	*1988*	*2000*
Financial assets	3.7	8.6	11.0
Land	1.8	4.9	3.0

- *Corporation taxation*. Corporate tax rates are currently at levels similar to other developed nations and no corporation tax rate reductions are foreseen. (See Table 11 at ¶1-220.) Future reforms will be based on the effectiveness of tax incentives for research and development and capital investment within the context of the entire tax system and tax burden in Japan, and maintaining a balance with the tax rates of other developed nations. Existing special tax measures for corporations need to be continuously reviewed for their effectiveness in revitalising and promoting structural reforms in the economy. The increasing importance of public interest corporations and non-profit organisations in Japan's ageing society requires further consideration into tax measures, including a re-examination of the system for taxing donations, which will increase the ability of these organisations to function and their transparency.

- *Corporation Enterprise Tax*. The Enterprise Tax on corporations is a tax based on the relationship between a corporation's activities within the taxing jurisdiction and the services provided by the local government (see ¶4-920). Changes in information technology and outsourcing practices necessitate a review of the basic system of prorating the Enterprise Tax among jurisdictions, which has not been examined since 1989. Preferential treatment of social insurance medical treatment fees should be eliminated in order to make the tax system more impartial.

- *International taxation*. The new income tax treaty with the United States which came into effect in March 2005 served to promote international commerce and technology transfers by drastically reducing source country taxes and establishing measures to ensure proper taxation. The treaty network between Japan and other countries will expand to help promote investment and strengthening of the economy. Appropriate adjustments to the domestic civil law relating to international taxation will be sought where needed to correspond to the complex and diverse nature of international economic activities. For example, a review of the aggregation tax system for foreign tax haven corporations (see ¶9-600) and the foreign tax credit system (see ¶4-632) need to take into consideration the scope of a foreign subsidiary subject to aggregation and the scope of the foreign tax credit. Withholding on income of Japanese Civil Code associations (*nin-i kumiai*, see ¶2-400) derived by non-residents of Japan or foreign corporations is needed to preserve the integrity of the tax system. Additional attention must also be directed towards the problem of international tax avoidance through the use of loopholes and inconsistencies between tax systems.

- *Liquor Tax*. Recent changes in lifestyle have been accompanied by diversification in the types of liquor consumed. The Liquor Tax has been based on conventional differences between ingredients and production methods. Changes in methods of production and manner of consumption dictate that the system of taxation of liquors be simplified to reduce the disparity between types of alcoholic beverages.

> ⇒ **Explanation: Low malt beer *(happoshu)***
>
> Japanese beer is fairly expensive, due in part to the Liquor Tax on beer of ¥222,000 per kilolitre. For example, a 350 ml can of beer might cost ¥220 on average. The tax rate is determined by the percentage of malt in the product. If the malt rate is less than 50%, but not less than 25%, the tax rate drops to ¥178,125. Beer with a malt rate less than 25% is taxed at ¥134,250 per kilolitre. Recently, low malt beer (*happoshu*), which substitutes other ingredients such as corn syrup, rice or sugar for malt, has become popular and usually sells for between ¥125 and ¥145 a can.

- *Issues related to global warming*. The Kyoto Protocol that provides for the targeted reduction of the release of greenhouse gases into the atmosphere will come into effect in February 2005. Japan needs to consider the introduction of an environmental tax. However, at present, it is not clear how such a tax will relate to other policy measures. The tax should ultimately provide an economic incentive to decrease emissions. Careful consideration must be given to whether revenues raised by an environmental tax should be considered general-purpose funds or special-purpose funds for specified global warming countermeasures.

Public corporation	*Governing statute*
Japan Sewage Works Agency	*Japan Sewage Works Agency Law* (Law No 41, 1972)
Japan Judiciary Support Center	*Comprehensive Legal Support Law* (Law No 74, 2004)
Development Bank of Japan	*Development Bank of Japan Law* (Law No 73, 1999)
Japan Racing Association	*Japan Racing Association Law* (Law No 205, 1954)
Japan Pension Service	*Japan Pension Service Act* (Law No 109, 2007)
Japan Broadcasting Corporation	*Broadcasting Law* (Law No 132, 1950
Agriculture, Forestry and Fisheries Finance Corporation	*Agriculture, Forestry and Fisheries Finance Corporation Law* (Law No 355, 1952)

Law: Art 2(1)(v), Art 4(3) and Separate Sch 1 of the *Corporation Tax Law; Agriculture, Forestry and Fisheries Finance Corporation Law; Broadcasting Law; Development Bank of Japan Law; Flood Control Societies Law; Independent Administrative Agency Regulation Law; Japan Bank for International Cooperation Law; Japan Finance Corporation for Municipal Enterprises Law; Japan Racing Association Law; Japan Sewage Works Agency Law; Land Improvement Law; Land Readjustment Law; Local Autonomy Law; Local Housing Supply Corporation Law; Local Road Corporation Law; National Life Finance Corporation Law; National University Law; Okinawa Development Finance Corporation Law; Port Authority Law; Promotion of Expansion of Publicly Held Land Law; Small Business Finance Corporation Law; Social Insurance Medical Fee Payment Fund Law; Japan Finance Corporation for Small and Medium Enterprise Act; Japan Pension Service Act; Comprehensive Legal Support Law*

[¶2-340] Public interest corporations (*Koeki Hojin* — 公益法人)

Public interest corporations (referred to in the *Standard Bilingual Dictionary* as "non-profit corporations") were, before the enactment of the reform of the public interest corporation system in 2006, established under Art 34 of the Civil Code (*Minpo*, Law No 89, 1896) which provided that an association (*shadan*) or foundation (*zaidan*) relating to worship, religion, charity, science, art, etc, relating to public interest and not having a profit motive, may be established as a corporation upon receiving the permission of the competent authorities. Public interest corporations include bodies such as municipal corporations and local public entities listed in Separate Schedule 2 of the *Corporation Tax Law* (CTL Art 2(1)(vi)) (see Table 11 below).

Associations (*shadan*) are generally corporate juridical persons with fee paying members who manage the association for some public purpose through the decisions of the members' general meeting. On the other hand, foundations (*zaidan*) generally manage assets according to the directions of the donor and do not have members.

Public interest corporations are subject to Corporation Tax only on income from their profit-making activities (including investment income) (CTL Art 7). If earnings or assets from a public interest corporation are transferred from its profit-making activity to its exempt activity, a deemed charitable gift is considered to have occurred and the

corporation may take a gift deduction of up to 20% of its profit (the greater of 50% of the profit or ¥2m in the case of a school or social welfare organisation) (CTL Art 37(4); CTL-EO Art 73(1)(iii)).

Reform of the public interest corporation system

On 2 June 2006, three new laws were enacted relating to *ippan shadan hojin* (general incorporated association) and *ippan zaidan hojin* (general incorporated foundation) entities (*Law Relating to Ippan Shadan Hojin and Ippan Zaidan Hojin*, Law No 48, 2006). The public interest corporation system was drastically changed when the laws came into force on 1 December 2008. A pre-existing *shadan hojin* or *zaidan hojin* incorporated under the former Civil Code Art 34 is treated as a Special Civil Code Corporation during the five-year transition period to the new system beginning 1 December 2008.

Table 11A: Taxation of public interest corporations (Koeki Hojin — 公益法人)

Corporate classification	*Scope of taxation (CTL Art 2(1)(xiii), Art 5, 7; CTL-EO Art 5)*	*Deemed donation (CTL Art 37(5); STML Art 66-11-2)*	*Corporation tax rate (CTL Art 66; STML Art 42-3-2)*
Public interest association (*koeki shadan hojin* — 公益社団法人) or public interest foundation (*koeki zaidan hojin* — 公益財団法人)	Taxed on profit-making activities; income from public interest activities is exempt	The greater of 50% of income or public interest disbursements	19% (CTL Art 66(3)) Annual income not exceeding ¥8m: 19% (15% from 1 April 2012 to 31 March 2017)
Non-profit general incorporated association (*ippan shadan houjin* — 一般社団法人) or foundation (*ippan zaidan houjin* — 一般財団法人)	Taxed on profit-making activities	N/A	23.9% (25.5% for tax years beginning before 1 April 2015) Annual income not exceeding ¥8m: 19% (15% from 1 April 2012 to 31 March 2017)

Transitional rules

During the five-year transitional period, beginning when the laws come into force (1 December 2008), existing public interest corporations must undertake procedures to convert to the new system.

Table 11B is a list of the public interest corporations currently included in Separate Schedule 2 of the CTL.

Table 11B: CTL Separate Schedule 2 — Public Interest Corporations

Public interest corporation	*Governing statute*
General Incorporated Foundations	(Law No 48, 2006)
General Incorporated Associations	
Medical Corporations (limited to Social Medical Corporations)	(Law No 205, 1948)
Loan Business Societies	(Law No 32, 1983)
Incorporated Schools	(Law No 270, 1949)
Corporate Pension Funds	*Defined Benefit Occupational Pension Law*
Corporate Pension Fund Associations	
Hazardous Materials Safety Techniques Association	(Law No 186, 1948)
Administrative Scrivener Association	(Law No 4, 1951)
Fishery Mutual Insurance Associations	(Law No 158, 1964)
National Federation of Fishery Mutual Insurance Associations	
Fishery Credit Fund Association	(Law No 346, 1952)
Fishing Vessel Mutual Insurance Associations	(Law No 28, 1952)
Central Association of Fishing Boat Insurers	
Workers Augmentation of Personal Financial Assets Fund	(Law No 92, 1971)
Law Concerning the Promotion of Workers' Property Ownership	
Light Motor Vehicle Inspection Organisation	(Law No 185, 1951)
Health Insurance Societies	(Law No 70, 1922)
Federation of Health Insurance Societies	
Nuclear Waste Management Organisation of Japan (NUMO)	(Law No 117, 2000)
The High Pressure Gas Safety Institute of Japan	(Law No 204,1951)
Regional Offshore Environmental Improvement Center	(Law No 76, 1981)
Public Interest Incorporated Foundations	(Law No 49, 2006)
Public Interest Incorporated Associations	
Corporate Employees' Pension Fund	(Law No 115, 1954)
Employees' Pension Fund Association	
Rehabilitation Aid Corporation	(Law No 86, 1995)
Small-Scale Auto Racing Association	(Law No 208, 1950)
Small Craft Inspection Organisation	(Law No 11, 1933)

Public interest corporation	*Governing statute*
National Public Service Personnel Mutual Aid Associations	(Law No 128, 1958)
Federation of National Public Service Personnel Mutual Aid Associations	
National Health Insurance Society	(Law No 192, 1958)
Federation of National Health Insurance Societies	
National Pension Fund	(Law No 141, 1959)
National Pension Fund Federation	
Urban Redevelopment Association	(Law No 318, 1969)
Bicycle Sports Association	(Law No 209, 1948)
Japan Safe Driving Center	(Law No 57, 1975)
Judicial Scrivener Association	(Law No 197, 1950)
Social Welfare Corporation	(Law No 45, 1951)
Social Insurance Labor Consultants Associations	(Law No 89, 1968)
Religious Corporations	(Law No 126, 1951)
Residential Street District Maintenance Associations	(Law No 67, 1975)
Brewery Associations	(Law No 7, 1953)
Central Association of Brewery Associations	
Federation of Brewery Associations	
Sake Union	
Central Association of Sake Unions	
Sake Union Federation	
Chamber of Commerce and Industry	(Law No 143, 1953)
Commerce and Industry Association	(Law No 89, 1960)
Union of Commerce and Industry Associations	
Societies of Commerce and Industry (limited to those that do not require members to make capital contributions)	(Law No 185, 1957)
Federation of Societies of Commerce and Industry (limited to those that do not require members to make capital contributions)	
Commodity Futures Association of Japan	(Law No 239, 1950)
Mutual Aid Fund of Compensation for On Duty Accidents of Fireman and Others	(Law No 107, 1956)
Personnel Associations, etc (limited to corporations)	(Law No 80, 1978)
Vocational Training Corporations	(Law No 64, 1969)
Credit Guarantee Corporations	(Law No 196, 1953)
Life Hygiene Guilds (limited to those that do not require members to make capital contributions)	(Law No 164, 1957)
Federation of Life Hygiene Guilds (limited to those that do not require members to make capital contributions)	

Public interest corporation	*Governing statute*
Certified Tax Accountants Association	(Law No 237, 1951)
Coal Mining Pension Fund	(Law No 135, 1967)
Seaman Accident Prevention Association	(Law No 61, 1967)
Japan Health Insurance Society	(Law No 70, 1922)
National Federation of Mutual Benefit Societies of Municipal Personnel	(Law No 152, 1962)
All Japan Federation of Certified Social Insurance Labor Consultant Associations	(Law No 89, 1968)
National Chamber of Agriculture	(Law No 88, 1951)
National Institute for Research Advancement	(Law No 51, 1973)
Fire and Marine Insurance Rating Association of Japan	(Law No 193, 1948)
Local Assembly Members Mutual Aid Association	(Law No 152, 1962)
All Japan Local Horse Racing Association	(Law No 158, 1948)
Local Public Servant Benefit Society	(Law No 152, 1962)
Federation of Local Public Servant Benefit Societies	
Local Public Servant Accident Benefit Fund	(Law No 121, 1967)
Japan Vocational Ability Development Association	(Law No 64, 1969)
Central Industrial Accident Prevention Association	(Law No 118, 1964)
Federation of Small Business Associations	(Law No 181, 1949)
Japan Investor Protection Fund (JIPF)	(Law No 25, 1948)
Independent Administrative Agencies (limited to those designated by the Minister of Finance as corporations not making private distributions of profits)	*Independent Administrative Regulation Law* (Law No 103, 1999)
Federation of Land Improvement Associations	(Law No 195, 1949)
Land-and-Building Surveyors Associations	(Law No 228, 1950)
Regional Vocational Ability Development Associations	(Law No 64, 1969)
Regional Agricultural Associations	(Law No 165, 1948)
Federation of Japanese Administrative Scriveners Associations	(Law No 4, 1951)
Japan Worker's Housing Association	(Law No 133, 1966)
Japan Institute of Certified Public Accountants	(Law No 103, 1948)
Japan Motorcycle Racing Organisation	(Law No 208, 1950)
Japan *Keirin* Association	(Law No 209, 1948)
Federation of Japanese Judicial Scrivener Associations	(Law No 197, 1950)
Japan Chamber of Commerce and Industry	(Law No 143, 1953)
Japan Fire Alarms Manufacturers' Association	(Law No 186, 1948)
Japanese Private School Promotion and Mutual Aid Enterprise Group	(Law No 48, 1997)

Public interest corporation	*Governing statute*
Japan Federation of Certified Tax Accountant's Associations	(Law No 237, 1951)
Japan Red Cross	(Law No 305, 1952)
Japan Electric Meters Inspection Corporation	(Law No 150, 1964)
Japan Federation of Land-and-Building Surveyors Associations	(Law No 228, 1950)
Japan Federation of Bar Associations	(Law No 205, 1949)
Japan Patent Attorneys Association	(Law No 49, 2000)
Japan Pilots Association Federation	(Law No 121, 1949)
Certified Financial Products Transaction Industry Association	(Law No 25, 1948)
Agricultural Mutual Aid Association	(Law No 185, 1947)
Federation of Agricultural Mutual Aid Associations	
Central Union of Agricultural Co-Operatives (JA)	(Law No 132, 1947)
Federation of Agricultural Co-Operatives (limited to those designated by the Minister of Finance as having established public medical facilities)	
Agricultural Credit Fund Association	(Law No 204, 1961)
Savings Insurance Corporation for Agricultural and Fishery Cooperatives	(Law No 53, 1973)
Debt Adjustment Association	(Law No 21, 1933)
Bar Association	(Law No 205, 1949)
Insurance Policyholders Protection Organisation	(Law No 105, 1995)
Pilots Association	(Law No 121, 1949)
Exporters' Associations (limited to those that do not require members to make capital contributions)	(Law No 299, 1952)
Importers' Associations (limited to those that do not require members to make capital contributions)	
Deposit Insurance Corporation	(Law No 34, 1971)
Labor Unions (limited to corporations)	(Law No 174, 1949)
Industrial Accident Prevention Organisation	(Law No 118, 1964)

Law: Art 34 of the Civil Code; Art 2(1)(vi), Art 7, Art 37(4) and Separate Sch 2 of the *Corporation Tax Law*; Art 73(1)(iii) of Corporation Tax Law Enforcement Order; *Defined Benefit Occupational Pension Law*; *Law Relating to Ippan Shadan Hojin and Ippan Zaidan Hojin*

[¶2-341] Non-profit organisations (*NPO Hojin* — NPO 法人)

The *Law to Promote Specified Non-Profit Activities* enacted in 1998 (Law No 7, 25 March 1998) made it possible for citizens and volunteer groups to be granted status as NPO corporations (*NPO hojin*) much more easily than under the old Civil Code procedures for NPOs (Civil Code Art 34). NPO corporations tend to be smaller and more independent of the Government than public interest corporations (*koeki hojin*). Many result in a loss (CTL Art 64(2)) or if the contract provides that half or more of the consideration is to be paid beyond one year from the date of the delivery of the constructed item (CTL-EO Art 129(2)). Under the 2008 legislation effective for tax years beginning on or after 1 April 2008, the percentage of completion method may be used when a loss is expected on a project that does not otherwise qualify as a long-term construction project and for software development projects (CTL Art 64(2)).

Table 7: Long-term large-scale construction contract

Date contract entered into	*Minimum contract price*
On or after 1 April 2008	¥1 billion
Before 1 April 1998 or between 1 April 2004 and 31 March 2008	¥5 billion
Between 1 April 1998 and 31 March 2001	¥15 billion
Between 1 April 2001 and 31 March 2004	¥10 billion

Law: Art 64(1) and Art 64(2) of the *Corporation Tax Law*; Art 129(1) and Art 129(2) of the Corporation Tax Law Enforcement Order

[¶4-340] Dividends received (*Uketorihaito* — 受取配当)

Dividends received by a domestic Japanese corporation from other Japanese domestic corporations (other than public interest corporations or non-juridical persons) are eligible for a dividend exclusion:

- *100% group members*. Effective for dividends declared during tax years beginning on or after 1 April 2010, dividends paid and received between members of a 100% corporate group (see ¶4-650) are treated similarly to dividends on stock of a consolidated corporation; they are excluded from income of the recipient and no reduction by the amount of allocable interest expense is required. (CTL Art 23(1), (4)(i), Art 81-4(1), (4)).
- *Other related corporations*. Dividends on stock of a corporation other than a consolidated corporation or a 100% group member owned at least 25% by the recipient corporation are excluded from income after reducing the amount by the amount of the recipient's interest expense allocated to the dividends (CTL Art 23 (1), (4)(ii)).
- *Consolidated corporations*. Dividends on stock of a consolidated corporation that is not a 100% group member or another related corporation, as described above, are excluded from the income of the recipient to the extent of 50% of the amount of the dividend less the amount of the recipient's interest expense allocated to the dividends (CTL Art 81-4).
- *Other corporations*. Dividends on stock of a corporation other than a 100% group member or a related corporation are excluded from income to the extent of 50% of the amount of the dividend less the amount of the recipient's interest expense allocated to the dividends (CTL Art 23(1), (4)(iii)).

For tax years beginning on or after 1 April 2015 the applicable dividend exclusion percentages are:

% ownership in related company	*Dividend exclusion %*
5% or less	20%
More than 5% but not more than 1/3	50%
More than 1/3 but less than 100%	100% less the amount of the recipient's interest expense allocated to the dividends
100%	100%

Law: Art 23(1), Art 23(4)(i), Art 23(4)(ii), Art 23(4)(iii), Art 81-4, Art 81-4(1) and Art 81-4(4) of the *Corporation Tax Law*

[¶4-350] Appraisal gains (*Hyokaeki* — 評価益)

The basis of asset valuation under the *Commercial Code* and tax laws is the acquisition cost of the property. For Corporation Tax purposes, increases in basis and related appraisal gains are not recognised (CTL Art 25). However, gain will be recognised when a corporation revalues assets to amounts not exceeding fair market value in the case of a reorganisation under the *Corporate Reorganisation Law* (CTL Art 25(1)) or a change in organisation (CTL-EO Art 24(1)).

Law: Art 25 and Art 25(1) of the *Corporation Tax Law*; Art 24(1) of the Corporation Tax Law Enforcement Order; Commercial Code; *Corporate Reorganisation Law*

[¶4-360] Refunds (*Kanpukin* — 還付金)

National and local taxes paid by a corporation, including Corporation Tax and the local Inhabitants Taxes, which are not allowed as expenses are not included in income when refunded to the corporation (CTL Art 26).

Law: Art 26 of the *Corporation Tax Law*

EXPENSES (*SONKIN* — 損金)

[¶4-400] Expenses (*Sonkin* — 損金)

Deductible expenses for the taxable year include the following (CTL Art 22(3)):

(1) Cost of goods sold, costs of completed construction contracts and similar costs. For these costs, the principle of matching the timing of costs to revenues is important (CTL Art 22(3)(i)).

(2) Sales expenses, administration expenses and other costs (excluding costs other than depreciation for which the liability is not fixed as of the end of the tax year). These expenses include period costs that are difficult to match directly to revenues.

(3) Losses other than from dealings in the capital of the company. Losses from casualties and thefts, etc, do not correspond to revenues and are treated as period costs.

The restrictions found in the US and UK tax codes, that deductible business expenses must be ordinary and necessary or exclusively for the purposes of trade, are not specifically incorporated into the Japanese tax rules.

Law: Art 22(3) and Art 22(3)(i) of the *Corporation Tax Law*

[¶4-410] Valuation of inventory (*Tanaoroshi Shisan No Hyoka* — 棚卸資産の評価)

Cost of goods sold is generally determined as:

Cost of sales = Beginning inventory + purchases of inventory – ending inventory

Corporations may elect to use either a cost method, the lower-of-cost-or-market method, or another method approved by the tax office to value inventories (CTL-EO Art 28).

Cost methods (*genkaho* — 原価法)

- Specific identification method (*kobetsuho* — 個別法) (CTL-EO Art 28(1)(i)(a))
- First-in, first-out method (*sennyu senshutsu* — 先入先出) (CTL-EO Art 28(1)(i)(b))
- Last-in, first-out method (no longer permitted)
- Weighted average method (*soheikinho* — 総平均法) (CTL-EO Art 28(1)(i)(c))
- Moving average method (*idoheikinho* — 移動平均法) (CTL-EO Art 28(1)(i)(d))
- Simple average method (no longer permitted)
- Last purchase price method (ending inventory is valued using the cost of the last unit purchased) (*saishu shire genkaho* — 最終仕入原価法) (CTL-EO Art 28(1)(i)(e))
- Retail method (sales price reduced by the marginal profit) (*baika kangenho* — 売価還元法) (CTL-EO Art 28(1)(i)(f))

Tax reform in 2009 disallowed the use of the simple average and last-in, first-out (LIFO) methods. The simple average method has never been widely accepted, but LIFO has been frequently used. The elimination of LIFO as an acceptable method followed the adoption of Accounting Standard No 9 by the Accounting Standards Board of Japan, effective after 31 March 2010, which eliminated LIFO inventory accounting as part of the program to eliminate differences between Japanese accounting standards and International Financial Accounting Standards.

Lower of cost or market method (*teikaho* — 低価法)

Under the lower-of-cost-or-market method, a corporation values its inventory at the lower of either:

- cost, as determined under the cost method selected by the corporation, or
- the regular cost to purchase the inventory at the end of the period (market value).

Table 8: Time of electing inventory method (CTL Basic Circular 5-2-18)

Newly established corporation	Date established
Corporation beginning business	Date business begins
Beginning another new business	Date new business begins
Changing type of business	Date of change

Change in inventory method

Once selected, an inventory method should be used continuously thereafter. If a change in method is desired, an application for approval of the change must be submitted to the tax office and approval must be received by the day before the beginning of the tax year of the change (CTL-EO Art 30(2)).

If no method is elected

If a corporation fails to select an inventory valuation method, the last purchase price method must be used (CTL-EO Art 31(1)).

Law: Art 28, Art 28(1)(i)(a), Art 28(1)(i)(b), Art 28(1)(i)(c), Art 28(1)(i)(d), Art 28(1)(i)(e), Art 28(1)(i)(f), Art 30(2) and Art 31(1) of the Corporation Tax Law Enforcement Order; CTL Basic Circular 5-2-18

[¶4-420] Employee compensation

Compensation to employees may include salary (*hoshu*), bonuses (*shoyo*) or retirement payments (*taishoku kyuyo*). These costs are generally deductible as business expenses (CTL Art 22(3)(ii)). Exceptions exist for excessive salaries and excessive retirement payments.

Excessive salaries to specially related employees

A specially related employee is one who is related to, is a *de facto* spouse of, or who is supported by and shares a livelihood with a corporation's director or a person who is supported by and shares a livelihood with such an employee (CTL-EO Art 72). Salaries paid to specially related employees in excess of that normally paid for the work rendered are not deductible by the corporation (CTL Art 36; CTL-EO Art 72-2).

Excessive retirement payments to specially related employees

Excessive retirement payments paid to specially related employees (based on the period of employment, circumstances of retirement and comparable payments in the industry) are not deductible by the corporation (CTL Art 34(2); CTL-EO Art 72-2).

Period in which employee bonuses are deductible (CTL-EO Art 134-2)

Table 9: Deductible employee bonuses

Circumstances of bonus	*When bonus is deductible*
Pay period is set by contract or rule and the amount of bonus has been announced	Later of the set payday or date of announcement
Bonuses included in expense and announced before the end of the period and paid within one month after the end of the period	Period in which the announcement is made
Others	Period when paid

Law: Art 22(3)(ii), Art 34(2) and Art 36 of the *Corporation Tax Law*; Art, 72, Art 72-2 and Art 134-2 of the Corporation Tax Law Enforcement Order

[¶4-430] Officers' compensation

Compensation paid to officers of Japanese companies is subject to rules different from the salaries paid to other employees. Officers of Japanese corporations include directors, auditors and liquidators. Examples of other officers of various corporate entities include the following (CTL-EO Art 7, Art 71):

- the president, vice-president, chairman and vice-chairman
- the president and vice-president of an association
- the administrator of a *gomei gaisha* or *goshi gaisha*
- representatives of foundations and non-juridical organisations
- a person specified as a director or counsellor in the articles of incorporation, and
- other persons serving as advisors, etc, whose duties and positions are similar to officers (CTL Basic Circular 9-2-1).

Officers' salary (*hoshu* — 報酬)

Salary is a continuous payment, based on a predetermined standard and computed for a period of one month or less (CTL Basic Circular 9-2-13). Salary paid to officers is generally deductible by corporations, but salary that is unreasonable in amount, or is not disclosed by the corporation, may not be deducted (CTL Art 34(1)). Compensation to officers in excess of that specified in the articles of incorporation and by the shareholders' meeting is not deductible (CTL-EO Art 69). Compensation of officers which is concealed or disguised may not be deducted (CTL Art 34(2)).

Officers' bonuses (*shoyo* — 賞与)

Pre-2006 rules. Officers' bonuses (*shoyo*) are usually based on the profitability of the company. For Corporation Tax purposes, they are considered as paid *from* income and may not be deducted to compute taxable income (CTL Art 35 before enactment of changes in 2006). A bonus is an extraordinary payment of compensation that is neither salary nor a retirement payment (CTL Art 35(4) before enactment of changes in 2006).

- *Officers acting in the capacity of employees*. Bonuses paid to officers acting in the capacity of employees are deductible to the extent they are reasonable in amount (CTL Art 35(2)). Such officers may include department heads, section chiefs, etc, employed on a full-time basis, but may not include the president, vice-president, chief director, representative director, executive director, managing director, liquidator or auditor, or the administrator of a *gomei gaisha* or *goshi gaisha* (CTL Art 71). The bonus must be paid at the same time as and the amount must be consistent with the bonuses paid to other employees (CTL Basic Circular 9-2-17).
- *Bargain transfers to officers*. If a corporation provides an economic advantage to an officer, the difference between the value received by the officer and the amount paid by the officer is considered to be compensation to the officer. Examples of bargain transfers include the items listed below (CTL Basic Circular 9-2-10). Compensation arising from one of these transfers is treated as a bonus payment and may not be deducted by the corporation (CTL Basic Circular 9-2-11):
  - gifts
  - bargain sales
  - sales to the corporation by an officer at above-market prices
  - forgiveness of an officer's debt
  - gratuitous assumption of an officer's debt
  - bargain rental of property to an officer
  - below-market loan to an officer
  - other services provided to an officer at a bargain price
  - secret payments, and travel and entertainment payments, to an officer not directly related to the corporation's business
  - personal expenses of the officer borne by the corporation, and
  - life insurance premiums paid for the benefit of an officer.

Profit-based compensation (*rieki rendo kyuyo* — 利益連動給与)

Under the 2006 tax legislation, the compensation paid to officers who take part in the administration of corporations, other than family corporations, that is based on the profits of the company (bonuses) may be deductible if (CTL Art 34(1); CTL-EO Art 69(1)):

(1) the company is not a family corporation

(2) the amount is determined according to an objective calculation method based on indexes of profits referenced in the securities reports

(3) the calculation method is set by the compensation committee within three months from the beginning of the accounting year (four months for insurance companies)

(4) the amount is limited under the determination method and is similar to the method used to compensate other executive officers

(5) after determination, the amount is reported in securities reports without delay, and

(6) the compensation is paid, or is expected to be paid, within one month of the determination of its amount.

Officers' retirement payments (*taishokukin* — 退職金)

Retirement payments to officers are deductible only to the extent that they are reasonable in amount (CTL Art 36). Reasonableness of a retirement payment is determined based on factors, including the period of time the officer was employed, the circumstances of the retirement, the amount of retirement payments paid by other companies in the same industry and the size of the company (CTL-EO Art 72).

Prior law: Compensation of officers of specially controlled family corporations (*tokushihai dozokugaisha no yakuin kyuyo* — 特殊支配同族会社の役員給与)

Tax legislation in 2010 repeals the limit on compensation paid to the owners of specially owned family corporations. For tax years ending before 1 April 2010, compensation paid to the chief executive officer (*gyomu shusai yakuin*) of a specially controlled family corporation ("individually owned company") could not be deducted in computing taxable income to the extent it exceeds ¥6m (¥8m for years beginning before 1 April 2007) (CTL Art 35).

A specially controlled family corporation is a family corporation where 90% or more of the stock or voting power is owned by the chief operating officer or persons related to that officer, including family relatives (*shinzoku*), persons in a relationship similar to a marital relationship, employees of that officer, persons supported by that officer and corporations controlled by that officer and such related persons (CTL-EO Art 72(1)).

Salary double deduction issue. Future tax legislation is expected to deal with the disparity in salary deductions provided under the tax rules for salaries paid to company owners while similar deductions are not allowed to sole-proprietors. The disparity arises because an employer may take a deduction for salary paid to owner-employees and the salaried employee may take an employment income deduction (see ¶3-235) based on the same income, while the employment income deduction is not available to a sole-proprietor.

Law: Art 34(1), Art 34(2), Art 35, Art 35(2), Art 35(4), Art 36 and Art 71 of the *Corporation Tax Law*; Art 7, Art 69, Art 69(1), Art 71, Art 72 and Art 72(1) of the Corporation Tax Law Enforcement Order; CTL Basic Circulars 9-2-1, 9-2-10, 9-2-11, 9-2-13 and 9-2-17

[¶4-440] Depreciation

The treatment of depreciation is discussed below. See ¶4-445A for the 2007 and 2011 changes to the depreciation rules.

[¶4-441] Acquisition cost

The cost of property which is put to use in a business or held for the production of income may be recovered as an expense for depreciation over the useful life of the property (CTL Art 31). The acquisition cost of depreciable property includes the purchase price and additional costs of obtaining the property, such as freight and loading expense, transport insurance fees, the purchase commissions, and tariffs and costs of self-constructed assets (CTL-EO Art 54).

Cost to demolish existing structures

Costs to demolish structures on acquired land are included in the acquisition cost of the land if the demolition commences within approximately one year from the time of acquisition (CTL Basic Circular 7-3-6).

Repairs

Costs to repair and property maintenance are ordinarily included in current expense. However, repairs which extend the useful life or enhance the value of the property are included in the acquisition cost (CTL Basic Circulars 7-8-1–6).

Expensing small amounts

A depreciable asset may be charged to expense in the current year if either: its expected useful life is one year or less, or the cost of the asset is not more than ¥100,000 (CTL-EO Art 133). Assets costing more than ¥100,000 each, but not more than ¥200,000, may be grouped together and depreciated over three years (CTL-EO Art 133-2).

Items not included in acquisition cost

The following costs are not included in the acquisition price of depreciable assets (CTL Basic Circular 7-3-3-2):

- taxes such as real estate acquisition tax, motor vehicle acquisition tax, office tax or registration licence tax
- costs of construction of buildings, etc, such as planning, surveying and basic construction, which become unnecessary due to a change in plans
- penalties for breach of contract to acquire assets, and
- interest on loans to acquire assets and the interest portion of instalment purchase payments.

Law: Art 31 of the *Corporation Tax Law*; Art 54, Art 133 and Art 133-2 of the Corporation Tax Law Enforcement Order; CTL Basic Circulars 7-3-3-2, 7-3-6 and 7-8-1-6

[¶4-442] Types of depreciable property

Tangible property

The allowance for depreciation is used to recover the cost, less salvage value, of most types of tangible property, including:

- buildings and equipment, such as air-conditioning equipment, lighting equipment and elevators which are attached to buildings
- structures such as docks, bridges and railroad tracks
- machinery and equipment
- ships, aircraft and vehicles
- tools and instruments
- furnishings and fixtures, including decorative or ornamental plants, and
- livestock and certain plants, such as fruit trees, with a useful life greater than one year (CTL-EO Art 13).

Law: Art 21-9(1), Art 21-9(2), Art 21-12(1), Art 21-13, Art 21-15(1), Art 21-15(3), Art 21-16(3), Art 21-16(4), Art 27-3 and Art 33-2(1) of the *Inheritance Tax Law*; Art 70-3(1), Art 70-3-2(2) and Art 70-3(3) of the *Special Taxation Measures Law*; 2012 Draft of Law to Partially Revise the Consumption Tax Law in Order to Secure Stable Resources for Social Security

[¶6-350] Exemption for gifts for educational costs (Kyouiku Shikin — 教育資金)

Gifts from a lineal ascendent (eg parent or grandparent) to a lineal descendent under 30 years of age for educational purposes may be exempt from Gift Tax from 1 April 2013 through 31 March 2019 (STML Art 70-2-2). Educational purposes include amounts received by an educational institution (including primary, secondary and tertiary educational institutions), including tuition, fees, childcare costs, field trip costs, school lunch costs, school commuter passes, and study abroad travel costs. The gift must be made through a trust account in a financial institution and is limited to a maximum gift amount of ¥15m. Gifts for other educational purposes, such as cram schools, swimming schools, sports schools, or schools for culture or arts, such as painting, music, or religion, are limited to a maximum gift amount of ¥5m.

[¶6-351] Exemption for gifts for marriage and child care (*Kekkon・Koiku Shikin* — 結婚・子育て資金)

To provide support for married couples, an exemption from gift tax is provided for gifts from a lineal ascendant (eg parent or grandparent) made from 1 April 2015 through 31 March 2019 to a lineal descendent at least 20 but not 50 years of age for use for marriage or child rearing (STML Art 70-2-3). The gift must be made through a trust account created with a financial institution. To minimize inheritance tax evasion, unused amounts remaining in the account at the time of death of the donor will be treated as inherited property. Unused amounts remaining in the account when the donee reaches age 50 are treated as gifts.

Amount of exemption. The maximum exemption is ¥10m per donee, but is limited to ¥3m in the case of gifts for marriage costs.

Eligible costs. Eligible costs include wedding costs, costs to set up a new home, moving expenses, child delivery costs, infertility treatment costs, post-natal care, child medical expenses and child care, including baby sitting costs. The donee must obtain a copy of the trust fund report from the financial institution and submit a copy to the local tax office. Withdrawals from the trust fund must be accompanied by evidence of the eligible costs and the evidentiary documents will be retained by the financial institution.

TAX RETURNS FOR INHERITANCE TAX AND GIFT TAX (*SHINKOKU* — 申告)

[¶6-400] Tax returns for Inheritance Tax and Gift Tax (*Shinkoku* — 申告)

Both the Inheritance Tax and the Gift Tax use the self-assessment system where the taxpayer prepares a tax return and pays the amount of tax shown on the return.

Tax returns for Inheritance Tax

Every person who receives property by bequest or succession in an amount in excess of the basic exemption must file an Inheritance Tax return within ten months from the time that he or she becomes aware of the opening of succession (*Inheritance Tax Law* Art 27). If such a recipient ceases to have a residence or domicile in Japan before the expiration of the 10-month period, the tax return is due when the period of residence or domicile in Japan ends.

Joint return

A joint Inheritance Tax return may be filed by two or more heirs or successors to property from the same decedent (*Inheritance Tax Law* Art 27(4)).

Revised return

A revised return may be filed after the due date of the Inheritance Tax return if, after the original return is filed, one of the following events occurs:

- undivided interests in property reported as received by the successors has been divided and the value received differs from that originally reported
- the heirs or successors have changed
- a person entitled to a legally secured portion has requested an abatement of property, and
- a will has been discovered or a renunciation of a bequest has occurred.

Table 14: Summary of Information on Inheritance Tax Return (Sch 1)

To the Director of the Tax Office of (district)	Decedent:		
Date	• Address • Name • Age • Date of opening of succession • Occupation		
Persons receiving property			
Name		Totals	
Address and phone number			
Occupation			
Relationship with decedent			
Value of taxable property			

(1) Value of property received			
(2) Value of property subject to gift tax settlement at time of inheritance procedure			
(3) Debts and funeral expenses			
(4) Net property value [(1) – (2)]			
(5) Gifts within three years of death			
(6) Taxable value [(3) + (4)]	(A) = total	(5) = per person	
Each person's tax amount			
Number of statutory successors and basic exemption	(B)		
(7) Total Inheritance Tax			
(8) Allocation %	(5) / (A)		
(9) Allocation of tax	(6) × (7)		
(10) Tax per special concessions			
(11) 20% Surtax (N/A to spouse or first degree relative)			
Tax payable by each person			
(12) Gift Tax credit			
(13) Spousal credit			
(14) Credit for a minor child			
(15) Handicapped person credit			
(16) Credit for a multiple successions			
(17) Foreign tax credit			
(18) Total			
(19) Balance of tax payable [(9) + (11) – (18) or (10) + (11) – (18)]			
(20) Gift tax paid under the gift tax settlement at time of inheritance procedure			
(21) Medical corporation special tax payment deferral (Form 8-4(2B)			
(22) Total [(19) – (20) – (21)]			
(23) Deferred tax due to farmlands			
(24) Deferred tax due to stockholdings			
(25) Deferred tax due to forestry			
(26) Medical corporation special tax payment deferral (Form 8-4(2A))			
(27) Tax due with the tax return [(22) – (23) – (24) – (25) – (26)]			
(28) Refund of overpaid tax			

Tax returns for Gift Tax

Every person who receives property by gift in excess of the basic exemption during the year must file a Gift Tax return within the period from 1 February to 15 March of the year following the gift (*Inheritance Tax Law* Art 28).

Table 15: Summary of Information on Gift Tax Return

Address				For use of the tax office			
Name				☐ Serial number			
Occupation				☐ Date filed			
				☐ Extension period			
				☐ Date departed Japan			
				☐ Date of death			
(fold line)							
I. Value of taxable property							
Date acquired	Donor's name and address	Type	Detail	Use, name, etc	Number	Unit	Value
(1) Total of taxable property							
(fold line)							
Calculation of tax payable							
(2) Spousal allowance							
(3) Basic exemption							
(4) Table amount after deduction of (2) and (3) [(1) – (2) – (3)]							
(5) Tax on amount after deduction of (2) and (3)							
(6) Foreign tax credit							
(7) Medical corporation special tax deduction							
(8) Tax payable [(5) – (6) – (7)]							
(9) Total of taxable property for each specified donor							
(10) Total of tax for each specified donor							
(11) Total taxable amount [(1) + (9)]							
(12) Total balance of tax [(8) + (10)]							
(13) Amount of deferred tax due to farmlands							
(14) Amount of deferred tax due to stockholdings							
(15) Medical corporation special tax payment deferral							
(16) Amount due with the tax return [(11) – (12)]							
For an amended tax return:	(17) Increase in the balance of tax						
	(18) Increase in amount payable with the tax return						

Law: Art 27, Art 27(4) and Art 28 of the *Inheritance Tax Law*

PAYMENT OF INHERITANCE TAX AND GIFT TAX (*ZEIKIN NO NOFU* — 税金の納付)

[¶6-500] Payment of Inheritance Tax and Gift Tax (*Zeikin No Nofu* — 税金の納付)

Time of payment

Payment of Inheritance Tax and Gift Tax is due at the due date for filing the tax return (*Inheritance Tax Law* Art 33).

Joint and several liability for tax

All recipients of property by inheritance or succession from the same decedent are jointly and severally liable for the Inheritance Tax, but no person may be liable for more tax than the value of the property received by that person (*Inheritance Tax Law* Art 34). The donor and donee are jointly and severally liable for Gift Tax (*Inheritance Tax Law* Art 34(4)). The donor's liability is limited to the portion of the donee's Gift Tax attributable to the property received from that donor and may not exceed the value of that property.

Law: Art 33, Art 34 and Art 34(4) of the *Inheritance Tax Law*

[¶6-510] Deferred tax payment (*Enno* — 延納)

Deferral of payment of Inheritance or Gift Tax through instalment payments may be permitted if the amount of the tax is at least ¥100,000 (*Inheritance Tax Law* Art 38). A written application must be filed by the due date of the return requesting permission to defer payment and cause must be shown as to why paying the tax on time would impose a difficulty on the taxpayer (*Inheritance Tax Law* Art 39(3)).

Security

If the deferral period is more than three years, and the amount of tax is at least ¥500,000, the taxpayer must provide security for the unpaid tax. Acceptable forms of security include (*General Law of National Tax* Art 50):

- Japanese national bonds or local government bonds
- corporate securities approved by the head of the tax office
- land, buildings, standing trees, ships, etc
- interests in railroads, manufacturing or mining foundations, or
- other security approved by the head of the tax office.

Deferral period and interest

The following table summarises the maximum deferral period for instalment payments and the interest rate (*rishi zei* — 利子税) charged on the unpaid tax (*Inheritance Tax Law* Art 52; STML Art 70-11).

Table 16: Maximum deferral period and interest rates

Inheritance Tax *(Type of property received from decedent to which deferred tax relates and % which is real property, etc)*	*Deferral period (years)*	*Annual interest rate (%)*
Tax on real property, etc, where real property, etc, is at least 75% of property received	20	3.6
Tax on real property, etc, where real property, etc, is at least 50%, but less than 75% of property received	15	3.6
Tax on other property where real property, etc, is at least 50% of property received	10	5.4
Tax on real property, etc, or other property where real property, etc, is less than 50% of property received	5	6
Gift Tax		
All property	5	6

Law: Art 50 of the *General Law of National Tax*; Art 38, Art 39(3) and Art 52 of the *Inheritance Tax Law*; Art 70-11 of the *Special Taxation Measures Law*

[¶6-511] Business succession tax system (*Jigyo Shokei Zeisei* — 事業承継税制)

Inheritance Tax

Legislation in 2008 established a new system for deferring Inheritance Tax on closely held business stock (STML Art 70-7-2). This system came into effect on the date of enforcement (1 October 2008) of the *Law Concerning Smoothing of Succession of Management of Small and Medium-Sized Enterprises* (*chushokigyo no keiei no shokei no enkatsuka ni kansuru horitsu* — 中小企業の経営の承継の円滑化に関する法律). The new system allows for deferral of the Inheritance Tax on 80% of up to two-thirds of the outstanding stock of the company. A business successor (*jigyo shokei sozokunin* — 事業承継相続人) must be the top shareholder in a related person group that owns a majority of the stock in a company designated as eligible by the Minister of Economy, Trade and Industry. For successions on or after 1 January 2013, designation of eligibility for the company by the Ministry of Economy, Trade and Industry is not required. The deceased must also have been the leading shareholder (excepting the business successor) in a related person group that had a majority interest at the time of death. The inherited company stock must be used to secure payment of the deferred tax.

Companies ineligible for the deferred tax system include companies listed on an exchange, companies other than small- and medium-sized companies, companies engaged in adult entertainment or food and entertainment businesses, asset management companies, and companies without at least one employee (at least five employees in the case of a foreign company) (STML Art 70-7-2(2)).

Employment security requirement (*koyo kakuho yoken* — 雇用確保要件). During the period within five years from the time for filing the Inheritance Tax return, if the ratio of the number of employees of the company divided by the number of employees at the beginning of succession drops below 80%, the deferred tax becomes due. For inheritances on or after 1 January 2015, the loss of deferral is only triggered if the average ratio of employees during the five year period commencing at the beginning of succession drops below 80% of the number of employees of the company at the beginning of succession.

The amount of Inheritance Tax eligible for deferral is the Inheritance Tax computed as if the business successor inherited only the company stock, less the Inheritance Tax computed as if the business successor inherited 20% of the company stock. Payment of the deferred tax is required when certain events occur as outlined below (STML Art 70-7-2(3)):

(a) If the business successor stops serving as a director of the company or disposes of any of the inherited shares of the company within five years from the due date of the Inheritance Tax return, the entire deferred tax becomes due.

(b) If, after five years from the due date of the Inheritance Tax return, the business successor transfers some or all of the stock, the deferred tax becomes due in proportion to the percentage of the stock transferred.

(c) In the event deferred tax becomes payable under the conditions described in (a) or (b) above, interest is also payable from the due date of the return. However, under the conditions described in (b) above, interest is not charged for the five year period beginning with the due date of the Inheritance Tax return.

(d) If a business successor retains the stock throughout their lifetime, the deferred Inheritance Tax is discharged.

Countermeasures will be implemented to prevent use of the business succession tax system to avoid tax on personal assets and other abuses.

Gift Tax

Legislation applicable to gifts on or after 1 April 2009 establishes rules for deferring payment of Gift Tax on receipt of shares of a closely held business stock, paralleling the rules for Inheritance Tax described above. A person who is confirmed by the Ministry of Economy, Trade and Industry (METI) as the successor to a medium- or small-sized company by a gift of stock from its director may defer Gift Tax on up to two-thirds of the value of the outstanding stock (including shares previously owned). On the death of the donor, the value of the gifted stock at the time of the gift is deemed received by the successor. It is included in the value of the taxable estate and, if approved by METI, is eligible for the Inheritance Tax deferral procedures.

Law: *Law Concerning Smoothing of Succession of Management of Small and Medium-sized Enterprises*

[¶6-512] Payment-in-kind (*Butsu No* — 物納)

The Inheritance Tax, but not the Gift Tax, may be paid using property rather than cash if the taxpayer obtains approval from the tax office. Approval is obtained by filing a written application stating the reason why payment in cash would be difficult and listing the types of property proposed to be used for payment (*Inheritance Tax Law* Art 42). Property for payment-in-kind is ranked in four categories:

Table 17: Property for payment-in-kind

First category	National Government bonds and local government bonds
Second category	Real property and ships
Third category	Corporate securities and beneficial interests in trusts
Fourth category	Personal property

Property in the third and fourth categories may only be used if the tax office recognises there are special circumstances.

Property in the third category may be used only if the property in the first and second categories is insufficient to pay the tax.

Property in the fourth category may be used only if the property in the first, second, and third categories is insufficient to pay the tax.

Law: Art 42 of the *Inheritance Tax Law*

[¶6-520] Public notice of inheritance and gift tax information (*Koji* — 公示)

The tax office is required to make public the names, place of tax payment and the taxable amounts contained in Inheritance Tax returns where the taxable amount is more than ¥200m or the value of the decedent's property at the date of death after deducting liabilities is more than ¥500m (*Inheritance Tax Law* Art 49(1)). Similar information is made public from a Gift Tax return if the taxable amount reported on the return is more than ¥40m (*Inheritance Tax Law* Art 49(2)).

Law: Art 49(1) and Art 49(2) of the *Inheritance Tax Law*

[¶6-530] Penalties (*Bassoku* — 罰則)

Evasion of tax

Evasion of Inheritance Tax or Gift Tax by fraud is punishable by not more than five years of penal servitude and/or a fine of up to ¥5m (*Inheritance Tax Law* Art 68). The amount of the fine may be increased by an amount of evaded tax that exceeds ¥5m, but is limited to the amount of the evaded tax.

Failure to file

A person who fails to file an Inheritance or Gift Tax return without reason is subject to punishment of not more than one year of penal servitude or a fine of up to ¥200,000 (*Inheritance Tax Law* Art 69). However, based on the circumstances of the case, the punishment may be waived.

Law: Art 68 and Art 69 of the *Inheritance Tax Law*

VALUATION OF PROPERTY (*ZAISAN NO HYOKA* — 財産の評価)

[¶6-600] Valuation of property (*Zaisan No Hyoka* — 財産の評価)

For purposes of the Inheritance and Gift Taxes, property received is valued at its market value at the time of acquisition by succession, bequest or gift, reduced by the amount of liabilities (*Inheritance Tax Law* Art 22). The rules for valuation of property are contained in the Property Valuation Basic Circular (*Zaisan Hyoka Kihon Tsutatsu* — 財産評価基本通達, "Valuation Circular", originally issued on 25 April 1964 and last revised on 2 March 2012).

Table 18: Examples of valuation methods used

Method	*Type of property valued*
Procurement price method	General personal property, large-scale ships
Replacement cost method	Buildings and attachments
Sales price method	Products and commodities
Purchase price method	Raw materials and work-in-process
Venture capital method	Housing under construction, immature trees
Compound interest present value method	Patent and utility model rights
Compound interest annuity present value method	Mining rights, goodwill
Dividend (earnings) reduction method	Unlisted stock other than family company stock
Other methods	Savings, loans, etc

Basic annual rate

The basic annual rate of interest used in the Valuation Circular is 3% per annum (Valuation Circular 4-4).

Superficies

A superficies is a right to use the land of another person for the purposes of owning buildings, trees or bamboo on the property (Civil Code Art 265). The value of a superficies is determined by multiplying the unencumbered value of the land by a percentage based on the remaining term of the superficies (*Inheritance Tax Law* Art 23).

Table 19: Value of a superficies (as % of land value)

Remaining term of the superficies is:		
More than (years)	*But not more than (years)*	*% of land value*
Not more than 10		5
10	15	10
15	20	20
20	25	30

Remaining term of the superficies is:		
More than (years)	*But not more than (years)*	*% of land value*
25	30	40
30	35	50
35	40	60
40	45	70
45	50	80
More than 50		90

Life insurance contracts

The value of a life insurance contract for which the contingency, for payment of the proceeds has not occurred, is equal to 70% of the premiums paid to date less 2% of the insurance proceeds (*Inheritance Tax Law* Art 26). However, if all the premiums are paid in a lump sum, the value is equal to the total of the premiums.

Standing trees

For Inheritance Tax and Gift Tax purposes, the value of standing trees is 85% of their market value (*Inheritance Tax Law* Art 26-2).

Land used for residential purposes

Land used for residential purposes may be valued using either the road tax method or the multiplier method:

- *Road tax method (rosenka hoshiki)*. Using the road tax method, a value per square metre of land is obtained from a table of land values prepared by the National Tax Agency. This method is applicable only if the property is located on a street in an urban area where the road tax values are available.
- *Multiplier method (bairitsu hoshiki)*. The multiplier method takes the value of land for the fixed assets tax and multiplies it by a multiplier provided by the Regional Tax Bureau.

Listed stocks

Listed stocks and stocks traded over the counter are generally valued using the last quoted price available on the valuation date. However, the lowest of the monthly average prices for the month, including the valuation date and the two preceding months, may also be used.

Unlisted stocks

Unlisted stocks are valued using methods based on the size of the company. However, certain minority shareholders may use the dividend return method.

Effective for tax years of designated tax haven subsidiaries beginning on or after 1 April 2010, the 5% ownership requirement in each of the above tests is changed to 10% direct or indirect ownership (STML Art 66-6(1)(i), (ii)).

Foreign corporation with multiple classes of stock

If a foreign corporation has more than one class of stock, possessing differing voting rights or rights to dividends or a combination of these factors, the 5% and 50% tests are applied to the ownership factor (number of shares owned, ratio of voting rights or ratio of dividend rights) that results in the highest percentage (STML Art 66-6(1)(i)).

Share ownership by directors

For years beginning on or after 1 April 2005, the share ownership of company directors is included in the calculations of the 5% and 50% tests (¶9-610) without regard to whether they are residents or non-residents of Japan. Foreign trusts similar to the specified trusts (*tokutei shintakum* — 特定信託), described in CTL Art 2-29(3), will be subject to the tax haven income inclusion rules (STML Art 66-6(2); STML-EO Art 39-14 (3), Art 39-16(6)). Any corporation controlled by directors of the domestic Japanese corporation is considered to be a member of an affiliated shareholder group.

Effective for tax years ending on or after 1 April 2008, shares owned by a domestic Japanese corporation's directors and their related persons are included (STML-EO Art 39-20-8).

Law: Art 2-29(3) of the *Corporation Tax Law*; Art 66-6(1)(i), Art 66-6(1)(ii) and Art 66-6(2) of the *Special Taxation Measures Law*; Art 39-14(3), Art 39-16(6) and Art 39-20-8 of the Special Taxation Measures Law Enforcement Order

[¶9-620] Amount subject to tax (*Kazei Taisho Kingaku* — 課税対象金額)

The amount subject to tax of a designated tax haven subsidiary is determined based on its undistributed income for the current taxable year using special rules to adjust income computed either under Japanese tax rules or income computed under the home country rules adjusted to conform to Japanese tax rules. Any net loss may be carried forward seven years (five years for losses arising in years ending before 1 April 2005). The amount subject to tax is included in income in the taxable year of the 5% Japanese shareholder, which includes the date that is two months from the day after the designated tax haven subsidiary's taxable year end (STML Art 66-6(1)). A deemed paid foreign tax credit is allowed to the 5% Japanese shareholder for its pro-rata share of foreign taxes on the income (STML Art 66-7(1)).

The amount subject to tax included in income in the taxable year by the 5% Japanese shareholder	=	The amount subject to tax of the designated tax haven subsidiary for the taxable year	×	% of the stock of the subsidiary owned, directly or indirectly, by the 5% Japanese shareholder

In tax years of the designated tax haven subsidiary beginning before 1 April 2009, dividends paid by the designated tax haven subsidiary generally reduced the amount subject to tax, subject to income inclusion by the 5% Japanese shareholder, but no reduction was allowed for dividends paid to other designated tax haven subsidiaries of a

5% Japanese shareholder or to a foreign company related to a 5% Japanese shareholder if the foreign company was located in a jurisdiction where the tax burden on dividends was 25% or less.

2009 foreign dividend exemption system

Effective for tax years of a designated foreign tax haven subsidiary beginning on or after 1 April 2009, the indirect foreign tax credit has been replaced with a system of exempting foreign dividends from the income of the Japanese company shareholder (see ¶4-633). Under this system, 95% of dividends received by a Japanese corporation from a foreign subsidiary, including a designated tax haven subsidiary, are not included in income. Expenses attributable to the dividend income are deductible to the extent that the income of the designated tax haven subsidiary is included in the income of the Japanese 5% shareholder.

The full amount of the current income of the designated tax haven subsidiary is included in income by the parent company and no deduction from the amount subject to tax of the designated tax haven subsidiary is allowed for dividends paid. However, dividends received by a designated tax haven subsidiary from the following foreign companies may be deducted from its amount subject to tax for the purposes of the tax haven income inclusion rules, provided that a detailed schedule is filed with the tax return:

(1) dividends from a foreign company if the designated tax haven subsidiary has held at least 25% of the foreign company's stock for at least six months prior to the date the obligation to pay the dividend arises

(2) dividends from another designated tax haven subsidiary if the income of that second tax haven subsidiary has already been included in income by the Japanese 5% shareholder.

For tax years beginning on or after 1 April 2016, no dividend deduction is allowed if the dividend is deductible in whole or part by the foreign subsidiary in the country where its home office is located. But dividends received by a designated tax haven subsidiary from another designated tax haven subsidiary whose income has been included in the income of the Japanese parent company are deductible by the designated tax haven subsidiary receiving the dividend.

If a 5% Japanese shareholder receives dividends from a designated tax haven that are not eligible for the foreign dividend exemption (see ¶4-633), the dividends are not included in its income to the extent the dividend is paid out of the amount subject to tax included in the income of the 5% Japanese shareholder during the ten years prior to the beginning of the taxable year the dividend was received.

Law: Art 66-6(1) and Art 66-7(1) of the *Special Taxation Measures Law*

[¶9-621] Deduction for previously taxed dividends

Dividends paid by a designated tax haven subsidiary to a Japanese shareholder are generally included in income in the same way as other dividends and a direct or indirect foreign tax credit is allowed for foreign taxes on the dividends under the regular rules (CTL Art 69(4)). To avoid double taxation of income previously taxed under the tax haven rules, a deduction is allowed for dividends paid out of retained earnings of the designated tax haven subsidiary that have previously been taken into income by a Japanese resident individual or Japanese corporation (STML Art 40-5, Art 66-8). The deduction is calculated by subtracting the income of the current year before Corporation Income Tax of the designated tax haven subsidiary from the amount of dividends paid and multiplying the result by the percentage of shares of the subsidiary owned directly or indirectly by the Japanese 5% shareholder (STML-EO Art 39-19(2)). The deduction is allowed for dividends from a designated tax haven subsidiary to the extent of the subsidiary's retained earnings that have been included in the income of the shareholder within the last ten years up to the end of the tax year preceding the year the dividends are received, reduced by prior deductions taken for distributions of that income (STML Art 66-8(1), (2)).

Effective for tax years of the Japanese shareholder beginning on or after 1 April 2010, a dividend exclusion is available to the Japanese shareholder for a dividend received from a foreign corporation for the "indirect specified tax amount" (*kansetsu tokutei kazei taisho kingaku* — 間接特定課税対象金), which is equal to the lesser of the following amounts that arose during the year the dividend was received by the Japanese shareholder or the prior two years (STML Art 66-8(11); STML-EO Art 39-19(11)):

(1) the Japanese shareholder's proportionate share of the dividends received by the foreign company from a second tier or lower foreign company, based on the percentage ownership of the Japanese shareholder as of the record date or equivalent date of the latest dividend received by the Japanese shareholder from the foreign company, or

(2) the Japanese shareholder's proportionate share of the amount subject to tax (*kazei taisho kingaku*) or the partially applicable amount (*bubun tekiyo taisho kingaku*, see ¶9-630 below) of the second tier or lower foreign company.

Law: Art 69(4) of the *Corporation Tax Law*; Art 40-5, Art 66-8 and Art 66-8(11) of the *Special Taxation Measures Law*; Art 39-19(2) and Art 39-19(11) of the Special Taxation Measures Law Enforcement Order

[¶9-630] Local country business exception

The tax haven countermeasures are not intended for bona fide business activities conducted in low tax jurisdictions and do not apply if all of the following criteria are satisfied (STML Art 40-4(3), Art 66-6(3)).

Effective for tax years of designated tax haven subsidiaries beginning on or after 1 April 2010, the local country business exception will not apply to certain types of includible passive income (the "partially applicable amount", *bubun tekiyo taisho kingaku*), including (STML Art 66-6(4), STML-EO Art 39-17-2):

(1) for shareholdings of less than 10%, dividends or gains from disposition of shares on an exchange or over the counter

(2) interest on bonds and gains from disposition of bonds on an exchange or over the counter

(3) royalties, other than from property rights developed by the subsidiary

(4) leasing fees for ships or aircraft.

Each of these items of includible passive income is reduced by any associated direct costs before including the amount in the amount subject to tax of the subsidiary. The amount of includible passive income cannot exceed the taxable income of the subsidiary. If the includible passive income of the subsidiary is less than 5% of the designated tax haven subsidiary's before-tax income or is less than ¥10m, the includible passive income rule does not apply (STML Art 66-6(5), STML-EO Art 39-17-2(8)).

Substance criterion

The substance criterion is satisfied if the designated tax haven subsidiary has an office, store, factory or other fixed facility in the jurisdiction where its head or main office is located and such facility is deemed necessary for it to conduct its main business there.

Local management and control criterion

The local management and control criterion is satisfied if the designated tax haven subsidiary itself manages and controls its main business in the jurisdiction where its head or main office is located.

The active business criterion

The active business criterion is satisfied if the main business of the designated tax haven subsidiary is other than holding debt or equity securities, licensing of industrial property rights, other technical rights, or copyrights, or leasing of ships or aircraft.

Business with unrelated persons criterion

If the main business of the designated tax haven subsidiary is wholesale trade, banking, trust company, securities business, insurance business or marine or air transport business, more than 50% of the business must be conducted with unrelated persons. Effective for tax years ending on or after 1 April 2008, related persons for this purpose includes any corporation controlled by directors of the subject Japanese domestic corporation, the designated tax haven subsidiary or their related corporations.

Local country business criterion

If the main business of the designated tax haven subsidiary is retail sales, manufacturing, services, real estate, personal property leasing, construction, land transport, agriculture, forestry, fisheries, mining or any business other than those covered by the business with unrelated persons criterion, the designated tax haven subsidiary may satisfy the local country business criterion by conducting its business mainly in the jurisdiction where its head or main office is located.

Special deduction for personnel costs (repealed)

If the designated tax haven subsidiary satisfies the substance, local management and control, and active business criteria, but fails to satisfy the relevant business with related persons or local country business criteria, a special rule allows 10% of the subsidiary's personnel costs to be deducted from its amount subject to tax that is subject to Japanese tax. The special rule applies to undistributed income arising in years ending on or after 1 April 2005 (STML Art 66-6(3); STML-EO Art 39-16(7)). Effective for tax years of the subsidiary beginning on or after 1 April 2010, the special deduction for personnel costs is repealed.

Regional headquarters companies (*tokatsu kaisha* — 統括会社)

Effective for tax years of designated tax haven subsidiaries beginning on or after 1 April 2010, the local business exception is extended to shares of a tax haven subsidiary that is a regional headquarters company. If the requirements are otherwise satisfied, a holding company that manages the businesses of at least two of its foreign controlled subsidiaries may qualify as a regional headquarters company (STML Art 66-6(3)).

For this purpose, a designated tax haven subsidiary is a regional headquarters company if (STML-EO Art 39-17):

(1) its shares are owned, directly or indirectly, 100% by the Japanese shareholder

(2) it owns directly at least 25% of the shares (including the voting shares) of two or more controlled foreign companies (beginning 1 April 2015, a Japanese company owned at least 50% may also qualify for this purpose) that carry on an active or substantial business in the country where their head or main office is located, and

(3) it actively conducts the business of its controlled foreign companies through a fixed place of business and with sufficient employees in the country where it is located.

Law: Art 40-4(3), Art 66-6(3), Art 66-6(4) and Art 66-6(5) of the *Special Taxation Measures Law*; Art 39-16(7), Art 39-17, Art 39-17-2 and Art 39-17-2(8) of the Special Taxation Measures Law Enforcement Order

[¶9-640] Direct or indirect 5% ownership

Whether or not a Japanese resident directly or indirectly owns 5% of the stock of a designated tax haven subsidiary is determined by examining the Japanese resident's ownership of stock in all foreign companies. Indirect ownership is determined by multiplying the Japanese resident's percentage ownership of the intervening foreign company by the percentage of the designated tax haven subsidiary that the intervening company owns. Indirect ownership of a designated tax haven subsidiary is not attributed to a Japanese person through Japanese corporations.

Example 1: Japanese 5% shareholders

A Japanese resident owns 50% of the stock of a foreign corporation, which in turn owns 10% of the stock of a designated tax haven subsidiary. The Japanese resident is a Japanese 5% shareholder in the designated tax haven subsidiary because she owns 5% of the stock indirectly through a foreign corporation.

Another Japanese resident owns 50% of the stock of a Japanese corporation, which in turn owns 10% of the stock of a designated tax haven subsidiary. This Japanese resident is not a Japanese 5% shareholder in the designated tax haven subsidiary because ownership of the designated tax haven subsidiary is not attributed to her through a Japanese corporation.

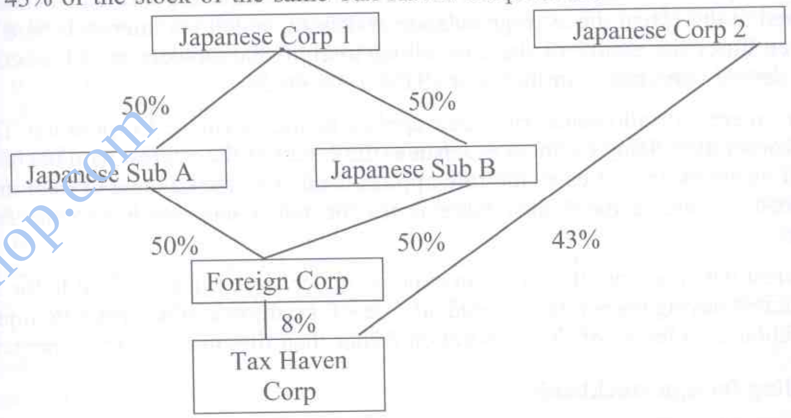
[¶9-650] Affiliated shareholder group (*Dozoku Kabunushi Gurupu* — 同族株主グループ)

An affiliated shareholder group consists of shareholders who own stock directly or indirectly in a foreign company, including individual residents of Japan, Japanese corporations and persons which have a special relationship with such shareholders under the family corporation rules (STML Art 66-6(1)(ii), Art 66-6(2)(vi)) (see ¶4-611).

Effective for tax years ending on or after 1 April 2008, an affiliated shareholder group also includes corporations controlled by a domestic Japanese corporation's directors and their related persons.

Example 2: Affiliated shareholder groups

Japanese Corporation 1 owns half of the stock in each of two Japanese corporations, Japanese Subsidiary A and Japanese Subsidiary B. The two subsidiaries each own half the stock of a foreign corporation, which in turn owns 8% of the stock of Tax Haven Corporation which is located in a jurisdiction which imposes no corporation taxes. Japanese Corporation 2, which is not related to any of the other Japanese corporations, owns 43% of the stock of the same Tax Haven Corporation.



Tax Haven Corporation is a designated tax haven subsidiary because it is located in a jurisdiction with no corporate income tax and more than 50% of the stock is owned by Japanese corporations (43% by Japanese Corporation 2 and 4% each by Japanese Subsidiaries A and B).

Japanese Corporation 2 is a 5% Japanese shareholder and must include its pro-rata share (43%) of the amount subject to tax of Tax Haven Corporation in its income currently.

Japanese Subsidiaries A and B are members of an affiliated shareholder group which owns 8% of the designated tax haven subsidiary. Japanese Subsidiaries A and B must each include 4% of the amount subject to tax of the Tax Haven Corporation in their income currently.

Law: Art 66-6(1)(ii) and Art 66-6(2)(vi) of the *Special Taxation Measures Law*

THIN CAPITALISATION RULES (*KASHO SHIHON ZEISEI* — 過少資本税制)

[¶9-700] Thin capitalisation rules (*Kasho Shihon Zeisei* — 過少資本税制)

The thin capitalisation rules are designed to prevent Japanese corporations and foreign corporations doing business in Japan from using excessive interest payments to foreign-related persons to reduce their Japanese Corporation Tax.

Disallowance of interest expense

Interest paid by a Japanese corporation on debt to controlling foreign stockholders is disallowed to the extent the average balance of debt on which the interest is paid is more than three times the equity of the controlling foreign shareholders in net assets of the interest paying corporation in that year (STML Art 66-5).

The interest disallowance rule also applies to the Japanese Corporation Tax of a foreign corporation doing business in Japan to the extent of the interest paid in connection with that business. In that case, the rule applies if the average balance of debt on which the interest is paid is more than three times the net assets relating to the Japanese business.

Interest which is not allowed as an expense under these rules is added to the amount of the interest paying corporation's residual assets for purposes of determining liquidation income upon dissolution of the corporation (other than dissolution due to merger).

Controlling foreign stockholders

A controlling foreign shareholder is a non-resident of Japan or a foreign corporation which:

- directly or indirectly holds 50% or more of the total outstanding stock (or contributed capital) of the interest paying corporation
- is a foreign corporation that is 50% or more owned by the same person who owns 50% or more of the interest paying corporation, or
- is a foreign corporation that has substantial control over the interest paying corporation due to interlocking directorates, or business, financial or technological dependence (see ¶9-520).

If both the thin capitalisation and earnings stripping rules (¶9-750) apply, except in cases where the earnings stripping rules are inapplicable because the net interest paid to related persons in the tax year does not exceed either ¥10m or 50% of total interest paid, whichever rule results in the largest disallowance will prevail (STML Art 66-5(4), Art 66-5-2(7)).

Revisions to thin capitalisation rules

By virtue of the 2006 tax reform, *gensaki* (repurchase or "repo") transaction debt can be excluded from treatment as debt to controlling foreign shareholders but, in such a case, the ratio of debt to equity of the foreign controlling shareholders triggering the disallowance of interest is reduced from 3:1 to 2:1. In addition, the definition of interest subject to the thin capitalisation rules has been expanded to include guarantee fees and other payments to secure financing paid to controlling foreign shareholders.

Law: Art 66-5 of the *Special Taxation Measures Law*

EARNINGS STRIPPING RULES (*KADAI SHIHARAI RISHI ZEISEI* — 過大支払利子税制)

[¶9-750] Earnings stripping rules (*Kadai Shiharai Rishi Zeisei* — 過大支払利子税制)

The legislation effective for tax years beginning on or after 1 April 2013 limits the amount of allowable deductions for net interest paid by a corporation on debt to a related person if the net interest paid exceeds 50% of the payor's adjusted taxable income (STML Art 66-5-2, Art 66-5-3, Art 68-89-2, Art 68-89-3).

The new rules are intended to supplement the thin capitalisation and transfer pricing rules in addressing the problem of taxpayers shifting income out of Japan. If the tax haven rules cause a Japanese corporation to currently report income of a foreign related person, the amount of interest disallowed under the earnings stripping rules is reduced by the amount of currently reported income corresponding to that interest.

The earnings stripping rules do not apply if the net interest paid to related persons in the tax year do not exceed either (i) ¥10m, or (ii) 50% of total interest paid (excluding from total interest paid any interest paid to a related person if the interest is subject to the Japanese Corporation Tax). In cases other than those described in the previous sentence, if both the thin capitalisation (¶9-700) and earnings stripping rules apply, whichever rule results in the largest disallowance will prevail (STML Art 66-5(4), Art 66-5-2(7)).

In the case of a member of a consolidated group, the earnings stripping rules are generally applied using amounts for the group as a whole and interest income does not include interest paid among group members.

Adjusted income (*chousei shotoku kingaku* — 調整所得金額). Adjusted taxable income is calculated by beginning with the corporation's taxable income for the year (1) plus the amount of related party interest paid, (2) plus depreciation and amortisation deductions, (3) plus dividends received that have not been included in income, and (4) plus special deductions such as the allowance for bad debts and minus special income items.

Related person. A related person is (a) any person related to the corporation where the direct or indirect ownership percentage is 50% or more, (b) a person in substance controlling (*jijitsu shihai* — 事実支配) or controlled by the corporation, and (c) a third person who has received a credit guarantee from a person described in (a) or (b).

Net interest paid (*jun shiharai rishi* — 純支払利子) **to a related person**. Interest paid to a related person includes both interest, payments amounting to interest, such as the interest component of lease payments, and loan guarantee fees, but not amounts treated as interest in repo (*gensaki* — 現先) transactions. Net interest is calculated by deducting from interest paid to a related person the amount of interest income related to interest paid to related persons.

Interest income related to interest paid to related persons. Interest income related to interest paid to a related person is calculated by multiplying the total interest income received by the percentage resulting from dividing the interest payments to related persons by the total interest payments.

$$\text{Interest income related to interest paid to related persons} = \text{Total interest income} \times \frac{\text{Interest paid to related persons}}{\text{Total interest paid}}$$

Interest received from a Japanese related person, including a Japanese corporation or foreign person (a non-resident of Japan or a foreign corporation) with a permanent establishment in Japan, is generally excluded from the amount of total interest income for the purpose of calculating interest income related to interest paid to a related person. However, interest received from a Japanese related person is included in total interest income to the extent the Japanese related person has received interest from an unrelated person or a foreign person without a permanent establishment in Japan. Amounts treated as interest in repo (*gensaki*) transactions are excluded from the calculation of interest paid to related persons, total interest payments and total interest income.

Carryover (*kurikoshi sonkin fusannyu gaku* — 繰越損金不算入額) **of disallowed interest paid to related persons.** Any net interest disallowed as a deduction because the net interest paid exceeds 50% of the payor's adjusted taxable income may be allowed as a deduction in any of the subsequent seven years to the extent the carryover and the current net interest do not exceed 50% of the payor's adjusted taxable income in the carryover year. In the case of a qualified merger or liquidation of a 100% subsidiary, the carryover applies to the successor corporation.

Law: Art 66-5-2, Art 66-5-3, Art 68-89-2 and Art 68-89-3 of the *Special Taxation Measures Law*

FINANCIAL INSTITUTION REPORTING RULES (*KINYU KOZA JOHO* — 金融口座情報)

[¶9-751] Financial institution reporting rules (*Kinyu koza joho* — 金融口座情報)

Beginning in 2018 (for information on accounts during 2017), Japanese financial institutions are required to report information on accounts held by non-residents of Japan to the National Tax Agency (NTA). The information will automatically be exchanged with the competent authorities of countries having exchange of information agreements with Japan (Law for Special Rules to Implement Tax Treaties with the Income, Corporation and Local Tax Laws, Law No 46, 17 June, 1969, Art 10-5 to 10-9 and Art 13). Information to be exchanged includes the account holder's name, address of the non-resident, taxpayer number, the account balance, and amounts of interest or dividends earned in the account.

TAX RETURN OF A FOREIGN CORPORATION

[¶9-800] Tax return of a foreign corporation

A foreign corporation is required to file a Japanese final tax return within two months from the day following the last day in its tax year (CTL Art 74(1), Art 145). If a permanent establishment of a foreign corporation terminates and the foreign corporation does not appoint a tax agent, or where a foreign corporation ceases the business of performing personal services in Japan, the final tax return is due at that time if earlier than the regular due date of the return (CTL Art 145).

Place of payment of taxes

The place of payment of taxes for a foreign corporation is usually the tax office with jurisdiction over the place of the foreign corporation's permanent establishment in Japan. If the foreign corporation does not have a residence in Japan, the tax office with jurisdiction over the applicable place falling first in the following list is where the taxes should be paid (CTL Art 17; CTL-EO Art 16):

(1) the location of a permanent establishment in Japan (the main permanent establishment if more than one)

(2) the location of real property from which income is derived in Japan, or

(3) the Kojimachi Tax Office in Tokyo.

Law: Art 17, Art 74(1) and Art 145 of the *Corporation Tax Law*; Art 16 of the Corporation Tax Law Enforcement Order