

CHAPTER 1

STRUCTURE OF THE JAPANESE TAX SYSTEM

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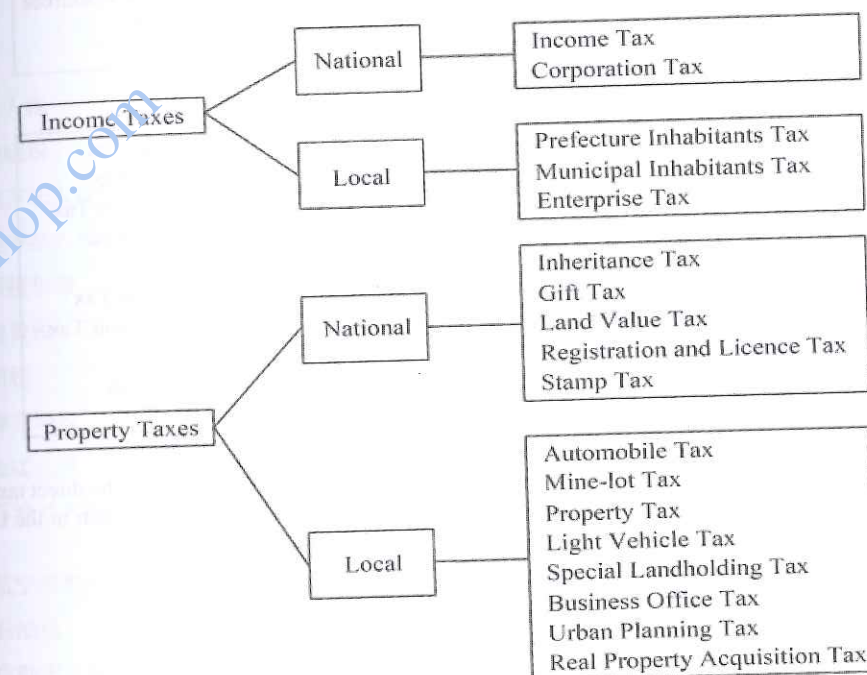
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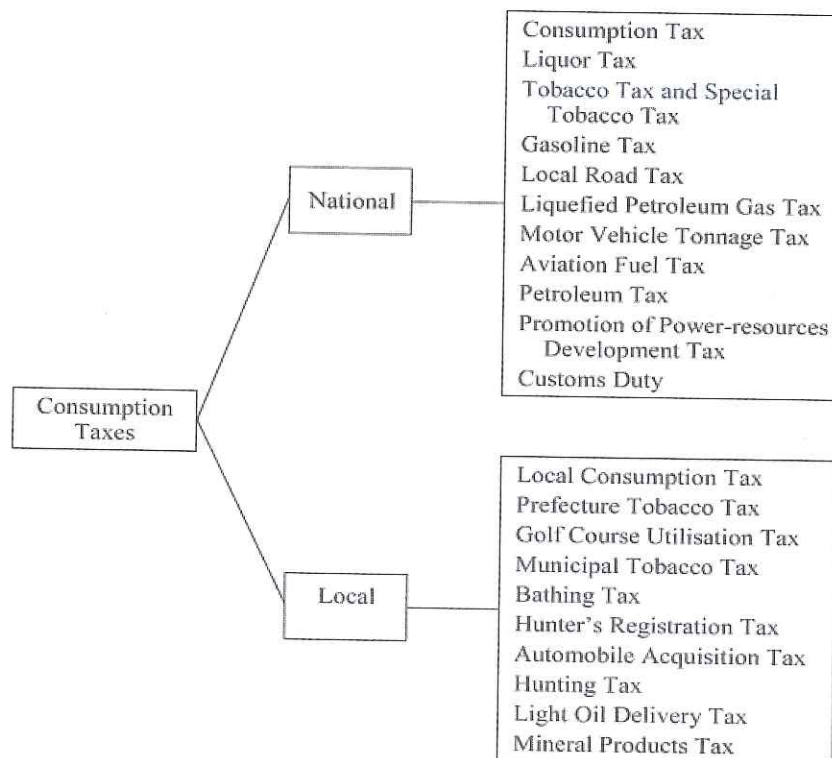
OVERVIEW OF THE JAPANESE TAX SYSTEM

¶1-100 Overview of the Japanese tax system

The modern Japanese tax system dates from 1950 when the Japanese Diet enacted a series of tax reform ideas advanced by Dr Carl Shoup. The Shoup plan was noteworthy for its comprehensiveness. It replaced a system based on indirect taxes with one which is now centered around direct corporate and individual income taxes, supplemented by indirect taxes on consumption, customs, property and environmental levies.

Diagram 1: Major taxes in the Japanese tax system





As the following tables indicate, the percentage of national revenue represented by direct taxes in Japan is about 58%, which is about the same as in the UK but considerably less than in the US where over 90% of federal tax revenues are derived from direct taxes.

Table 1: Japanese direct and indirect taxes (all yen amounts in ¥ billion)

		FY 2016		FY 2017	
		Budget amount	% of total	Budget amount	% of total
直接税	Direct tax	35,024	57.23%	35,477	57.76%
所得税	Income Tax	18,352	29.99%	18,324	29.83%
源泉分	- Withholding Tax	15,059	24.61%	14,874	24.22%
	- Self-assessed Tax	2,916	4.76%	3,074	5.00%
	- Special Restoration Tax	377	0.62%	376	0.61%
法人税	Corporation Tax	12,233	19.99%	12,391	20.17%
相続税	Inheritance Tax	1,921	3.14%	2,115	3.44%
地方法人特別税	Local Corporate Special Tax	1,881	3.07%	2,003	3.26%
地方法人税	Local Corporation Tax	637	1.04%	644	1.05%
間接税等	Indirect tax	26,173	42.77%	25,947	42.24%
消費税	Consumption Tax	17,185	28.08%	17,138	27.90%
酒税	Liquor Tax	1,359	2.22%	1,311	2.13%
揮発油税	Gasoline Tax	2,386	3.90%	2,394	3.90%
たばこ税	Tobacco Tax	923	1.51%	929	1.51%
石油ガス税	Liquefied Petroleum Gas Tax	9	0.01%	8	0.01%
航空機燃料税	Aviation Fuel Tax	52	0.08%	52	0.08%
石油税	Petroleum Tax	688	1.12%	688	1.12%
自動車重量税	Motor Vehicle Tonnage Tax	385	0.63%	370	0.60%
関税	Custom duty	1,106	1.81%	953	1.55%
とん税	Tonnage Tax	10	0.02%	10	0.02%
印紙収入	Stamp duty revenue	1,052	1.72%	1,092	1.78%
地方揮発油税	Local Gasoline Tax	255	0.42%	256	0.42%
石油ガス税(譲与分)(特)	Liquefied Petroleum Gas Tax (SA)	9	0.01%	8	0.01%
航空機燃料税(譲与分)(特)	Aviation Fuel Tax (SA)	15	0.02%	15	0.02%

		FY 2016		FY 2017	
		Budget amount	% of total	Budget amount	% of total
自動車重量税 (譲与分) (特)	Motor Vehicle Tonnage Tax (SA)	264	0.43%	254	0.41%
特別とん税 (特)	Special Tonnage Tax (SA)	12	0.03%	12	0.02%
電源開発促進税 (特)	Promotion of Power-resources Development Tax (SA)	320	0.52%	313	0.51%
たばこ特別税 (特)	Special tobacco surtax	143	0.24%	144	0.23%
総計	Total	61,197	100.00%	61,424	100.00%

SA: Special account revenue not included in the general revenue.

(Derived from MOF figures)

Table 2: Comparison of composition of national revenue among G6 countries (direct tax, indirect tax)

Fiscal Year	Japan		US		UK	
	Direct	Indirect	Direct	Indirect	Direct	Indirect
1991	73.3	26.7	90.8	9.2	56.9	43.1
1992	70.7	29.3	90.3	9.7	55.9	44.1
1993	69.4	30.6	90.5	9.5	54.1	45.9
1994	66.6	33.4	90.3	9.7	54.0	46.0
1995	66.1	33.9	90.8	9.2	54.9	45.1
1996	65.3	34.7	92.1	7.9	54.7	45.3
1997	63.4	36.6	92.6	7.4	56.8	43.2
1998	59.3	40.7	93.2	6.8	57.4	42.6
1999	57.2	42.8	92.5	7.5	57.3	42.7
2000	61.3	38.7	93.3	6.7	58.2	41.8
2001	59.5	40.5	93.2	6.8	58.3	41.7
2002	56.3	43.7	92.3	7.7	57.2	42.8
2003	56.1	43.9	91.6	8.4	56.2	43.8

Fiscal Year	Japan		US		UK	
	Direct	Indirect	Direct	Indirect	Direct	Indirect
2004	58.2	41.8	91.8	8.2	57.1	42.9
2005	60.3	39.7	92.7	7.3	59.1	40.9
2006	61.9	38.1	93.5	6.5	60.0	40.0
2007	61.4	38.6	94.5	5.5	59.6	40.4
2008	57.7	42.3	94.0	6.0	61.2	38.8
2009	52.9	47.1	92.7	7.3	59.7	40.3
2010	56.3	43.7	92.3	7.7	58.5	41.5
2011	57.2	42.8	92.6	7.4	56.3	43.7
2012	58.7	41.3	92.7	7.3	56.1	43.9
2013	60.8	39.2	93.3	6.7	54.1	45.9
2014	56.8	43.2	N/A	N/A	54.6	45.4
2015	56.8	43.2	N/A	N/A	N/A	N/A
2016	57.2	42.8	N/A	N/A	N/A	N/A
2017	57.8	42.2	N/A	N/A	N/A	N/A

Fiscal Year	Germany		France		Italy	
	Direct	Indirect	Direct	Indirect	Direct	Indirect
1991	49.6	50.4	40.6	59.4	55.6	44.4
1992	49.8	50.2	39.7	60.3	58.5	41.5
1993	47.6	52.4	40.2	59.8	59.4	40.6
1994	45.8	54.2	39.3	60.7	54.2	45.8
1995	47.9	52.1	39.6	60.4	54.8	45.2
1996	46.0	54.0	39.2	60.8	55.4	44.6
1997	45.8	54.2	39.6	60.4	56.7	43.3
1998	45.4	54.6	39.6	60.4	52.4	47.6
1999	46.9	53.1	41.5	58.5	53.6	46.4
2000	47.4	52.6	43.3	56.7	52.1	47.9
2001	43.9	56.1	44.7	55.3	54.4	45.6

Fiscal Year	Germany		France		Italy	
	Direct	Indirect	Direct	Indirect	Direct	Indirect
2002	42.3	57.7	43.1	56.9	52.9	47.1
2003	41.7	58.3	42.8	57.2	51.5	48.5
2004	41.2	58.8	41.2	58.8	50.6	49.4
2005	41.4	58.6	53.0	47.0	50.7	49.3
2006	43.4	56.6	41.9	58.1	52.2	47.8
2007	43.7	56.3	42.0	58.0	53.6	46.4
2008	44.9	55.1	42.4	57.6	55.1	44.9
2009	41.6	58.4	40.6	59.4	55.0	45.0
2010	41.3	58.7	43.0	57.0	53.4	46.6
2011	42.4	57.6	41.1	58.9	52.5	47.5
2012	43.9	56.1	42.6	57.4	53.6	46.4
2013	45.0	55.0	43.9	56.1	N/A	N/A
2014	45.6	54.4	43.3	56.7	N/A	N/A

Source: Japan Ministry of Finance

As the table indicates, Japan underwent a significant shift from reliance on direct taxes to indirect taxes from 1991 to 2017. For the period for which comparable data is available for most of the G6 countries — 1991 through 2014 — in Japan, the contribution of indirect taxes to national revenue rose from 26.7% to 43.2%, an increase of 16.5 percentage points. During the same time, the percentage contribution of indirect taxes increased by 4.0% in Germany, 2.3% in the UK and 2.0% in Italy (through 2012), while decreasing by 2.5% in the US (2013) and 2.7% in France.

¶1-110 Japanese Government finance

Japanese national revenues have been increasing at an average rate of 1.89% a year from 1991 to 2014, while tax revenues have been shrinking at a rate of 0.47% a year.

Table 3: Ratio of tax revenues to total Japanese national account revenues (¥100m)

Year	General account revenue	Revenue from taxes and stamps	% of revenue from taxes and stamps
1991	729,906	598,204	82
1992	714,660	544,453	76
1993	777,312	541,262	70

Year	General account revenue	Revenue from taxes and stamps	% of revenue from taxes and stamps
1994	763,390	510,300	67
1995	805,572	519,308	65
1996	818,090	520,601	64
1997	801,704	539,415	67
1998	897,827	494,319	55
1999	943,763	472,345	50
2000	933,610	507,125	54
2001	869,030	479,481	55
2002	872,890	438,332	50
2003	856,228	432,824	51
2004	888,975	455,890	51
2005	890,003	490,654	55
2006	844,127	490,691	58
2007	845,535	510,182	60
2008	892,082	442,673	50
2009	1,071,142	387,331	36
2010	1,005,346	414,868	41
2011	1,099,795	428,326	39
2012	1,077,620	439,314	41
2013	1,060,447	469,529	44
2014	1,046,791	539,707	52

Source: Japan Ministry of Finance

The gap between general revenues and tax revenues has been financed primarily by issuing deficit bonds. In 1990, newly-issued Japan Government Bonds totaled ¥7.312 trillion, about 10% of general revenues. These were primarily construction bonds, used to finance public works projects. In 2017, ¥34.4 trillion worth of bonds were included in the national budget, constituting 35.3% of total expenditures, compared to ¥25.35 trillion and 37.6% in 2009. This represents a substantial decrease in bond dependence from 2014 (¥41.25 trillion of bonds making up 43.02% of total expenditures). For 2017, only ¥6.1 trillion was earmarked for public works, the balance to be used to cover operating and pension related deficits. No country in the G6 other than Japan derived less than 85% of its national revenues from taxes during the 2014 fiscal year.

Table 4: Comparison of composition of national revenue derived from taxes among G6 countries (% for fiscal year 2014)

Country	% of national expenditures funded by taxes	% of national revenues from taxes
France	78.2	95.5
Germany	92.2	92.3
Italy	75.4	87.7
United Kingdom	75.5	91.7
United States	49.9	94.4
Japan	54.6	51.6

Source: Japan Ministry of Finance

The tax burden in Japan, computed as the ratio of tax revenues to national income, has not changed significantly from 26.6% in 1991 to 26.1% in 2016. As of 2013, at 22.7%, it was the lowest of the G6 countries, except for the United States where the burden had dropped from 26.4% in 2007 to 24.2% in 2013.

Table 5A: Percentage of tax burden to national income

Country	National and local taxes	Taxes and social security contributions
France (2013)	40.7	67.6
Germany (2013)	30.4	52.6
Sweden (2013)	49.9	55.7
United Kingdom (2013)	35.9	46.5
United States (2013)	24.2	32.5
Japan (1995)	24.0	36.7
Japan (2000)	23.7	37.3
Japan (2005)	23.3	37.6
Japan (2008)	24.1	40.3
Japan (2010)	22.3	38.8
Japan (2011)	22.9	40.1
Japan (2012)	22.7	39.9
Japan (2013)	22.7	40.0
Japan (2014)	24.1	41.6
Japan (2016)	26.1	43.9

Table 5B: Japan's Government tax burden rate and debt burden compared to GDP

Year	Government burden rate (tax and social security burden plus deficits)	Surplus (deficit) rate	Government debt as % of GDP
1995	46.0	-9.3	86.2
2000	47.2	-9.9	135.4
2005	43.3	-5.7	175.3
2007	42.6	-3.3	167
2010	50.4	-11.5	200
2011	54.8	-14.7	211.7
2012	51.2	-11.4	219.1
2013	53.2	-13.3	227.2
2014	51.9	-10.3	231.9
2016	50.6	-6.7	233.8

Source: Japan Ministry of Finance

The ratio of government debt to GDP in Japan is considerably higher than that of any other G7 nation.

Table 5C: Government debt as % of GDP for G7 nations

Year	Japan	USA	UK	Germany	France	Italy	Canada
2000	137.5	54.5	45.2	60.8	65.7	120.8	82.4
2011	205.5	102.7	97.9	87.2	100.1	119.7	83.8
2012	214.1	108.6	104.2	88.5	105.5	122.7	84.5
2013	224.3	113.0	110.4	86.2	108.2	129.6	85.5
2014	231.9	106.3	110.0	83.4	115.8	146.7	97.1
2015	233.8	110.1	97.6	75.8	117.4	149.2	94.3
2016	232.4	111.4	115.5	75.0	121.3	159.9	94.8

Source: Japan Ministry of Finance

The tax burden of income tax is low in Japan in comparison with the income tax burden in other advanced countries. The individual income tax burden in Japan at 7.1% was the lowest of the G6 countries in 2010. The tax burden borne by corporations in Japan for 2010, at 4.4% of national income, was higher than that of all other G6 countries except Sweden, and has increased to 4.6% in 2013.

Table 6: Percentages of income and corporation tax burdens to national income (GNP)

Country	% Income tax burden	% Corporation tax burden
France (FY 2013)	12.0	3.7
Germany (FY 2013)	12.8	2.4
Sweden (FY 2013)	18.5	4.0
United Kingdom (FY 2013)	12.3	3.4
United States (FY 2013)	12.4	2.7
Japan (FY 2010)	7.1	4.4
Japan (FY 2013)	7.3	4.6
Japan (FY 2014)	7.4	5.0
Japan (FY 2015)	7.7	5.4
Japan (FY 2016)	8.1	5.7

Source: Japan Ministry of Finance

The Japanese consumption tax was initially enacted in 1989 at a rate of 3%. The rate was raised to 5% (4% national tax and 1% local tax) in 1997. The rate was again raised to 8% in April 2014 and was scheduled to increase to a maximum rate of 10% with a new multiple tax rate structure as of 1 April 2017. However, on 18 November 2016, the Japanese Diet passed legislation effective 28 November 2016 that delays implementation of the 10% rate until 1 October 2019 (Law No 85, 28 November 2016).

Through 2015 the Japanese consumption tax was comparable to the US sales taxes as a percentage of national income, although the rate was lower in Japan. However, in the future, the burden of Japanese consumption tax is expected to more closely resemble the European value added taxes.

Table 7: International comparison of taxes on consumption

Country	Tax rate (%) (2016)	Consumption tax as a percentage of GNP (2013)
France (VAT)	20	11.0
Germany (VAT)	19	10.4
UK (VAT)	20	10.9
US (state, local and city retail sales taxes)	8.875 (New York City)	4.4
Japan (consumption tax)	8	5.3

Source: Japan Ministry of Finance

¶11-120 The outlook for future Japanese tax reforms

Most major Japanese tax legislation are derived from reports of the Tax Commission (*Zeisei Chosa Kai* — 税制調査会), an advisory body to the Japanese Cabinet that until 2009 was made up of prominent economists and tax experts. From October 2009 through December 2012, the make-up of the Tax Commission was drastically changed under the Democratic Party of Japan-led government of Prime Minister Yukio Hatoyama. Members of the Tax Commission during that time consisted of Ministers of State, including the Minister of Finance, who chaired the Commission, the Minister of Internal Affairs and Communications, the Minister of National Strategy, and Senior Vice-Ministers, including the Senior Vice Finance Minister, who was the Chief Investigator for the Commission's Planning Committee, and the Senior Vice-Ministers of Internal Affairs and Communications, the Cabinet Office, Justice, Foreign Affairs, Education, Culture, Sports, Science and Technology, Health, Labor and Welfare, Agriculture, Forestry and Fisheries, Economy, Trade and Industry, Land, Infrastructure, Transport and Tourism, Environment, and Defense, as well as the Chairman of the National Commission on 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.

¶11-121 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 globalization. The main conclusions of the Tax Commission regarding the outlook for Japanese tax reforms are summarized below.

General tax reform principles

- Raising taxes in the short-run is not feasible in the current unfavorable 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 ¶13-280) 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 equalize 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 ¶3-238 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 favorable 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 recognizable 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 organizations 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 organizations.
- 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 globalization. While the consumption tax is criticized 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 equalize 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 computerization and globalization 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 globalization, 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 (summarized 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 decentralize (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 minimization 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 12 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 revitalizing and promoting structural reforms in the economy. The increasing importance of public interest corporations and non-profit organizations 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 organizations 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 kiloliter. 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 kiloliter. 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.
- **Other issues.** A comprehensive examination of the system of taxation for private pensions (including the corporation tax on retirement pension funds) needs to be performed, including the tax treatment of contributions, management and benefits. Countermeasures are needed to address the emerging problem of tax avoidance schemes using partnerships (*kumiai*).

Source: *The Tax Commission: 2005 Tax Reform Report (November 2004)*

¶1-124 The Tax Commission's 2006 Tax Reform Report

The Tax Commission's main conclusions regarding the outlook for Japanese tax reforms in 2006 were presented in a report issued in November 2005 and are summarized below.

General principles

- With the worst fiscal situation among the developed nations, Japan is undergoing structural changes, including a low birth rate, an ageing population and globalization.
- The Japanese Government is working on broad-based structural reforms to sustain a fair society in the future and to realize continued activity in the economic society.
- For example, in recent years the Government has promoted a programme for disposition of delinquent loans and has initiated bold regulatory reforms while developing plans focusing on strengthening the basics of the economy and civilian needs.
- Within the tax system, plans for the materialization of a "desirable tax system" (*arubeki zeisei*) are progressing.

- In addition to the Trinity Reform Package (*Sanmitai no Kaikaku*), it will be necessary to take a closer look at the benefits, burdens and revenues and expenditures in the social security system in order to make drastic reforms.
- While public service expenditure associated with an ageing population is increasing dramatically, the tax burden on our citizens is lower than in other developed countries.
- It is necessary to undertake a comprehensive examination of tax bases and tax burdens associated with the Income Tax, Consumption Tax and taxes on property.

Individual income taxation

- The Trinity Tax Reforms should be advanced in the 2006 tax reforms by amending the *Income Tax Law* and *Local Tax Law* to make permanent shifts in the source of taxation from the Income Tax to the Individual Inhabitants Tax.
- The fixed rate reduction (*teiritsu genzei*) in Income Tax was introduced as an emergency economic measure that is not suited to current conditions.
- The per capita local inhabitants tax amounts are very low compared to the expansion in the amounts of per capita national income, and the per capita local inhabitants tax amounts should be increased.

Corporation Tax

- In light of structural changes making the economic system more flexible and changes in the corporate laws regarding consolidations and corporate restructurings, adjustments to the corporation taxation system are needed.
- Moreover, the forms of economic entities are becoming more diverse and rules are needed to guarantee neutrality in the selection of a form of entity.
- The unfairness in relative tax burdens between businesses operating as proprietorships and those operating as corporations should be rectified.
- The current Corporation Tax rate is similar to other developed countries and should be maintained.
- Further consideration is required regarding the taxation of not-for-profit entities.

International taxation

- Negotiations to revise the existing tax treaties with the UK and India should be concluded at the earliest possible date.
- It is necessary to expand the information collection procedures for the exchange of information needed to prevent tax evasion under income tax treaties.
- In order to rationalize the tax system, it is necessary to reconsider the non-permanent resident system of taxation for resident aliens who stay in Japan for short terms in order to limit the scope of Japanese tax.
- Consideration must be given to dealing with cases of international tax avoidance taking advantage of the differences between tax treaty provisions and the civil law.

Special taxation measures

- The special provisions for research and development and for IT investment, introduced in 2003, are set to expire this year. The main points of these provisions should be temporarily continued.
- Special tax mitigation provisions for the Registration and Licence Tax relating to real property set to expire this year need not be extended.

- The public announcement system (*koshi seido*), whereby income tax information has been made public has the intended effect of using third-party scrutiny to provide a check on the tax system. However, instances of criminal activity and harassment connected with the public announcement system lead to the conclusion that it should be abolished.
- It is necessary to review the penalty tax system (*kasan zeisei*) in order to take steps to deal with non-reporting of income connected with internet commerce.

¶1-125 The Tax Commission's 2007 Tax Reform Report

The Tax Commission's main conclusions regarding the outlook for Japanese tax reforms in 2007 were presented in a report issued in December 2006 and are summarized below.

General principles

- Financial reconstruction cannot take place without growth of the overall economy.
- The priority should be to minimize burdens on the people and to minimize expenditure.
- Comprehensive tax reform over the mid-term should take place through an examination of the role of each item of taxation in the context of Japan's 21st century social-economic system.
- Social security systems and measures should be established to deal with declining birth rates that do not leave the burdens to future generations.
- Economic growth, stimulated by a shift of cash flows from the Government to the people, will provide the impetus for a sound system of public finance.
- Examination of a tax system that promotes economic activity includes the consideration of sound government finances, international competitiveness, fairness, simplicity, openness and promotion of innovation.
- Reduction of the effective tax rate for corporations is an issue requiring examination. The resulting increased value added in the business sector may also spread to the household sector. The comparability of corporation tax rates and social insurance premiums internationally and the impact of a rate reduction on employment also need examination.
- The impact of tax policy on innovation, the future of the research and development tax system, and the way the latter influences various means for financing the growth of enterprises need to be considered.
- The tax treaty network should be expanded to promote economic exchange to reduce the tax burden on investments and technology transfers.
- Future tax deliberations should make the best use of accumulated knowledge in the field and take into consideration, the relationship between the economy, public finance, industry and households, including social security issues.

Proposed tax reforms

- *Depreciation.* Depreciation is currently limited to 95% of the acquisition cost of assets and is generally calculated annually using a statutory residual value of 10% of the acquisition cost. To encourage investment and innovation, and to be more in line with international norms, these limits should be eliminated. Useful lives and asset classes should be re-examined and simplified. In particular, the specified useful lives of assets should be shortened to reflect the speed of innovation.

- *Family corporation tax on retained earnings.* The tax basis for the tax on accumulated earnings of family corporations was reduced by legislation in 2006. Further consideration of this tax is needed in order to promote capital accumulation by medium- and small-sized companies, support innovation and strengthen competitiveness.
- *Angel taxation system.* Promotion of the supply of investment funds to venture businesses is necessary for the future of Japanese industry. Consideration needs to be given to ways to facilitate the angel taxation system and broaden the range of eligible venture businesses.
- *Estate taxation for business succession.* Special estate tax provisions applicable to the succession of medium- and small-sized businesses need to be considered from the point of view of preserving economic vitality, fairness and impartiality. Appropriate consideration needs to be given to the estate tax valuation of new types of shares, including non-voting shares, authorized by the new *Company Law*.
- *International taxation.* Efforts should be made to expand and continue the role of the tax treaty network that serves as the infrastructure for the promotion of foreign economic exchanges. In the international transfer pricing area, means to clarify procedures should be continued, the mutual agreement process should be strengthened and the procedures for obtaining an advanced pricing agreement under the pre-confirmation system should be sped up. Procedures should be considered to reduce the burden of double taxation while mutual agreement procedures are pending.
- *Factor-based enterprise tax.* The factor-based enterprise tax system was introduced in 2003. Companies with at least ¥100m of capital use a tax basis made up of factors including income, value added and capital in lieu of the traditional income-only basis. Some companies have been decreasing their capital in order to avoid using the three factor tax basis. In ensuring fairness, considering the benefit principle of taxation, the criteria for companies being subject to the factor tax needs to be reviewed.
- *Triangular mergers.* The new *Company Law* provides new rules for triangular mergers (*sankaku gappei*) beginning May 2007. Appropriate adjustments to the tax system are needed to deal with such mergers based on principles that do not discriminate between domestic and cross-border reorganizations. Attention must also be given to tax haven issues raised by the new rules for triangular mergers.
- *Proposed changes to the trust laws.* A new law governing trusts is currently being deliberated on by the Diet. It is anticipated that the new trust law will provide for a wider range of types and uses for trusts. However, there are concerns that this may lead to use of trusts for tax avoidance. Various measures need to be considered, including taxation at the trust level, when necessary, to ensure tax neutrality and fairness.
- *Proposed changes in accounting rules for leases.* Changes in accounting rules to better reflect the economic realities of leases are currently being proposed. Corresponding changes in the tax rules should be considered in order to reduce the burden on taxpayers and reflect the economics of leases for tax purposes.
- *Reduced tax rates on dividends and capital gains.* Reduced rates of tax on dividends and capital gains from stocks of listed companies were introduced in 2003 to deal with widespread problems stemming from a sluggish stock market and poorly performing loans. These conditions have improved and these favorable treatments of dividends and capital gains should not be continued.

¶3-520 Local Enterprise Tax (*Kojin Jigyozei* — 個人事業税)

The Local Enterprise Tax for individuals applies only to individuals who carry on the following types of businesses (LTL Art 72):

Table 37: Types of business subject to Local Enterprise Tax

Business type	Tax rate
Type 1 Sales of goods, Real estate leasing, Manufacturing, restaurants	5%
Type 2 Livestock, fisheries and charcoal manufacture (excluding businesses where family members provide most of the labor)	4%
Type 3 Professions such as medicine or law and beauticians	5%

The tax rate indicated is the standard rate and may differ by locality. Under Type 3, a reduced rate of 3% applies to masseurs, midwives, farriers, etc.

Calculation of the Enterprise Tax

The tax base for the Enterprise Tax is similar to the taxable income determined for business and leasing income for the Income Tax. The main difference is the allowance of a proprietor's deduction (*jigyonushi kojo*) of ¥2.9m.

Law: Art 72 of the *Local Tax Law*

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Local Corporation Special Surtax (<i>Chiho Hojin Tokubestu Zei</i> — 地方法人特別税) and Local Corporation Special Transfer Tax (<i>Chiho Hojin Tokubestu Juyo Zei</i> — 地方法人特別譲与税).....	¶4-940
Local Corporation Tax (<i>Chiho Hojin Zei</i> — 地方法人税)	¶4-941

INTRODUCTION

¶4-100 Introduction

The Japanese corporation tax is a direct tax on the income of entities classified as corporations under the *Corporation Tax Law* (CTL) (see ¶2-310). The following table summarizes the Japanese tax scheme applicable to corporations.

Table 1: Taxation of Japanese domestic corporations

Type	Annual income	Income during liquidation	Liquidation income
Ordinary corporation (<i>futsu hojin</i> — 普通法人)	All income are taxed at regular rates (CTL Art 5, Art 66). A surtax known as the Special Reconstruction Corporation Tax equal to 10% of the standard corporation tax, applies for tax years beginning during the period from 1 April 2012 through 31 March 2014 (<i>Restoration Funding Act</i> , Law No 117, 2 December 2011, Art 48)	Effective for corporate dissolutions occurring on or after 1 October 2010, the tax on liquidation income is repealed. A corporation or co-operative is taxable during the period of liquidation under the regular corporation tax rules (CTL Art 5)	
		Prior to 1 October 2010, income during liquidation was not taxed (former CTL Art 6)	Prior to 1 October 2010, taxed at special rates (former CTL Art 5, Art 99(1))
Public interest corporation (<i>koeki hojin</i> — 公益法人)	Taxed at reduced rates on income from profit-making businesses (CTL Art 4(1), Art 7, Art 66(3))		
Public corporation (<i>kokyo hojin</i> — 公共法人)	Not taxed (CTL Art 4(2))		
Co-operative (<i>kyodo kumiai</i> — 共同組合)	Taxed at reduced rates (CTL Art 5, Art 66(3))		
Non-juridical organization (<i>jinkaku no nai shadan</i> — 人格のない社団)	Taxed at regular rates on income from profit-making businesses (CTL Art 4(1), Art 7, Art 66(1), Art 66(2))		

Type	Annual income	Income during liquidation	Liquidation income
NPO	Taxed at reduced rates on income from profit-making businesses (CTL Art 7, Art 9(3))		Not taxed
Mutual benefit non-profit corporations	Taxed at regular rates on income from profit-making businesses (CTL Art 5, Art 66; <i>Tax Reduction Law</i> Art 16(1))	Not taxed (CTL Art 6)	Taxed at regular rates (CTL Art 5, Art 99(1))

Table 2: Japanese corporation taxation of foreign corporations (see ¶9-100)

Ordinary corporation (<i>futsu hojin</i> — 普通法人)	Taxed at regular rates on specified income from sources within Japan (CTL Art 4(3), Art 9(1), Art 141, Art 143(1))
Public interest corporation (<i>koeki hojin</i> — 公共法人)	Taxed at reduced rates on Japanese source income from profit-making businesses (CTL Art 4(3), Art 9(2), Art 143)
Non-juridical organization (<i>jinkaku no nai shadan</i> — 人格のない社団)	Taxed at regular rates on Japanese source income from profit-making businesses (CTL Art 4(3), Art 9(2), Art 143)

Law: Art 4(1), Art 4(2), Art 4(3), Art 5, former Art 5, Art 6, former Art 6, Art 7, Art 9, Art 9(1), Art 9(2), Art 9(3), Art 10, Art 66, Art 66(1), Art 66(2), Art 66(3), Art 99(1), former Art 99(1), Art 99(2), Art 141, Art 143, Art 143(1) and Art 143(3) of the *Corporation Tax Law*; Art 16(1) of the *Tax Reduction Law*; Art 48 of the *Restoration Funding Act*

¶4-101 Medium- and small-sized companies (*Chushokigyo* — 中小企業)

Medium- and small-sized enterprises are eligible for numerous benefits under the *Corporation Tax Law*, including:

- Reduced tax rates (CTL Art 66(2)) (¶4-610)
- Carry back and carry-over of losses (STML Art 66-13) (¶4-460)
- Reserve for bad debts (STML Art 57-10) (¶4-471).

A medium- or small-sized company is generally a company with capital stock (*shihonkin*) or invested capital (*shushikin*) of not more than ¥100m. However, for purposes of reduced tax rates, a company may not be treated as a medium- or small-sized company if it is owned 100% by a large-sized company with capital stock or invested capital of ¥500m or more (CTL Art 66(6)(ii)). Under the 2011 legislation, a company may not be treated as a medium- or small-sized company for purposes of the reduced tax rates applicable to medium- or small-sized companies and for purposes of exemption from the tax on excess retained earnings of family corporations (see ¶4-611) if it is owned 100% by more than one large-sized company within a 100% corporate group (see ¶4-650) (CTL Art 66(6)(iii)).

Law to Revise the Income Tax, etc., 22 June 2011, Art 2). For years on or after 1 April 2019, the special provisions provided to medium- or small-sized companies are not available to companies whose average income for the previous three years exceeds ¥1.5 billion.

Law: Art 66(2), Art 66(6)(ii) and Art 66(6)(iii) of the *Corporation Tax Law*; Art 2 of the *Law to Revise the Income Tax, etc.*; Art 57-10 and Art 66-13 of the *Special Taxation Measures Law*

¶4-110 Place of payment of taxes (*Nozeichi* — 納税地)

The place of payment of taxes for a domestic Japanese corporation is usually the place where its head office or principal office is located (CTL Art 16). The tax office with jurisdiction over the place of tax payment is where the corporation will not only pay tax, but also file various notifications and requests for approval regarding tax matters. The corporation must notify the tax office with jurisdiction within two months of incorporating and before moving from the jurisdiction (CTL Art 20, Art 148, Art 150). The National Tax Agency (NTA) may specify a different tax payment place if circumstances dictate. For example, if a corporation's headquarters is nominally in one jurisdiction, but the center of its business activity is in a distant branch, the NTA may treat the branch as the actual headquarters where taxes are paid (CTL Art 18).

Law: Art 16, Art 18, Art 20, Art 148 and Art 150 of the *Corporation Tax Law*

¶4-120 Final tax return (*Kakutei Shinkoku* — 確定申告)

The amount of a corporation's tax obligation is reported on a final tax return filed with the tax office with jurisdiction within two months after the end of the corporation's tax year even if there is no tax due, as in the case of a loss for the year (CTL Art 74). In the event that the tax return is not ready by the due date because of a disaster or audit by a Certified Public Accountant (CPA) or similar reason, the corporation may file a request for an extension of time to file the return within 45 days of the end of the tax year in the case of a disaster, etc., or by the last day of the tax year in the case of an audit (CTL Art 75, Art 75-2). Where a company has engaged an independent auditor and the time of the company's annual meeting is specified in the articles of incorporation as not occurring within three months of the company's year end, beginning 1 April 2017 an extension of time to file the final tax return of up to four months from the original due date (six months from the company's year end, three months before the 2017 revision) may be granted by the tax office.

The following information is reported on the corporation tax return on various schedules numbered from 1(1) through 16-4 (CTL Art 74, Art 151; CTL-ER Art 34):

- corporation name
- place of payment of tax
- representative's name
- tax year
- amount of income or loss
- amount of Corporation Tax
- amount of Income Tax refund
- interim tax payment deduction amount
- interim tax payment refund amount
- other reference matters.

Attachments

The following items must be attached to the final tax return (CTL Art 74(2); CTL-ER Art 35):

- balance sheet
- profit and loss statement
- schedule of disposal of profit or loss
- detailed schedules supporting the balance sheet and profit and loss statement
- detailed schedule of changes in capital surplus.

Law: Art 74, Art 74(2); Art 75, Art 75-2 and Art 151 of the *Corporation Tax Law*; Art 34 and Art 35 of the *Corporation Tax Law Enforcement Regulations*

¶4-130 Interim tax return (*Chukan Shinkoku* — 中間申告)

Interim tax returns are used to pay Corporation Tax during the tax year. A corporation should file an interim tax return within two months from the end of the sixth month of the tax year (CTL Art 71). The interim tax payment is usually based on the tax for the prior year pro-rated by months, but an estimate of taxes may also be based on an interim closing of the books for the first six months of the year. If the tax for the prior year on a six month basis was ¥100,000 or less, no interim tax return is required.

Law: Art 71 of the *Corporation Tax Law*

¶4-140 Blue tax return (*Aoiro Shinkoku* — 青色申告)

The “blue tax return” system (named for the color of the tax form) was initiated following a recommendation by the Shoup Mission in 1950 in order to promote the use of modern accounting methods by taxpayers. Substantial privileges are accorded to individuals and corporations who meet the accounting requirements and who receive permission to file interim and final blue tax returns.

To receive permission to file a blue tax return, a corporation must:

- record transactions in books and maintain and preserve those books and records (CTL Art 126), and
- submit an Application for Approval to File a Blue Tax Return (see Form 4 at ¶2-700) with the head of the tax office before the beginning of the tax year for which the blue tax return is to be filed (CTL Art 122). In the case of a newly incorporated company wishing to file a blue tax return for its first tax year, the due date for the application is the earlier of the last day of the first tax year or the day after three months from the date of incorporation.

E-Commerce records

Under the legislation effective for transactions on or after 1 April 2005, permission to file a blue tax return will be revoked if the methods used to retain records of electronic transactions (e-commerce) do not comply with the requirements of Japan’s electronic bookkeeping law relating to national taxes (*Special Rules for Methods of Preservation of Electronic Bookkeeping Records in Connection with National Taxes*, Law No 25, 1998, Art 11 — 電子計算機を使用して作成する国税関係帳簿書類の保存方法等の特例に関する法律).

Privileges accorded to filers of blue tax returns

- Ability to carry over losses for seven years (CTL Art 57).
- Ability to claim tax refunds by carrying back net losses (CTL Art 80). This provision has been suspended for tax years ending between 1 April 1992 and 31 March 2012 (STML Art 66-13). Subsequent legislation extends the suspension to 31 March 2018. However, medium- and small-sized companies with capital not exceeding ¥100m are not subject to the rule of suspension and may carry back losses under the regular rule.
- Prohibition of the tax office from making corrections to the corporation’s tax return not based on an investigation of the books and records (CTL Art 130(1)).
- The tax office is required to provide a written explanation of any corrections made to the tax return (CTL Art 130(2)).
- The tax office may not make a correction to the tax return based on estimates (CTL Art 131).
- Allowance of specially recognized depreciation (STML Art 42-5 to Art 52-3).
- Ability to expense amounts accumulated in various reserve funds (STML Art 55 to Art 57-9, Art 58, Art 61-2).
- Special deduction for expenditures in prospecting for new mineral deposits (STML Art 59).
- Special tax deductions for corporations in Okinawa (STML Art 60).
- Special tax deductions for corporations engaged in experimentation and research (STML Art 42-4).
- Special tax credits for corporations promoting the reform of the energy supply structure (STML Art 42-5(2)).
- Special tax credits for corporations acquiring facilities promoting the reduction of environmental impact of energy usage (STML Art 42-5-2(2)).
- Special tax credits for medium- and small-sized companies that acquire machinery, etc (STML Art 42-6(2)).
- Special tax credits for corporations acquiring machinery for industrial use in specified districts of Okinawa (STML Art 42-9).
- Special tax credits for specified medium- and small-sized companies in Okinawa that acquire management innovating equipment (STML Art 42-10(2)).
- Special tax credits for corporations acquiring equipment for use in special comprehensive strategic global zones (STML Art 42-11(2)).
- Special tax deductions for corporations increasing the number of employees (STML Art 42-12).
- Special taxation of revenues for Japanese vessels operating outside of Japan (STML Art 59-2).
- Special taxation of designated companies in special comprehensive strategic global zones (STML Art 60-2).
- Special taxation of companies carrying out authorized research and development (STML Art 60-3).
- Special taxation of acquisition of agricultural land (STML Art 61-3).

- Special taxation of technological research associations (STML Art 66-10).
- Special provision excluding receipts of dividends from casualty insurance companies (STML Art 67-7).

Law: Art 57, Art 80, Art 122, Art 126, Art 130(1), Art 130(2) and Art 131 of the *Corporation Tax Law*; Art 42-4 to Art 42-12, Art 42-4, Art 42-5 to Art 52-3, Art 55 to Art 57-9, Art 58, Art 58-3, Art 59, Art 59-2, Art 60, Art 60-2, Art 60-3, Art 61-2, Art 61-3, Art 66-10, Art 66-13 and Art 67-7 of the *Special Taxation Measures Law*; Art 11 of the *Special Rules for Methods of Preservation of Electronic Bookkeeping Records in Connection with National Taxes* (Law No 25, 1998)

¶4-150 Payment and refund of tax (Nofu To Kanpu — 納付と還付)

Tax reported on interim and final tax returns is paid by the due date for filing those returns (CTL Art 76, Art 77). Late payments of tax carry a penalty (*entaizei*) at a rate of 14.6% per annum (7.3% for the first two months the payment is overdue) (*General Law of National Tax* Art 60).

Excess tax payments may be either refunded or applied to unpaid national taxes:

- *Refund of Income Tax or foreign taxes.* If the amount of Japanese Income Tax or foreign taxes allowed as deductions from tax exceeds the amount of tax, the balance is refunded (CTL Art 78).
- *Refunds of interim tax payments.* If the final tax return shows an overpayment of tax from interim tax payments, the balance will be refunded to the corporation, including interest on the overpayment from the date of the interim payment (CTL Art 79).
- *Refund from loss carryback.* Net losses from the current year may be carried back for one year to reduce income in that prior year (CTL Art 80). This provision has been suspended for tax years ending between 1 April 1992 and 31 March 2012 (STML Art 66-13). Subsequent legislation extends the suspension to 31 March 2018. However, medium- and small-sized companies with capital not exceeding ¥100m are not subject to the rule suspension and may carry back losses under the regular rule. Prior to 1 February 2009, the loss carryback of medium- and small-sized companies was limited to that arising during their first five years of existence. Any resulting decrease in the tax from that prior year is refunded according to the following formula:

$$\text{Refund} = \frac{\text{Loss carried back}}{\text{Carryback year income before loss carryback}} \times \text{Tax of the carry back year}$$

Example 1: Refund from loss carryback

A medium- or small-sized corporation records a profit in year 1 of ¥5m and pays tax (at a 22% rate) of ¥1.1m. In year 2, the corporation incurs a loss of ¥2m. It is eligible for a refund on the prior taxes paid of ¥440,000.

$$(\text{¥2m}/\text{¥5m}) \times \text{¥1.1m} = \text{¥440,000}$$

Law: Art 76, Art 77, Art 78, Art 79 and Art 80 of the *Corporation Tax Law*; Art 60 of the *General Law of National Tax*; Art 66-13 of the *Special Taxation Measures Law*

¶4-160 Tax year (Jigyo Nendo — 事業年度)

The tax year of a corporation is the year specified in its articles of incorporation or in laws or regulations (CTL Art 13). If the tax year is not so specified, the corporation may elect a tax year by notifying the tax office within two months of the date of incorporation. Once established, the tax year may be changed by notifying the tax office (CTL Art 15). A tax year of less than 12 months is possible, but not a tax year of more than 12 months (CTL Art 13(1)). Most large Japanese corporations have a 12-month tax year ending on 31 March. But, as the following table indicates, the tax years of smaller corporations tend to be distributed more evenly throughout the year.

Table 3: Tax years of corporations for years ending between 1 April 2012 and 31 March 2014

End of tax year	Number of corporations	Capital under ¥100m	%	Capital ¥100m or more	%
April	184,993	184,434	7%	559	2%
May	214,200	213,292	8%	908	3%
June	249,868	248,496	10%	1,372	4%
July	197,922	197,365	8%	557	2%
August	228,176	227,379	9%	797	3%
September	283,268	281,406	11%	1,862	6%
October	117,800	117,312	5%	488	2%
November	86,013	85,501	3%	512	2%
December	258,682	254,129	10%	4,553	15%
January	90,168	89,551	3%	617	2%
February	172,337	171,021	7%	1,316	4%
March	507,523	490,366	19%	17,157	56%
Total	2,590,950	2,560,252	100%	30,698	100%

Source: Japan National Tax Agency

Law: Art 13, Art 13(1) and Art 15 of the *Corporation Tax Law*

TAXABLE INCOME (SHOTOKU NO KINGAKU — 所得の金額)

¶4-200 Taxable income (Shotoku No Kingaku — 所得の金額)

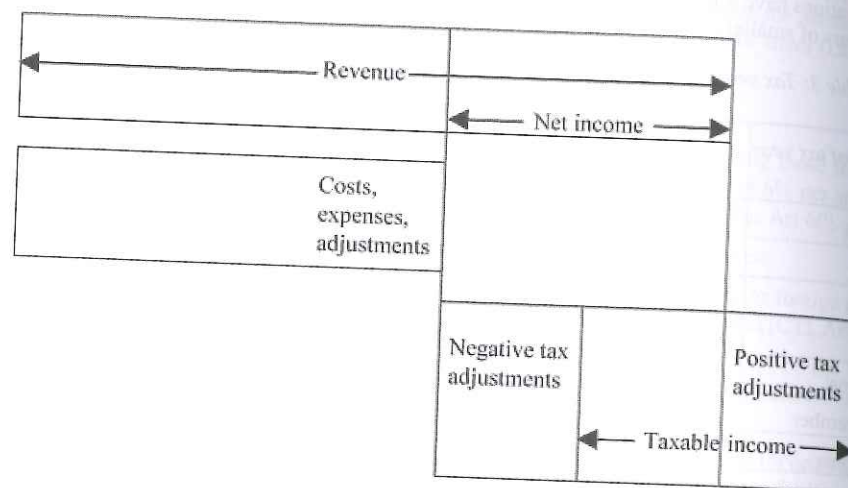
The basis of taxation for the Corporate Tax is the amount of taxable income, computed as the excess of the gross revenues (*ekikin no gaku* — 益金) over the deductible expenses (*sonkin no gaku* — 損金の額) for the taxable year (CTL Art 22(1)). Generally accepted accounting principles are used to determine the amounts of income and loss for tax purposes (CTL Art 22(4)).

Law: Art 22(1) and Art 22(4) of the *Corporation Tax Law*

¶4-210 Tax adjustments (*Zeimu Chosei* — 税務調整)

For tax purposes, both revenues and expenses must be determined based on generally accepted accounting principles (CTL Art 22(4)). But various adjustments to accounting income are required in order to determine taxable income.

Diagram 1: Tax adjustments



Tax adjustments occur in connection with closing of the accounts and from preparation of the tax return. Tax return adjustments may be voluntary or mandatory.

Table 4: Adjustments in closing accounts

<i>Adjustments in closing accounts</i>	<i>Reference</i>
Allowable depreciation expense	CTL Art 31
Allowable depreciation on deferred assets	CTL Art 32
Compensation of officers serving concurrently as employees	CTL Art 35(2)
Exclusion of excess retirement allowance for officers	CTL Art 36
Advanced depreciation on assets with reduced bases	CTL Art 42
Reserves for bad debts and returns	CTL Art 52, Art 53
Reserves for losses, etc	STML Art 52, etc
Accounting for long-term installment sales	CTL Art 63

Table 5: Voluntary tax return adjustments

<i>Voluntary tax return adjustments</i>	<i>Reference</i>
Exclusion of dividends received	CTL Art 23(6)
Income Tax credit	CTL Art 68(3)

Table 6: Mandatory tax return adjustments

<i>Mandatory tax return adjustments</i>	<i>Reference</i>
Exclusion of appraisal gains from gross income	CTL Art 25
Exclusion of refunds from gross income	CTL Art 26
Exclusion of appraisal loss from expense	CTL Art 33(1)
Exclusion of excess compensation of officers from expense	CTL Art 34
Exclusion of officers' bonuses from expense	CTL Art 35
Exclusion of excess retirement allowance for officers from expense	CTL Art 36
Exclusion of excess compensation for employees from expense	CTL Art 36-2
Exclusion of excess retirement allowances for employees from expense	CTL Art 36-3
Exclusion of donations from expense	CTL Art 37
Exclusion of the amount of Corporation Tax from expense	CTL Art 38
Exclusion of the amount of Income Tax credited against Corporation Tax	CTL Art 40
The amount of reserves for bad debts included in gross income of the following period	CTL Art 52(9)
Net loss carry-overs	CTL Art 57
Excess depreciation, excess reserves and allowances, etc, not included in expense	CTL Art 31, etc
Exclusion of entertainment expenses from expenses	STML Art 61-4

Law: Art 22(4), Art 23(6), Art 25, Art 26, Art 31, Art 32, Art 33(1), Art 34, Art 35, Art 35(2), Art 36, Art 36-2, Art 36-3, Art 37, Art 38, Art 40, Art 42, Art 52, Art 52(9), Art 53, Art 57, Art 63 and Art 68(3) of the *Corporation Tax Law*; Art 52 and Art 61-4 of the *Special Taxation Measures Law*

¶4-220 Credit for overpayment of tax due to disguised accounting (*Kaso Keiri Nimotodzuku Kadai Shinkoku No Bai No Kosei Ni Tomonauhojin Zeigaku No Kojo* — 仮装経理に基づく過大申告の場合の更正に伴う法人税額の控除)

The *Corporation Tax Law* generally requires a company to record expenses for financial statement purposes if they are deducted on the tax return (CTL Art 22(4); see ¶4-210). Following a series of accounting scandals involving inflated earnings reports by companies seeking to maximize their share prices or secure bank financing in the mid-1960s, a provision was enacted which

prevented companies that improperly inflated their earnings from obtaining an immediate refund of Corporation Tax when the accounts were adjusted to their proper levels by the tax authorities. Instead, the overpaid tax may be taken as credits against Corporation Tax for the year before the year that the correction is made and against Corporation Tax in the five-year period beginning in the year of the correction (CTL Art 70(1)).

Law: Art 22(4) and Art 70(1) of the *Corporation Tax Law*

GROSS REVENUES (*EKIKIN NO GAKU* — 益金の額)

¶4-300 Gross revenues (*Ekikin No Gaku* — 益金の額)

Gross revenues include income (*shueki*) from the following types of transactions (CTL Art 22(2)):

- (1) sales of property
- (2) transfers of property with or without compensation
- (3) provision of services with or without compensation
- (4) receipt of property without payment, and
- (5) other transactions, other than capital transactions.

Transfers without compensation or for low compensation

When a corporation transfers property to another party without compensation or for low compensation, the transfer is deemed to occur for fair market value; a gain and a contribution are recognized (CTL Art 22(2)).

Diagram 2: Journal entries — transfer without consideration

<i>Transferor</i>			
Property transferred — cost	XXX		
Gift expense	YYY		
		Book value of property transferred	XXX
		Gain on transfer	YYY
<i>Transferee</i>			
Value of property received		YYY	
		Gift income	YYY

Example 2: Transfer without compensation and receipt without payment

A corporation transfers real property to a related corporation without compensation. The property has a basis to the corporation of ¥5m and a market value of ¥50m. The corporation has a gain on the transaction of ¥45m (¥50m property transfer income less ¥5m cost) and a contribution of ¥50m. The related corporation reports income from the receipt of property without payment in the amount of ¥50m and records the property on its books with a value of ¥50m.

Transactions increasing capital surplus

Capital transactions resulting in an increase or decrease in the capital, capital surplus or reserve accounts and distributions of profit or surplus (CTL Art 22(5)) are not included in income. The following amounts increase capital surplus and do not result in taxable income (CTL Art 2(17)):

- amounts in excess of the stated capital amount received on issue of stock
- gains on treasury stock
- fees received by a cooperative for admission of new members
- in the case of a merger, separation or subsidiary-type corporate division, or a qualified contribution-in-kind incorporation, the excess of the assets net of liabilities received over the increase in the capital account
- recognized book value adjustment gain resulting from a qualified subsequent contribution-in-kind incorporation
- in the case of an incorporation of a wholly-owned subsidiary, the excess of the value of the subsidiary stock received over the amount of increase in the capital account
- amounts transferred to capital surplus pursuant to a capital reduction (recapitalization)
- amounts transferred to revaluation reserve funds or capital reserves, and
- value of money or property net of gift or inheritance tax contributed or bequeathed to the establishment of a medical foundation.

Law: Art 2(17), Art 22(2) and Art 22(5) of the *Corporation Tax Law*

¶4-310 Timing of income

Generally, Japanese corporate taxation follows a realization principle which is based on the accrual basis of accounting (CTL Art 22).

Sales of inventory

Income from sales of inventory is generally recognized at the time of transfer, which is typically the date the goods are shipped or handed over to the buyer (CTL Basic Circular 2-1-1). If it is unclear when the goods are transferred, either of the following dates may be used (CTL Basic Circular 2-1-2):

- when most (ie 50% or more) of the sales proceeds are received, or
- the date of application for transfer of title.

Sales discounts and rebates

A discount is treated as a reduction in the sales price and is recognized at the time of sale. A rebate is a payment back to the buyer based on the amount or quantity purchased. If the method of determining the rebate is predetermined and communicated to the buyer beforehand, the rebate is accounted for by the buyer as of the date of the sale. Otherwise, the rebate is accounted for as of the time the buyer is informed of the rebate or, if the buyer is not informed, as of the date of payment (CTL Basic Circular 2-4-1).

Consignment sales

Income from consignment sales is recognized in the tax year when the consignee sells the item (CTL Basic Circular 2-1-3). However, if statement of consignment sales is prepared, the income may be recognized in the tax year the statement is received.

Income from contracts

Income from contracts where something is to be transferred to the other party is recognized at the time of transfer. If the contract is for performance of work or services, income is recognized at the time the performance is completed (CTL Basic Circular 2-1-5).

Transfers of fixed assets

Income from transfers of fixed assets is generally recognized in the year of transfer. But income from transfers of land and buildings is recognized as of the effective date of the contract of transfer (CTL Basic Circular 2-1-14).

Law: Art 22 of the *Corporation Tax Law*; CTL Basic Circulars 2-1-1, 2-1-2, 2-1-3, 2-1-5, 2-1-14 and 2-4-1

¶4-320 Installment sales

Corporations may report income from sales, services, or construction projects (other than long-term construction projects subject to CTL Art 64) on installment basis if:

- (1) the payments are to be received in three or more installments
- (2) the last payment is to be received at least two years after the completion of the transaction giving rise to the payment, and
- (3) no more than two-thirds of the payments have been received by the time the transaction has been completed by the transfer of the item sold, etc (CTL Art 63, CTL-EO Art 126).

Income under the installment method is determined as follows (CTL-EO Art 124):

Income currently recognized = Net sales price × installment ratio

The net sales price is the sales price less cost of goods sold and sales commissions, etc (CTL-EO Art 124).

$$\text{Installment ratio} = \frac{\text{Amount of denominator due or paid in the current period}}{\text{Installment sale amount}}$$

Law: Art 63 and Art 64 of the *Corporation Tax Law*; Art 124 and Art 126 of the *Corporation Tax Law Enforcement Order*

¶4-330 Construction contracts

Income from construction contracts, other than long-term large-scale construction contracts, may generally be reported using either the completed contract method or the percentage of completion method. Long-term large-scale construction contracts are reported on the percentage of completion method only. A long-term large-scale construction contract is one with a construction period of more than one year (two years before the change implemented by the 2008 legislation) (CTL Art 64(1); CTL-EO Art 129(1)) and a contract price of more than the minimum amount indicated in the following table. The percentage of completion method is not applicable if the project is expected to 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 as shown in the following table:

Table 8: Applicable dividend exclusion percentages

% 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 recognized (CTL Art 25). However, gain will be recognized when a corporation revalues assets to amounts not exceeding fair market value in the case of a reorganization under the *Corporate Reorganisation Law* (CTL Art 25(1)) or a change in organization (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 (*senmyu 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 9: 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 10: 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 1 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 organizations
- 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)). Beginning 1 April 2016, pre-transfer notification to the tax office of transfers of restricted stock as compensation for future services is not required.

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.

Performance-based compensation (*gyoseki rendo kyuyo* — 業績連動給与)

Under the 2006 tax legislation, the deductible compensation in the form of bonuses paid to officers who take part in the administration of corporations, other than family corporations, was based on the profits of the company (CTL Art 34(1); CTL-EO Art 69(1)). Beginning 1 April 2017, in order to provide more flexibility to companies, "profit-based compensation (*rieki rendo kyuyo* — 利益連動給与)" was expanded to include "performance-based compensation". Companies may now use, in addition to indicators based on profits, indicators based on stock performance and sales to determine bonuses (Art 2 of the Law Partially Revising the Income Tax Law, etc, Law No 4, 27 March 2017). In addition, indicators for years after the current year may also be included in the calculation of compensation. To be deductible for tax purposes, each of the requirements (1) through (6) enumerated below need to be satisfied.

- (1) The company is not a family corporation (beginning 1 April 2017, compensation paid by a family corporation in a 100% control relationship with a non-family company may be considered profit-based compensation).
- (2) The amount is determined according to an objective calculation method based on indicators of profits referenced in the securities reports (legislation effective 1 April 2016 clarifies that indicators such as ROE (return on equity) may be used). Beginning 1 April 2017, indicators based on stock performance and sales may also be used.
- (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. Beginning 1 April 2017, the amount may be indicated by the predetermined number of stock shares or stock options to be issued or exercisable as compensation provided that the number of shares or options is determined based on performance-based indicators.
- (5) After determination, the amount is reported in securities reports without delay.
- (6) The compensation is paid, or is expected to be paid, within one month of the determination of its amount.

Restricted shares (*joto seigentsuki kabushiki* — 譲渡制限付株式)

For restricted shares granted as compensation for future services on or after 1 April 2016, the company may deduct the shares as compensation expense in the year the income is included in the taxable income of the individual (that is, when rights to the shares become vested by the employee) (CTL Art 54). However, beginning 1 October 2017, restricted shares are not considered deductible compensation if the number of shares to be released from restrictions on transfer is based on performance-based indicators.

In the case of compensation to non-residents of Japan, beginning 1 October 2017 the compensation may be deducted by the company in the year the non-resident would have included the compensation in taxable income if that person was a resident of Japan.

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). Beginning 1 October 2017, in order to be deductible, retirement payments based on performance-based indicators must meet the requirements for performance-based compensation described above.

Prior law: Compensation of officers of specially controlled family corporations (*tokushihai deizokugaisha 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 or ¥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 installment 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).

Intangible property

Depreciation is also used to recover the cost of intangible property such as:

- software
- goodwill
- patents and trademarks
- utility model rights
- design rights, and
- rights regarding mining, fishing, water use, use of railway property, use of electrical or gas supply facilities, and use of heat supply, water supply or telegraph or telephone facilities (CTL-EO Art 13).

Law: Art 13 of the *Corporation Tax Law Enforcement Order*

¶4-443 Useful lives of new depreciable assets

The following table sets forth the useful lives of selected new assets as designated by the Ministry of Finance (Ordinance No 15 (1965) and No 34 (30 March 2001)).

Table 11: Useful lives of selected buildings

Types of structures and uses	Useful lives (years)	
	Buildings acquired before 1 April 1998	Buildings acquired on or after 1 April 1998
Reinforced concrete buildings:		
• Office or art museum ("office, etc")	65	50
• Residential use buildings, shops and stores, schools, dormitories, gymnasiums, etc ("residential, etc")	60	47
• Restaurants and theatres ("restaurants, etc")	50	41
• Restaurants, if more than 30% of the floor area is made of wood	40	34
• Hotel or hospital ("hotel, etc")	47	39
• Hotel, if more than 30% of the floor area is made of wood	36	31
Brick, stone or block buildings:		
• Office, etc	50	41
• Residential, etc	45	38
• Restaurants, etc	45	38
• Hotel, etc	42	36

Types of structures and uses	Useful lives (years)	
	Buildings acquired before 1 April 1998	Buildings acquired on or after 1 April 1998
Metal buildings (limited to cases where the frame is more than 4 millimeters thick):		
• Office, etc	45	38
• Residential, etc	40	34
• Restaurants, etc	35	31
• Hotel, etc	33	29
Metal buildings where the frame is more than 3 but not more than 4 millimeters thick:		
• Office, etc	34	30
• Residential, etc	30	27
• Restaurants, etc	28	25
• Hotel, etc	26	24
Metal buildings where the steel frame is not more than 3 millimeters thick:		
• Office, etc	24	22
• Residential, etc	20	19
• Restaurants, etc	20	19
• Hotel, etc	18	17
Buildings made of wood, plastic or synthetic resins:		
• Office, etc	26	26
• Residential, etc	24	22
• Restaurants, etc	22	20
• Hotel, etc	18	17
Mortared wood frame buildings:		
• Office, etc	24	22
• Residential, etc	22	20
• Restaurants, etc	20	19
• Hotel, etc	16	15
Simple wooden buildings:		
• If main pillars are not more than 10 square centimeters	10	10
• Temporary buildings	7	7

Table 12: Useful lives of selected attachments to buildings

Types of attachment	Useful lives (years)
Electrical facilities and lighting	15
Heating and air conditioning	15
Air conditioning, if power is 22 kilowatts or less	13
Water supply	15
Elevators	17
Escalators	15
Fire extinguishing equipment and emergency alarms	8
Air curtain and automatic door opening equipment	12
Simple movable partition walls	3
Other movable partition walls	15
Most other attachments not mentioned above:	
If predominantly made of metal	18
Others	10

Leasehold improvements are generally depreciated based on an estimate of their useful life, considering the life of the building, the nature of the improvements and the materials used. However, if the lease is non-renewable and there is no purchase option, the term of the lease may be used as the depreciable period (Circular Regarding the Application, etc of Useful Lives 1-1-3).

Table 13: Useful lives of vehicles and aircraft

Types of vehicles or aircraft	Useful lives (years)
Motor vehicles used in transportation business	3
Trucks	4
Ships (2,000 tons or more)	15
Ships (less than 2,000 tons)	10
Oil tankers (2,000 tons or more)	13
Airplanes with maximum take-off weight exceeding 130 tons	10
Airplanes with maximum take-off weight exceeding 5.7 tons, but not more than 130 tons	8
Other airplanes, helicopters and gliders	5

CHAPTER 7

CONSUMPTION TAX

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INTRODUCTION

¶7-100 Introduction

In Japan, indirect taxes make up a little over a third of national and local tax revenues, which is less than is commonly seen in Europe, but considerably more than in the United States.

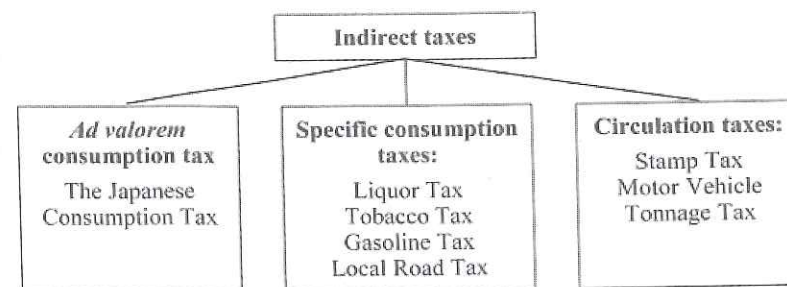
Table 1: International comparison of composition of national revenue ratio of direct taxes to indirect taxes (figures for Japan are estimates for 2016 and final figures for 2013; figures for the other countries are based on OECD data for 2013)

Country	Ratio of direct taxes to indirect taxes (national and local)
Japan (2016)	67:33
Japan (2013)	71:29
US	77:23
UK	56:44
Germany	53:47
France	56:44

Source: Japan Ministry of Finance

Japanese indirect taxes are of three general kinds: *ad valorem* Consumption Tax, specific consumption taxes based on units and circulation taxes on transactions and acts.

Diagram 1: Types of Japanese indirect taxes



The *ad valorem* Consumption Tax accounts for over half of the indirect tax revenues in Japan.

Table 2: Composition of Japanese indirect tax revenues 2016 – 2017

Indirect tax	Indirect tax revenues (¥1m)		% of indirect tax revenues	
	2016	2017	2016	2017
Consumption Tax	171,850	171,380	67%	68%
Gasoline Tax	23,860	23,940	9%	9%
Liquor Tax	13,590	13,110	5%	5%
Stamp duty revenue	10,520	10,920	4%	4%
Tobacco Tax	9,230	9,290	4%	4%
Customs duty	11,060	9,590	4%	4%
Other	14,640	14,410	6%	6%
Total indirect taxes	254,750	252,640	100%	100%

Although politically unpopular, indirect taxes are projected to become an increasingly important component of the Japanese tax system in the future due to a “hollowing out” of the tax base for the Income Tax as the population ages. Most of this increased burden is expected to be taken up by increases in the Consumption Tax rate, which increased from 5% to 8% in 2014. An increase in the rate to 10% originally scheduled to take place on 1 October 2015 was delayed to 1 April 2017. Legislation to further delay the implementation of the 10% rate was passed by the Diet in November 2016 and the rate increase to 10% is now scheduled to take effect on 1 October 2019 (Law No 85 (national tax) and Law No 86 (local tax) of 2016, 28 November 2016). The Tax Commission, Japan's tax policymaking panel, believes that an increase in the Consumption Tax rate to 20% will be needed to handle Japan's fiscal needs.

THE CONSUMPTION TAX (SHOHIZEI — 消費税)

7-200 The Consumption Tax (Shohizei — 消費税)

The *Consumption Tax Law* was enacted on 30 December 1988, effective for transactions on or after 1 April 1989. The original rate of 3% was raised to 5% (4% national tax and 1% Local Consumption Tax, which is set at 25% of the national rate) in April 1997.

Table 3A: Consumption Tax rates from 1 April 1997 through 31 March 2014

Combined Consumption Tax rate:	5%
National rate:	4% (<i>Consumption Tax Law</i> Art 29)
Local rate:	25% of the national rate (1%) (<i>Local Tax Law</i> Art 72-82, 72-83)

Increase in the rate of Consumption Tax. As part of a comprehensive plan to strengthen the stability of the social security system, on 22 August 2012, legislation was enacted which includes a two-stage increase in the Consumption Tax (*Law to Partially Revise the Consumption Tax Law in Order to Secure Stable Resources for Social Security* — 社会保障の安定財源の確保等を図る税制の抜本的な改革を行うための消費税法の一部を改正する等の法律, Law No 68, 22 August 2012, effective 1 April 2014).

Table 3B: Consumption Tax rates from 1 April 2014 (*Law No 68, 22 August 2012, Art 2 and Art 3*)

Effective dates	Combined Consumption Tax rate	National rate	Local rate
Beginning 1 April 2014	8%	6.3%	1.7%
Beginning 1 October 2019	10%	7.8%	2.2%
Reduced tax rate for food, drink, and newspaper subscriptions beginning 1 October 2019	8%	6.24%	1.76%

The two-stage increase in Consumption Tax rates beginning 1 April 2014 was originally conditioned on continuing favorable economic conditions. The increase to an 8% combined rate was formally adopted on 1 October 2013, effective 1 April 2014. Implementation of the second-stage increase to a 10% combined rate had been initially set for 1 October 2015 but was delayed to 1 April 2017 and further postponed to 1 October 2019 by legislation in late 2016. A transition period for implementation of the 10% rate affecting construction projects, etc., had been set to begin on 1 October 2016. A provision allowing for reconsideration of implementation of the 10% rate based on economic indicators such as real and nominal rates of growth and price trends has been repealed (Law No 68, 22 August 2012, Supplementary Provisions Art 18 as revised by Law No 9, 1 April 2015).

Delay in increase of rate to 10%. Legislation to postpone the implementation of the 10% Consumption Tax rate was passed by the Diet in November 2016 and the rate increase to 10% is now scheduled to take effect on 1 October 2019 (Law No 85 (national tax) and Law No 86 (local tax) of 2016, 28 November 2016).

System of reduced rates (on necessities) (*keigen zeiritsu seido* — 軽減税率制度). The 2012 tax rate increase legislation did not contain any provision for lower Consumption Tax rates on daily necessities such as food. However, effective with the Consumption Tax rate increase to 10%, scheduled to occur on 1 October 2019, a reduced tax rate of 8% (6.24% national tax and 1.76% local tax) is allowed for certain food and drink and for subscriptions to newspapers which feature articles on politics, economics, society, and culture, etc., and that publish at least twice weekly (*Law to Partially Revise the Income Tax Law*, etc, Law No 15 of 2016, 29 March 2016, Art 5, Supplementary Provisions Art 34).

Food and drink items not eligible for the reduced rate include:

- Alcohol described in the Liquor Tax Law.
- “Dining out” (*gaishoku* — 外食) — meals consumed in restaurants, cafes, etc. But food eligible for the reduced tax rate includes:
 - “Take out” food put in a container or packaging for off the premise consumption
 - Food provided at an elderly care facility
 - Food provided to students at kindergarten, elementary and middle schools, etc.

- Catered meals.
- Food that is combined with a non-food product generally is not eligible for the reduced rate. But if the selling price of the combined product before tax does not exceed ¥10,000 and the food component of the product accounts for at least $\frac{2}{3}$ of the selling price then the entire combined product is eligible for the reduced rate (Consumption Tax Law Enforcement Order Partial Revision Order No 148 of 2016).

Transitional rules. During the period that the 8% Consumption Tax rate is in effect, under the following transition rules the pre-change 5% rate will continue to apply (Law No 68, 22 August 2012, Supplementary Provisions Art 5). Similar measures are expected to apply retaining the 8% rate during a transition period when the 10% rate comes into effect.

Table 4: Items covered by transitional rule

Item covered by transitional rule	Details
Entrance fees to a race track, bicycle race track, art museum, amusement park, film or play or amounts received for passenger	Amounts received before 1 April 2014 for services rendered after that date
Electricity, gas, telephone, etc, utility costs	Amounts received for services contracted before 30 April 2014 under a contract continuously in effect before 1 April 2014
Construction contract concluded between 1 October 1996 and 30 September 2013	Amounts received for transfers of taxable materials after 1 April 2014 under preexisting contract
Lease contract concluded between 1 October 1996 and 30 September 2013	Amounts received under lease contract after 1 April 2014 under preexisting contract provided certain conditions are satisfied regarding definiteness of payments and changes in contract terms, etc
Labor contract concluded between 1 October 1996 and 30 September 2013	Amounts received under labor contract after 1 April 2014
Publication subscriptions continuously in effect before 1 October 2013	Amounts received by 1 April 2014 for publications delivered after that date or for delivery of weekly, monthly, etc, magazines or newspapers with sales date before 1 April 2014
Mail order goods where price and conditions have been determined before 1 October 2013	Amounts received for goods after 1 April 2014 where the order has been received before that date
Elderly lifetime care facility contract concluded between 1 October 1996 and 30 September 2013	The portion of a lump-sum payment received upon commencing elderly care for services provided after 1 April 2014

Overview of the Consumption Tax. The Consumption Tax is a multi-step, broad-based consumption tax on most transactions in goods and services in Japan and the receipt of foreign goods from bonded areas in Japan. The tax is assessed at each stage of manufacturing, wholesale and retail processes. Deductions for consumption taxes paid at previous stages by businesses result in the consumer bearing the full burden of the Consumption Tax.

Example 1: Assessment of Consumption Tax

(A) Materials provider		
Sale price to manufacturer	¥ 100,000	
Consumption Tax	¥ 5,000	→ ¥5,000
(B) Manufacturer		
Sale price to wholesaler	¥ 200,000	
Consumption Tax	¥ 10,000	→ ¥5,000
Less: tax on purchases	¥ (5,000)	
Net Consumption Tax	¥ 5,000	
(C) Wholesaler		
Sale price to retailer	¥ 300,000	
Consumption Tax	¥ 15,000	→ ¥5,000
Less: tax on purchases	¥ (10,000)	
Net Consumption Tax	¥ 5,000	
(D) Retailer		
Sale price to consumer	¥ 400,000	
Consumption Tax	¥ 20,000	→ ¥5,000
Less: tax on purchases	¥ (15,000)	
Net Consumption Tax	¥ 5,000	
	Consumer	Total received by government from A, B, C and D
Purchase price	¥ 400,000	
Consumption Tax	¥ 20,000	= ¥20,000
Total cost	¥ 420,000	

Display of tax-inclusive pricing. Product price labels and handbills advertising products are required to present the price inclusive of the Consumption Tax (including local Consumption Tax). However, in light of the changes in tax rates this requirement has been suspended until 31 March 2021 provided that sellers take steps to avoid misleading consumers regarding the tax-inclusiveness of the price.

Law: Art 29 of the *Consumption Tax Law*; Art 72-82 and Art 72-83 of the *Local Tax Law*; *Law to Partially Revise the Consumption Tax Law in Order to Secure Stable Resources for Social Security*

¶7-210 Scope of taxation for the Consumption Tax (*Kazei No Taisho* — 課税の対象)

The scope of the Consumption Tax includes (*Consumption Tax Law* Art 4(1), (2)):

- (1) The transfer of property or the provision of services in Japan by an enterprise in return for payment (*Consumption Tax Law* Art 2(1)(viii), Art 4(1)).
- (2) The removal of foreign goods from a bonded area (*Consumption Tax Law* Art 4(2)).
 - “Japan” refers to the enforcement area of the Consumption Tax (*Consumption Tax Law* Art 2(1)(i)).
 - “Enterprise” means either a sole proprietorship (operated by a natural person) or a corporation (*Consumption Tax Law* Art 2(1)(iii), (iv)). For this purpose, a business conducted by a local public body or a non-juridical organization is considered to be a corporation (*Consumption Tax Law* Art 3, Art 60).
 - “Property” includes not only inventory and fixed assets but also intangible property rights (*Consumption Tax Law Basic Circular* 5-1-3).
 - “Bonded area” includes a specific bonded area, a bonded warehouse, bonded factory, bonded exhibiting area and comprehensive bonded area (*Consumption Tax Law* Art 2(1)(ii); *Customs Law (Kanzeiho)* Art 29).
 - The supply of property or services not involving an enterprise within Japan is not subject to Consumption Tax, but the importing of goods by a person other than an enterprise is subject to Consumption Tax.
 - Sale of personal assets, such as sale of a personal residence, is not subject to Consumption Tax.

Law: Art 2(1)(i), Art 2(1)(ii), Art 2(1)(iii), Art 2(1)(iv), Art 2(1)(viii), Art 3, Art 4(1), Art 4(2) and Art 60 of the *Consumption Tax Law*; Art 29 of the *Customs Law (Kanzeiho)*

¶7-211 Domestic transactions (*Kokunai Torihiki* — 国内取引)

Provision of services

Services are considered domestic transactions if the services are provided within Japan (*Consumption Tax Law* Art 4(3)(ii); *Consumption Tax Law Basic Circular* 5-7-15) (see ¶7-212).

Artists and athletes. Prior to 1 April 2016, a foreign enterprise that provides the services of artists or athletes in Japan is obligated to pay the Consumption Tax arising from the services. Beginning 1 April 2016, Consumption Tax payment for services of artists and athletes is the obligation of the Japanese recipient of the services under the “reverse charge” system (see ¶7-212).

Transfers or leases of property

Generally, if a property is located in Japan at the time it is transferred or leased, the transaction will be treated as a domestic transaction. A transfer or lease of a ship, aircraft, patent, etc, registered with a body in Japan is treated as a domestic transaction.

If an enterprise purchases a property outside of Japan and transfers it without bringing it into Japan, the transaction is not subject to Consumption Tax (*Consumption Tax Law Basic Circular* 5-7-1).

Transfers for payment

Only transfers for payment are subject to Consumption Tax. Excluded are transfers without payment, such as gifts, financial assistance, dividends, lottery winnings, etc, (*Consumption Tax Law Basic Circular* 5-2-8).

Deemed transfers and other transactions subject to Consumption Tax

The following are examples of deemed transfers and other transactions subject to Consumption Tax:

- the consumption of inventory or other business property by a sole proprietor in his/her household (*Consumption Tax Law* Art 4(4)(i))
- a gift by a corporation to an officer (*Consumption Tax Law* Art 4(4)(ii))
- an accord and satisfaction (*Consumption Tax Law* Art 2(1)(viii))
- exchange of property, investment-in-kind, or onerous gift (*Consumption Tax Law Enforcement Order (Consumption Tax Law-EO* Art 2).

Imports

All properties removed from a bonded area are subject to Consumption Tax regardless of whether the transfer is for payment. This includes items used for personal consumption by the importer (*Consumption Tax Law Basic Circular* 5-6-2). This rule is necessary to maintain the tax balance between foreign and domestic goods. Consumption or use within bonded areas is considered a removal from the bonded area subject to tax. But if imports are used within bonded areas as raw materials in the manufacture of products subject to Consumption Tax, that consumption or use is not subject to tax.

Law: Art 2(1)(viii), Art 4(3)(ii), Art 4(4)(i) and Art 4(4)(ii) of the *Consumption Tax Law*; Art 2 of the *Consumption Tax Law Enforcement Order*

¶7-212 Cross-Border Services (*Kokkyo o Koetta Ekimu no Teikyo* — 国境を越えた役務の提供)

In order to provide equitable treatment to domestic and foreign — companies, beginning 1 October 2015, Consumption Tax will apply to electronic commerce such as the delivery of an electronic book, music, advertisements, or cloud services that an overseas company performs outside of Japan (*Consumption Tax Law* Art 2, Art 4 as amended by Law No 9, 1 April 2015). This rule overrides the general rule that services are considered domestic transactions if the services are provided within Japan (see ¶7-211). The method of tax collection differs depending whether the recipient of the services is a business or consumer. Foreign businesses with taxable sales less than ¥10m during the base period (generally the second year before the current year) may qualify for tax-exempt status (see ¶7-310). Other foreign companies with a business establishment in Japan related to the services or which have a tax representative in Japan may apply to the tax office to be “registered overseas business” eligible for the credit for taxable purchases (see ¶7-610).

Business recipients of cross-border services (B2B). If a business in Japan receives services from outside of Japan, the Japanese business service recipient has the obligation to file the Consumption Tax return and pay the on the service under a "reverse charge" system. Effective 1 January 2017, B2B digital services received by a foreign permanent establishment of a Japanese business in connection with foreign business activity is not subject to Consumption Tax but such services received by a Japanese permanent establishment of a foreign business for purposes of sales in Japan will be treated as Japanese domestic transactions subject to the reverse charge rules.

Consumer recipients of cross-border services. A consumer in Japan who receives services from outside of Japan is not obligated to pay the Consumption Tax. Instead, the foreign service provider has the obligation to file the Consumption Tax return and pay the Tax on the service.

¶7-220 Non-taxable transactions (*Hikazei* — 非課税)

Transfers of certain designated types of property are non-taxable under the *Consumption Tax Law* either because the property is not of the type contemplated for the Consumption Tax or for reasons based on social policy concerns (*Consumption Tax Law* Art 6(1), Table 1).

- (1) *Sales and leases of land and rights to land.* Transfers of land, including superficies, air rights, easements, rights to lease land, etc, are not taxed under the *Consumption Tax Law*. However, transfers of mining rights, quarry rights and rights to use hot springs are taxable:
 - *Short-term use of land.* A lease or other use of land for less than one month is not considered a non-taxable use of land and is subject to Consumption Tax (*Consumption Tax Law-EO* Art 8). Use of improvements to land, such as buildings, parking lots, and sports facilities, is subject to Consumption Tax.
 - *Transfer of land and buildings.* If land (not taxable) and buildings (taxable) are transferred in a single transaction, the transfer price is allocated between the land and buildings based on the normal transaction price for each (*Consumption Tax Law Basic Circular* 10-1-5).
- (2) *Transfers of securities.* Non-taxable property includes:
 - national and local government bonds
 - corporate stocks and bonds
 - beneficial interests in investment trusts and bond trusts
 - commercial paper
 - mortgage bonds
 - membership interests in limited companies (*yugen kaisha*) and cooperatives (*kyodo kumiai*)
 - loans, deposits, receivables, and other monetary claims
 - means of effecting payment, including checks, traveler's checks, foreign exchange conversion fees, postal orders and letters of credit.
- (3) *Financing transactions.* Lending and other financial transactions and services are non-taxable under the *Consumption Tax Law*, including (*Consumption Tax Law Basic Circular* 6-3-1):
 - national and local government bonds, corporate bonds, convertible bonds, stock rights, deposits, savings and loans
 - distributions from joint operation trusts or investment trusts
 - credit guarantee fees, insurance premiums, mutual aid premiums and discounts on bills

- commissions on installment payment sales
 - insurance and interest included in financing lease payments (limited to amounts specified in the contract).
- (4) *Sales of postage stamps and document stamps.* Government postage stamps and stamps used for the Stamp Tax are not subject to Consumption Tax. Other mail-related items sold by the post office are also non-taxable, including postcards, cash envelopes, prepayment cards and parcel post wrapping materials (*Consumption Tax Law Basic Circular* 6-4-2). However, sales of collectible stamps are subject to tax.
 - (5) *Merchandise and service cards.* Transfers (including sales from vending machines) of prepaid telephone cards, prepaid railway fare cards, book cards, gift certificates, etc, are not subject to Consumption Tax.
 - (6) *Government fees.* Fees collected by the national or local governments or public bodies for permits, registration fees, document fees, etc, are not subject to Consumption Tax.
 - (7) *International money orders and foreign exchange.* International postal money orders, traveler's checks, letters of credit and foreign exchange transaction fees are not subject to Consumption Tax.
 - (8) *Medical services received under public medical security laws.* Medical services received under public laws regarding health are not subject to Consumption Tax, including the *Health Insurance Act*, the *Seaman's Insurance Law*, the *Elderly Persons' Health Protection Act*, the *Physically Handicapped Person's Welfare Law*, the *Compensation to Victims of Damage to Health from Pollution Law*, the *Livelihood Protection Act*, the *Workers' Injury Compensation Insurance Act*, etc, (*Consumption Tax Law Basic Circular* 6-6-1).
 - (9) *Nursing care services provided under the Nursing Care Insurance Act* (*Consumption Tax Law Basic Circular* 6-7-1).
 - (10) *Social welfare services.* Various enterprises provide goods and services under the provision of the social welfare laws (*Consumption Tax Law Basic Circular* 6-7-5). Examples include:
 - enterprises providing relief facilities under the *Livelihood Protection Law*
 - day care centers, infant and mother support facilities, and nursing homes under the *Child Welfare Act*
 - homes for the aged under the *Elderly Persons Welfare Act*
 - home services, day services, and short stay facilities provided under various welfare laws for children, the elderly and handicapped persons.
 - (11) *Property transferred in connection with medical and midwife services for childbirth* (*Consumption Tax Law Basic Circular* 6-8-1).
 - (12) *Burial and cremation fees.* However, funeral expenses are taxable (*Consumption Tax Law Basic Circular* 6-9-1).
 - (13) *Transfers and leases of special items for the handicapped.* Tax-exempt items include wheelchairs, safety canes, artificial eyes, Braille machines, and other equipment or structures with special facilities for the handicapped (*Consumption Tax Law Basic Circular* 6-10-1).
 - (14) *School and education costs.* Tax-exempt education costs are those related to schools, Job Ability Development Schools and special training colleges specified under the *School Education Law*. Examples of tax-exempt costs include tuition, entrance fees, facilities fees and fees for proof of student status documents, etc, (*Consumption Tax Law Basic Circular* 6-11-1).

- (15) *Textbooks specified in the School Education Law* (Consumption Tax Law Basic Circular 6-12-1).
- (16) *Residential lease*. Tax exemption applies to leases of homes, apartments, dormitories, company housing, etc. Short-term leases for less than one month are generally taxable (Consumption Tax Law-EO Art 16). Costs of hotels, *ryokan*, or resorts are taxable even if for a period of greater than one month (Consumption Tax Law Basic Circular 6-13-1).
- (17) *Receipt of tax-exempt foreign goods from bonded areas*. Tax exemption applies to the receipt from bonded areas of foreign property of the types otherwise qualifying for exemption, including securities, postage stamps, special articles for the use of the disabled, textbooks, etc.
- (18) *Sale of virtual currencies*. Pursuant to a revision in the Law for Settlement of Funds (Law No 59, 24 June 2009), beginning 1 July 2017 the sale of virtual currencies is no longer subject to the Consumption Tax.

Law: Art 6(1) and Table 1 of the *Consumption Tax Law*; Art 8, Art 16 of the *Consumption Tax Law Enforcement Order*; *Child Welfare Act*; *Compensation to Victims of Damage to Health from Pollution Law*; *Elderly Persons' Health Protection Act*; *Elderly Persons Welfare Act*; *Health Insurance Act*; *Livelihood Protection Act*; *Livelihood Protection Law*; *Nursing Care Insurance Act*; *Physically Handicapped Person's Welfare Law*; *Workers' Injury Compensation Insurance Act*; *Seaman's Insurance Law*; *School Education Law*

¶7-230 Exempt transactions (*Menzei Torihiki* — 免税取引)

The Consumption Tax is based on the principle of taxing goods and services in the place where they are consumed. Exemptions from the Consumption Tax are therefore provided for goods for export and international communications and transport activities.

¶7-231 Tax-free exports (*Yushutsu Menzei* — 輸出免税)

An exemption from the Consumption Tax applies to the transfer of goods or provision of services in Japan by an enterprise that is described in one of the following classes of exempt export transactions (*Consumption Tax Law Art 7(1)(i)*):

- (1) A transfer or lease of property that is an export from Japan (*Consumption Tax Law Art 7(1)(i)*):
 - This exemption applies only to enterprises involved directly in exporting. It does not apply to subcontractors who provide goods to exporters or others who sell products to enterprises engaged in exporting (*Consumption Tax Law Basic Circular 7-2-2*).
- (2) A transfer or lease of foreign goods (*Consumption Tax Law Art 7(1)(ii)*):
 - This exemption applies to goods that have entered a bonded area in Japan without undergoing import processing and is then shipped outside of Japan (*Consumption Tax Law Basic Circular 7-2-3*).
- (3) Transportation of passengers or goods or telecommunications between Japan and outside Japan (*Consumption Tax Law Art 7(1)(iii)*).
- (4) A transfer, lease, or repair of ships or aircraft used for the transport of passengers or goods between Japan and outside Japan (*Consumption Tax Law Art 7(1)(iv)*).
- (5) Similar transfers or services specified in regulations (*Consumption Tax Law Art 7(1)(v)*).

Examples

Examples of exempt export transactions include (*Consumption Tax Law Basic Circular 6-11-1*):

- transfer or lease of foreign freight
- international transport of travelers or freight (including domestic transport which is a part of the international transport)
- provision of ships or aircraft for international transport (including those of Japanese registry)
- repairing of ships or aircraft used for international transport
- transfer or lease or repair of containers used for export shipping or for shipping between foreign countries
- services and facilities provided to ships and aircraft for entering and leaving harbors, mooring, taking off and landing, etc
- loading and unloading, warehousing, inspecting, etc, of foreign freight
- communications or mail between Japan and a foreign country
- transfer or lease of intangible assets to a non-resident of Japan
- services provided to a non-resident other than:
 - (a) transport or safekeeping of property in Japan
 - (b) provision of food or lodging in Japan
 - (c) services similar to (a) and (b) provided in Japan.

Law: Art 7(1)(i), Art 7(1)(ii), Art 7(1)(iii), Art 7(1)(iv) and Art 7(1)(v) of the *Consumption Tax Law*

¶7-232 Tax-free shops (*Yushutsu Buppin Hanbaiba* — 輸出物品販売場)

Non-residents of Japan may purchase items for personal use at specially designated "tax-free shops" without paying Consumption Tax on the purchase (*Consumption Tax Law Art 8*; *Consumption Tax*). Among the most visible of these shops are the duty-free shops found in international airports and in the Akihabara "Electric Town" neighborhood of Tokyo. Prior to 1 October 2014, exempt purchases were limited to those over ¥10,000 and included only such items as electric goods, handbags and clothing (*Consumption Tax Law-EO Art 18*). Beginning 1 October 2014, exempt purchases will also include items used in consumable items used in daily life such as food, beverages, medicines, and cosmetics. The separate exemption for consumable items applies to purchases costing at least ¥5,000 but not more than ¥50,000 beginning 1 April 2015.

Retailers must obtain permission from the tax office to operate tax-free shops (*Consumption Tax Law Art 6*). Consumption Tax will be exempted on purchases from a tax-free shop on the condition that the article is to be taken out of Japan. The purchaser must present his/her passport at the shop and receive a "Record of Purchase of Consumption-Tax-Exempt for Export", which is attached to the passport. The card is collected by a customs officer at the time the purchaser leaves Japan. To facilitate qualifying purchases to meet the minimum purchase amounts, beginning 1 April 2015 merchants in shopping streets and centers, etc, may establish tax exemption counters where consumers who pay Consumption Tax on purchases at authorized individual stores may apply for refund based on the combined amount of the qualified exempt purchases.

Law: Art 6 and Art 8 of the *Consumption Tax Law*; Art 18 of the *Consumption Tax Law Enforcement Order*

¶7-233 Special export exemptions

Special exemptions from the Consumption Tax are provided for:

- items for foreign commerce loaded into ships and aircraft of Japanese registry (STML Art 85(1))
- goods provided to a foreign embassy (STML Art 86(1))
- goods provided to a Navy shop or PX operated by the US Navy under the Japan-US Mutual Cooperation and Security Agreement
- property supplied for the use of the US military (Consumption Tax Law Basic Circular 15-2-1).

Law: Art 85(1) and Art 86(1) of the *Special Taxation Measures Law*

TAXPAYERS (NOZEI GIMUSHA — 納税義務者)

¶7-300 Taxpayers (Nozei Gimusha — 納税義務者)

For purposes of the Consumption Tax, taxpayers are either:

- (1) an enterprise which transfers property or provides services in Japan in return for payment (*Consumption Tax Law Art 5(1)*), or
- (2) any person who removes foreign goods from a bonded area (*Consumption Tax Law Art 5(2)*):
 - An enterprise includes a sole proprietorship or a corporation, including a business conducted by a local public body or a non-juridical organization (*Consumption Tax Law Art 2(1)(iv)*, Art 3, Art 5, Art 60).
 - It is not necessary for a taxpayer to have a residence or domicile in Japan in order to be subject to the Consumption Tax.
 - The obligation to pay Consumption Tax is extended beyond enterprises to consumers in the case of imports in order to maintain the tax balance between domestic and imported goods.

Trusts

Generally, the beneficiary of a trust is treated as the owner of trust property and bears the obligation to pay Consumption Tax on transactions performed by the trust. However, this rule does not apply to joint investment trusts (*shudan toshi shintaku* — 集団投資信託), corporate taxation trusts (*hojin kazei shintaku* — 法人課税信託), retirement pension trusts (*taishoku nenkin nado shintaku* — 退職年金等信託) or specified public trusts (*tokutei koeki shintaku* — 特定公益信託) (*Consumption Tax Law Art 14(1)*).

Law: Art 2(1)(iv), Art 3, Art 5, Art 5(1), Art 5(2), Art 14(1) and Art 60 of the *Consumption Tax Law*

¶7-310 Exempt enterprises (Menzei Jigyosha — 免税事業者)

In order to lessen the clerical burden on small-volume businesses, an exemption from obligation to pay Consumption Tax has been provided since the inception of the *Consumption Tax Law* for small businesses. Small businesses continue to collect the tax from consumers, but are not obligated to pay it to the Government, resulting in a perceived windfall to exempt enterprises. More than 60% of businesses by number qualified for the exemption.

Election to be a taxable enterprise

A small business otherwise qualifying as an exempt enterprise may elect to be subject to the obligation to pay Consumption Tax by filing a notification with the district director of the tax office with jurisdiction over the taxpayer (*Consumption Tax Law Art 9(4)*). The election may be revoked upon notice to the tax office, but the notice of revocation may not be filed before the beginning of the second tax period following the period of the election (*Consumption Tax Law Art 9(5)*, Art 9(6)).

Application of exemption

For tax periods beginning on or after 1 April 2004, the exemption only applies to enterprises with not more than ¥10m of taxable sales (net of refunds, etc) during the base period.

The tax period for individuals is the calendar year, so the first year when the new rule applies will be 2005 for which the base year is 2003.

Corporations with a March year end are subject to the new rule for the first time for their tax year beginning on 1 April 2004 and the base year at that time will be their tax year beginning on 1 April 2002.

Legislation enacted in 2011 and effective for tax years beginning on or after 1 January 2012 disallows the exemption to companies with sales of ¥10m or more in the first half (six months) of the prior year (January to June for a calendar year taxpayer) (*Consumption Tax Law Art 9-2*).

Newly established sole proprietorships

A newly established sole proprietorship without a base period or with no sales during the base period is exempt from Consumption Tax for its first two years (*Consumption Tax Law Basic Circular 1-4-6*).

Newly established corporations

Newly established corporations without a base period or with no sales during the base period may be exempt only if their capital is not more than ¥10m at the beginning of the tax year (*Consumption Tax Law Art 12-2*). Effective for companies established on or after 1 April 2014, the disqualification from the exemption for companies with capital in excess of ¥10m includes certain controlled companies. A controlled company for this purpose is a corporation in the first two years of its operation that has been established by an enterprise (*jigyosha* — 事業者), that may be individual or corporate in nature, if the establishing enterprise has taxable sales in excess of ¥500m and owns, directly or indirectly, more than 50% of the new corporation (*Law to Partially Revise the Consumption Tax Law in Order to Secure Stable Resources for Social Security*, Law No 68, Art 2 — 社会保障の安定財源の確保等を図る税制の抜本的な改革を行うための消費税法の一部を改正する等の法律).

Restrictions on use of the exempt enterprise system

Effective for tax years beginning on or after 1 April 2010, for companies established on or after that, there is no limitation on the use of the exempt enterprise system for companies acquiring fixed assets. If, during one of the two periods listed below, a company acquires fixed assets (assets other than inventory with a cost of at least ¥1m net of tax) and the simplified tax system (¶7-620) does not apply during that period, the exempt enterprise system may not be used during the tax year the assets were acquired or the following two tax years (*Consumption Tax Law Art 9-7*):

- (1) The two-year period following an election to be subject to the Consumption Tax, during which the election may not be revoked by the taxpayer.
- (2) The two-year period following the establishment of a new company with capital of at least ¥10m, during which the company is treated as a taxpayer, but does not have a base period.

The simplified tax system may not be used during the period that this restriction prevents the exempt enterprise system from being used.

For purchases of high-value assets on or after 1 April 2016, neither the exempt enterprise system or the simplified tax system may be used for three years from the first day of the year of the transaction by a business that constructs or purchased designated fixed assets or inventory with a unit cost of cost of ¥10m or more other than purchases under a contract entered into on or before 31 December 2015.

Tax period (*kazei kikan* — 課税期間) (Consumption Tax Law Art 19-1)

Sole proprietorships

The tax period for individuals is the calendar year.

Corporations

The tax period for corporations is their fiscal year.

Base period (*kijun kikan* — 基準期間) (Consumption Tax Law Art 2(1)(xiv))

Sole proprietorships

The base period for individuals is the calendar year two years before the current tax year.

For 2004, the base period is the calendar year 2002.

Corporations

The base period for corporations with a tax year of one year is the tax year two years before the current tax year. If that prior tax year is less than a full year, the base year is obtained by combining all business years starting during the one year period beginning on the day two years before the start of the current tax year.

Taxable sales during the base period (*kijun kikan no kazei uriagedaka* — 基準期間の課税売上高)

Taxable sales during the base period are equal to the total amount of sales less returns, rebates and discounts computed before application of the Consumption Tax (Consumption Tax Law Art 9(2)).

Corporations with a short tax year

If a corporation's base year is not a full 12 months, the taxable sales during the base year is obtained by dividing the sales net of discounts, etc, by the number of months in the base period and multiplying the result by 12 (Consumption Tax Law Art 9(2)(ii)).

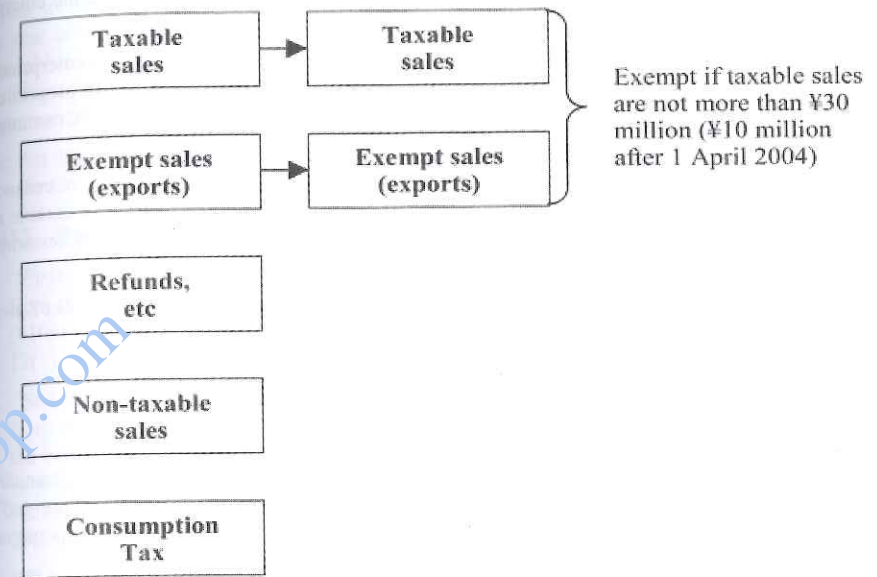
Deemed transactions and exempt transactions

Deemed transactions (¶7-211) and exempt transactions (¶7-230) are included in taxable sales during the base period (Consumption Tax Law Basic Circular 1-4-2).

Non-taxable transactions

Non-taxable transactions (¶7-220) are not included in taxable sales during the base period.

Diagram 2: Exemption from Consumption Tax for Small Enterprises



Law: Art 2(1)(xiv), Art 9(2), Art 9(2)(ii), Art 9(4), Art 9(5), Art 9(6), Art 12-2 and Art 19-1 of the Consumption Tax Law; 2012 Draft of Law to Partially Revise the Consumption Tax Law in Order to Secure Stable Resources for Social Security

¶7-311 Special rules for exemption of inherited enterprises

If a sole proprietor inherits or succeeds to an enterprise, special rules are used to determine the amount of taxable sales during the base period:

- *In the year of inheritance or succession.* If the successor operates a sole proprietorship with less than ¥30m (¥10m after 1 April 2004) of taxable sales during the base period corresponding to the current year and the enterprise operated by the decedent has more than ¥30m (¥10m after 1 April 2004) of taxable sales in the base period, the enterprise in the hands of the successor is not exempt from Consumption Tax for the period beginning the day after the inheritance to the end of the year (Consumption Tax Law Art 10(1)).
- *In the first two years following the inheritance or succession.* If the taxable sales for the base period of the enterprise operated by the decedent and the taxable sales for the base period of a business operated by the successor together total more than ¥30m (¥10m after 1 April 2004), the enterprise in the hands of the successor is not exempt from Consumption Tax (Consumption Tax Law Art 10(2)).
- *Two or more successors.* If an enterprise operated by a decedent passes to two or more successors, the amount of taxable sales must be allocated among the successors.

- *Separate business locations.* If the decedent's enterprise was operated at different locations and each successor receives a share consisting of separate business locations, the taxable income for the base period of each location is allocated to the successors to that portion of the enterprise (Consumption Tax Law-EO Art 21(1)).
- *Undivided interests.* If the successors receive undivided interests in a decedent's enterprise, the amount of taxable sales in the base period must be allocated to each successor in proportion to their statutory shares of the estate as specified in Civil Code Art 900 to Art 903 (Consumption Tax Law Basic Circular 1-5-5).
- *Multiple successions.* If a decedent's enterprise was acquired by the decedent by inheritance or succession during the three-year period preceding the current year, the amount of taxable sales in the base period is determined by including the taxable sales of each successor (Consumption Tax Law-EO Art 21(2)).

Law: Art 900 to Art 903 of the Civil Code; Art 10(1) and Art 10(2) of the *Consumption Tax Law*; Art 21(1) and Art 21(2) of the Consumption Tax Law Enforcement Order

¶7-312 Special rules for corporate mergers

Mergers: amalgamation by absorption (*kyushu gappei* — 吸収合併)

In a merger, or amalgamation by absorption, one company (the "merging" or "transferee" corporation) succeeds to the property and obligations of another company (the "merged" or "transferor" corporation) and the transferor corporation ceases to exist as a result of the amalgamation (Commercial Code Art 409).

Merger in the current year

If the transferee (merging) corporation in a merger has not more than ¥30m (¥10m after 1 April 2004) of taxable sales during the base period and the transferor (merged) corporation has more than ¥30m (¥10m after 1 April 2004) of taxable sales in the base period, the transferee corporation is not exempt from Consumption Tax for the period in the current year beginning from the date of the merger (*Consumption Tax Law* Art 11(1)).

Merger in a base period year

If a merger occurs after the first day of the base period, but before the beginning of the current year, and the combined taxable sales for the transferee (merging) corporation and transferor (merged) corporation are more than ¥30m (¥10m after 1 April 2004) in the base period, the transferee corporation is not exempt from Consumption Tax for the current year (*Consumption Tax Law* Art 11(2)).

Amalgamation by incorporating a new corporation (*shinsetsu gappei* — 新設合併)

In an amalgamation by incorporating a new company, the property and obligations of transferor companies are succeeded to by a newly established transferee corporation and the transferor companies cease to exist as a result of the amalgamation (Commercial Code Art 410).

Incorporation in the current year

If any of the transferor (merged) corporations have more than ¥30m (¥10m after 1 April 2004) of taxable sales in the base period corresponding to the year of the incorporation, the transferee (new) corporation is not exempt from Consumption Tax in the year it is incorporated (*Consumption Tax Law* Art 11(3)).

Incorporation in a base period year

If a merger occurs during the period from the day two years before the beginning of the current tax year to the day before the beginning of the current tax year, and the taxable sales during the base year of the new transferee corporation is not more than ¥30m (¥10m after 1 April 2004), but the combined taxable sales of the transferee and transferor corporations during the base year of the transferee corporation are more than ¥30m (¥10m after 1 April 2004), the transferee corporation is not exempt from Consumption Tax in the current year (*Consumption Tax Law* Art 11(4)).

Law: Art 409 and Art 410 of the Commercial Code; Art 11(1), Art 11(2), Art 11(3) and Art 11(4) of the *Consumption Tax Law*

¶7-313 Special rules for corporate divisions

- *"First period" — division in the current year.* A newly established subsidiary will not be exempt from the Consumption Tax if the parent corporation(s) has/have taxable sales exceeding ¥30m (¥10m after 1 April 2004) during the base period of the subsidiary (*Consumption Tax Law* Art 12(1); Consumption Tax Law-EO Art 23(1)).
- *"Second period" — division in first prior year.* If a division occurs in the period extending from the day before one year before the beginning of the current tax year to the day before the beginning of the current tax year, the taxable sales of the parent corporation(s) during the base period corresponding to the subsidiary's tax year are used to determine if the subsidiary is eligible for the exemption (*Consumption Tax Law* Art 12(2); Consumption Tax Law-EO Art 23(2)).
- *"Third period" — division in earlier years.* If a division occurs prior to the day before one year before the start of the current tax year and the taxable sales of the subsidiary are not more than ¥30m (¥10m after 1 April 2004) during its base period, and if specified conditions are satisfied, the taxable sales of the subsidiary and those of its parent are combined for the subsidiary's base period. If the combined total is more than ¥30m (¥10m after 1 April 2004), the subsidiary is not exempt from the Consumption Tax in the current year (*Consumption Tax Law* Art 12(3); Consumption Tax Law-EO Art 23(3), Art 23(4)).
- *Specified conditions.* The specified conditions are satisfied if 50% or more of the subsidiary's total outstanding shares or total capital is owned by the parent corporation or a person specially related to the parent corporation (*Consumption Tax Law* Art 12(3); Consumption Tax Law-EO Art 23(4)).

Law: Art 12(1), Art 12(2) and Art 12(3) of the *Consumption Tax Law*; Art 23(1), Art 23(2), Art 23(3) and Art 23(4) of the Consumption Tax Law Enforcement Order

TIMING OF THE OBLIGATION TO PAY TAX (NOZEI GIMU NO SEIRITSU — 納税義務者の成立)

¶7-400 Timing of the obligation to pay tax (Nozei Gimu No Seiritsu — 納税義務者の成立)

The timing of the obligation to pay consumption tax is discussed below.

¶7-410 General rules

The general rule is that the obligation to pay Consumption Tax arises when taxable property is shipped by the seller or moved out of a bonded area (*General Law of National Tax* Art 15(2)(vii)). Rules for specific kinds of transactions are summarized in the following table.

Table 5: Timing of obligation to pay Consumption Tax

Type of transaction	Timing of tax obligation
Inventory sales (other than consignment sales)	Date inventory is delivered (<i>Consumption Tax Law Basic Circular</i> 9-1-1). The delivery date is based on the method used by the seller which is reasonable considering the type and quality of the product and the contents of the sales agreement, such as the date received or made available for use by the buyer or the date the quantity supplied has been confirmed by a method such as a meter reading (<i>Consumption Tax Law Basic Circular</i> 9-1-2).
Inventory sales by consignment	Date of consignment sale by the consignee, but if sales statements are received, enterprises may use the date of the sales statement if the method is consistently applied (<i>Consumption Tax Law Basic Circular</i> 9-1-3).
Transfers of capital assets (other than industrial property rights)	Date of delivery (<i>Consumption Tax Law Basic Circular</i> 9-1-13).
Transfers of land or buildings	Date of delivery, but may elect to use the effective date of contract of sale (<i>Consumption Tax Law Basic Circular</i> 9-1-13).
Transfers of securities	Date of delivery (<i>Consumption Tax Law Basic Circular</i> 9-1-17).
Establishment or transfer of industrial property rights	Effective date under the contract, but the enterprise may use the registration date of the rights if the contract comes into effect upon registration (<i>Consumption Tax Law Basic Circular</i> 9-1-15, 9-1-16).
Royalties for industrial property rights, know-how, etc	Date that the amount becomes fixed, but the enterprise may use the date of payment stipulated in the contract if the method is consistently applied (<i>Consumption Tax Law Basic Circular</i> 9-1-21).
Contracted work — involving transfers of property	Date the object of the contract is completed and handed over to the buyer (<i>Consumption Tax Law Basic Circular</i> 9-1-5).

Type of transaction	Timing of tax obligation
Contracted work — not involving transfers of property	Date when the work is completed (<i>Consumption Tax Law Basic Circular</i> 9-1-5).
Lease of property — payment dates determined by contract or custom	Date when the payment is due. But if the payment is in dispute for a reason other than a change in the amount of rent and not received currently, the date the dispute is resolved and the amount becomes fixed may be used (<i>Consumption Tax Law Basic Circular</i> 9-1-20).
Interest	Accrual date, but non-financial enterprises may use the due date if the method is consistently applied (<i>Consumption Tax Law Basic Circular</i> 9-1-19).

Law: Art 15(2)(vii) of the *General Law of National Tax*

¶7-420 Instalment sales (Choki Kappu Hanbai — 長期割賦販売)

Year of sale

If an enterprise reports income from sales of inventory or services under the installment method provided under Art 65(1) of the *Income Tax Law* or Art 63(1) of the *Corporation Tax Law*, the amount which has not come due in the tax year is not treated as transferred in the current year, except to the extent payment is actually received (*Consumption Tax Law* Art 16(1)).

Subsequent years

The amount of any installment payments for sales of inventory or services which come due, or are actually received in a tax year after the year of sale, are treated as amounts received for transfers of inventory in that later year (*Consumption Tax Law* Art 16(2)).

Law: Art 16(1) and Art 16(2) of the *Consumption Tax Law*; Art 63(1) of the *Corporation Tax Law*; Art 65(1) of the *Income Tax Law*

¶7-430 Long-term construction contracts

If an enterprise reports income from long-term construction contracts under the percentage of completion method described in Art 66(1) of the *Income Tax Law* or Art 64(1) of the *Corporation Tax Law*, the enterprise may treat the revenue accounted for under that method as the amount of property transferred during the current tax year for purposes of the Consumption Tax (*Consumption Tax Law* Art 17(1)). In the year of completion, the amount that has previously been treated as property transferred is not treated as a transfer of property and may be deducted from the amount paid for that construction work (*Consumption Tax Law* Art 17(3)).

Law: Art 17(1) and Art 17(3) of the *Consumption Tax Law*; Art 64(1) of the *Corporation Tax Law*; Art 66(1) of the *Income Tax Law*

TAX BASIS (KAZEI HYOJUN — 課税標準)

¶7-500 Tax basis (Kazei Hyojun — 課税標準)

The tax basis is the amount upon which the Consumption Tax is determined when multiplied by the Consumption Tax rate. It is the amount paid in return for transfers of property or services (*Consumption Tax Law Art 28(1)*).

Payment

Payment for Consumption Tax purposes consists of the amount of money plus the value of other property or economic benefits received other than the national or local Consumption Tax (*Consumption Tax Law Art 28(1)*).

Transfer fees

Registration and licence fees paid on the transfer of property, such as the Motor Vehicle Tonnage Tax, Automobile Acquisition Tax, etc, are not included in the amount of payment subject to the Consumption Tax rights (*Consumption Tax Law Basic Circular 10-1-4*).

Value of other property

The value of other property received is the amount determined in the bargain among the parties and may not necessarily be the same as the usual market price (*Consumption Tax Law Basic Circular 10-1-8*).

Imported property

Payment for foreign property removed from a bonded area includes (*Consumption Tax Law Art 28(3)*):

- the value of the property determined under s 4 through 4-8 of the *Customs Tariff Law (Kanzei Teiritsu Ho, Law No 54 of 1910)* (usually the CIF price)
- indirect taxes on the property other than the Consumption Tax, including Liquor Tax, Tobacco Tax, Benzene Tax, Local Road Tax, LPG Tax and Petroleum Tax, and
- customs duties.

Transfers to officers

If a corporation transfers property to an officer as a gift, the market value will be considered the payment (*Consumption Tax Law Art 28(2)(ii)*).

Personal consumption

If a sole proprietor consumes or otherwise converts inventory or other property of an enterprise to personal use, the value of the property is treated as the amount of payment (*Consumption Tax Law Art 28(2)(i)*).

Transfers of taxable and non-taxable property

When taxable and non-taxable property are transferred together for a single price, and the price of the taxable and non-taxable properties cannot be separately determined, the total price is allocated to each based on their respective market values (*Consumption Tax Law Enforcement Order Art 45(3)*).

Indirect taxes

Indirect taxes on the property other than the Consumption Tax, including Liquor Tax, Tobacco Tax, Benzene Tax, Local Road Tax, LPG Tax and Petroleum Tax, are included as part of the payment. However, light oil delivery tax, golf course use tax and bathing tax are not included in the payment because they are paid by the consumers (*Consumption Tax Law Basic Circular 10-1-11*).

Withholding tax

If Income Tax withholding is required on the payment, the amount subject to Consumption Tax is determined before Income Tax Withholding (*Consumption Tax Law Basic Circular 10-1-13*).

Undetermined amounts

If the amount of the payment has not been determined by the end of the tax year, the amount should be estimated and any difference added to or subtracted from the tax base in the tax year when the amount is determined (*Consumption Tax Law Basic Circular 10-1-20*).

Law: Art 28(1), Art 28(2)(i), Art 28(2)(ii) and Art 28(3) of the *Consumption Tax Law*; Art 45(3) of the *Consumption Tax Law Enforcement Order*; s 4 to s 4-8 of the *Customs Tariff Law*

CREDIT FOR TAXABLE PURCHASES (SHIIRE ZEIGAKU KOJO — 仕入税額控除)

¶7-610 Introduction

If an enterprise other than a tax exempt enterprise (see ¶7-310) makes a taxable purchase in Japan or removes taxable goods from a bonded area, a credit for taxable purchases may be allowed against the Consumption Tax for the taxable year in which the transaction occurred. The amount of the credit is equal to the total Consumption Tax on those transactions (*Consumption Tax Law Art 30(1)*).

The Japanese Consumption Tax is a multi-step tax assessed at all levels of the commercial process. This section describes the credit system used to apportion the tax among the participating enterprises. In most industrialized countries, a credit-invoice method value-added tax (VAT) provides a credit to enterprises for all VAT paid on purchases of taxable goods and services used in the enterprise. The cumulative VAT at all stages of production and distribution is equal to the purchase price paid by the consumer multiplied by the tax rate (see ¶7-200). The credit ensures that the VAT paid at each stage is based on only the value added by that enterprise and prevents the imposition of multiple layers ("cascading") of tax summing to more than the tax based on the price charged to the consumer.

Japan's Consumption Tax works like a credit method VAT, but prior to the introduction of multiple rates, the regular 10% rate and the reduced 8% rate on food, drink, etc, Japan did not use an invoice system. Instead Japan required enterprises to either maintain books and records to support amounts claimed for the credit or to use a simplified system for estimating the credit.

Delay in increase of rate to 10%. Legislation to further delay the implementation of the 10% rate and the reduced 8% rate on food, drink, etc, was passed by the Diet in November 2016 and the rate increase to 10% is now scheduled to take effect on 1 October 2019 (*Law No 85 (national tax) and Law No 86 (local tax) of 2016, 28 November 2016*).