

- 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 co-operatives (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 globalisation. While the consumption tax is criticised as regressive in relation to income, it is neutral across economic activities and across generations.
- The rate of the consumption tax needs to be raised from the current 5% (see ¶7-200) to double-digit levels (similar to European value added tax levels) in order to fund increasing expenditures for public pensions and healthcare for the elderly (Note: European directives provide a standard rate of 15% or more for value added tax. As of April 2001, the rate was 21% in Belgium, 20% in Italy, 19.6% in France, 17.5% in the UK and 16% in Germany).
- To mitigate the regressive nature of a double-digit percentage consumption tax, lower rates will apply to a limited number of items, such as food.
- When differing rates of consumption tax apply, an invoice system will be needed in order to compute the credit for taxable purchases (see ¶7-611).

#### Inheritance and gift tax proposals

- The inheritance tax base should be expanded to reflect the diminishing role of families and the increasing role of society in providing care for the aged.



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

#### Income tax proposals

- Before implementation of a series of rate cuts in the late 1980s, the Income Tax accounted for 30% of national revenues and 25% of local revenues. The Income Tax should be restored to its position as a "main" tax by scaling back tax rate cuts and personal and special deductions and exemptions.
- The fixed rate reduction in Income Tax (see ¶3-280) should be repealed.
- Changes in social and living conditions in Japan have decreased the need for many existing income tax deductions and exemptions. Personal deductions and exemptions, other than the exemptions for the taxpayer, taxpayer's spouse, dependants and the disabled, should be streamlined or discontinued. (See ¶3-259 to ¶3-266.) The special deduction for spouse (see ¶3-265) was terminated beginning in 2005.
- The employment income deduction (see ¶3-235A) 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.)

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#### Inheritance and gift tax proposals

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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	1.9	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 10 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



- 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 summarised 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 for ways to facilitate the angel taxation system and to 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, authorised 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 ¥100 million 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 3 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.

## ¶1-126 The Tax Commission's 2008 Tax Reform Report

The Tax Commission's main conclusions regarding the outlook for Japanese tax reforms in 2008 were presented in a report issued in December 2007 and are summarised below.

### General principles

Drastic tax reform is an urgent policy need. The Tax Commission's overall examination addressed a mid-range approach to developing an ideal way for the tax system as a whole to correspond to the structural changes in the Japanese economy and society in the 21st century and looking at the role that each tax item plays. Time is running out on the need to develop solutions to the fiscal problems facing the social welfare system. It is therefore necessary to obtain a national consensus and implement a drastic tax reform as soon as possible.

Two major structural issues are of great concern. First, the declining birth rate and the super-ageing of society have resulted in a decline in population beginning 2005, while the "baby boom" generation will begin to qualify for pension benefits. Second is the impact of globalization. World markets are becoming integrated, and human resources and capital are transcending national borders, while international competition is putting great pressure on improving the way business is done.

In 2007, the proportion of tax revenue used for social security benefits, pensions, medical treatment, nursing, etc, reached 60% or more, and national and local debt reached ¥773 trillion (148% of gross domestic product). This made the tenability

of the social security system doubtful and people at all levels uneasy about the future. If a serious solution to this problem is not developed and the debt balance continues to increase, international confidence in Japan's economy might be lost.

Finding a solution through economic growth of the type seen during the period when Japan was catching up to the developed nations is not possible in the current competitive international circumstances. Japan is facing keen international competition in developing technological innovations.

### Specific directions for drastic reform

Tax reform should be based on the principles of fairness, neutrality and simplicity.

#### Individual income taxes

Previous tax reforms have raised the minimum income subject to tax and expanded the brackets in order to promote employment and industry. As a result, the burden of income tax in Japan is extremely low compared to other countries and personal income taxes have played a decreasing role as a source of government revenues in Japan. The income tax is also distorted by numerous special deductions. Drastic tax reform should consider the levels and range of tax brackets in conjunction with an examination of personal exemptions and deductions to reform the income tax base, including the amount of the top bracket, from the point of view of income redistribution. The replacement of various deductions with tax credits, including refundable credits for low income taxpayers, whose value does not vary with the taxpayer's tax bracket, should be considered in order to promote income redistribution.

#### Corporation taxes

In 2007, a restructuring of the depreciation system was accomplished as part of a reform of corporation taxes. Further reductions in the effective corporate tax rate are needed to provide a level playing field for enterprises facing international competition. Multinational corporations in many countries, including Germany, are sourcing income outside of the home country to reduce their domestic tax burdens. However, this reform must be preceded by other measures resulting in an expansion of the tax and an increase in the rate of value added tax. Expansion of the factor tax form of corporate enterprise tax should be considered.

#### International taxation

The principle of tax neutrality should be maintained in the international area. In the case of foreign tax credits, it is necessary to consider such factors as an increase of the foreign operations ratio and the amount of retained profit of an overseas branch in order to prevent credits that exceed the domestic tax liability.

#### Consumption Tax

The Consumption Tax is regressive in nature compared to the income tax, but it can also play a positive role in the redistribution of income. Continued



focus of support for dependants from deductions to allowances. The 2010 tax reforms revised the deduction for dependants in order to shift from an emphasis on deductions to allowances. An increase in the tobacco tax reflected an interest in the health of the people. In 2011, the corporation tax rate was reduced by 5% in order to promote international competitiveness and employment by, and investment in domestic corporations. Citizens' public interest taxation was also expanded to support the "new community" and taxpayers' interests were reflected in administrative changes, including clarifying and extending the period for a taxpayer to request a correction of taxes (更正の請求 – *kosei no seikyu*) and introducing procedures to clarify investigative procedures by the tax office.

Beginning in December 2010 and proceeding through 2011, the Government and ruling party has been engaged in developing a proposal for functional enhancement of the social security system while strengthening public finance.

### Taxation measures for realizing a new growth strategy

Tax measures are needed to implement the "new growth strategy" announced by the Cabinet on 18 June 2010, involving the promotion of environmental issues and demand for innovation to provide for a strong future and also to address the historically high level of the yen, the hollowing out of Japan's industry, promotion of domestic employment and revival from the earthquake disaster.

It is proposed that the temporary rate reductions for "eco-cars" in the Motor Vehicle Tonnage Tax (see ¶5-540) be continued and expanded for automobiles meeting environmentally friendly standards. Similarly, the research and development tax system's special provisions should be continued and tax incentives for environmentally related investments, such as renewable energy, should be expanded.

Incentives should be provided to promote the expansion of investment by medium- and small-sized companies that provide over half of the employment in Japan. Promotion of high quality housing stocks should be encouraged through the expansion and extension of gift tax exemptions for transfers of housing assets from older to younger persons and gift tax provisions for home acquisition funds related to energy saving and earthquake resistant housing.

### Securing an equitable tax system with a fair base though a review special tax measures

The trust of the people is important to the work of making major reforms in the tax system. In reviewing the special measures tax system, any "skewness" must be corrected and international consistency considered. Above all, special taxation measures and policy-based reductions in the tax burden are exceptions from the basic principle of tax equity and must be constantly reviewed in light of the changing times. These measures must be reviewed from the point of view of the current rationality of the underlying policies, their effectiveness

in achieving the policy purpose and the equivalence of alternative measures such as subsidies. In addition, advances in global tax collection should be pursued, including seeking international mutual assistance in tax collection and reaching assets located abroad. There also remains work to be done in resolving various issues arising under the new taxpayers' charter and the need for a common taxpayer identification number for the social security and tax systems.

### Improving the local tax system and promoting local autonomy

By promoting local autonomy, unevenness in sources of tax revenue should be reduced and tax collections should become more stable. In the 2012 tax reform proposals, under the rubric "Our Town's Exception", special provisions should be considered to implement local determination and tax burden reduction measures for the local tax system.

### Remaining items from the 2011 tax reform

The social security system needs functional enhancement and financial strengthening and, at the same time, the entire tax system, including income tax, corporation tax, consumption tax and fixed assets tax, needs to undergo a thorough reform-based examination. The 2011 tax reform legislation addressed the need for a corporation tax rate reduction (the effect of which was reduced for 3 years by a corporation income tax surtax to finance reconstruction following the Great Eastern Japan Earthquake), but other important tax reform issues were deferred. Tax reform in 2012 will have to take into consideration the adequacy of taxation in light of the severe financial circumstances facing Japan. One such issue is the need to limit the maximum amount of employment income deduction. Tax reform in 2012 should also consider taxes that address the problem of global warming in order to promote a livable environment for future generations.

### 2012 tax reform

Social security is the largest fiscal expenditure item in the Japanese budget (social security represents 29.2% of budgeted 2012 expenditures while debt service, the second largest expenditure item, constitutes 24% of the proposed budget) and is increasingly important due to anticipated growth in this expenditure due to further ageing of the population in the future. By establishing trust in the social security system, it will be possible to expand consumption by the people. However, it is not sustainable to continue shifting the burdens of the social security system to future generations.

Market concerns have been raised due to financial risks associated with the European debt crisis, so governmental financial strictness and financial strengthening in Japan are unavoidable. In these circumstances, a definite plan was drawn up in June 2011 to address a joint reform of the taxation and social security systems, and was followed up by cabinet decisions setting out policy in this area later in 2011. Tax reform proposals for 2012 reflect an effort to realize the goal of a significant reform of the tax system in combination with these overall issues.



In addition, the low birthrate and ageing population give rise to medium- and long-term fiscal problems including uneven resources within and among generations and the need to stabilize local tax revenues. The 2013 reforms of the Consumption Tax and reforms of funding for social security were indispensable steps in dealing with these issues. New taxation measures will be based on changes in the society from within and without and reflecting the ability to bear taxes.

Change in the industrial structure and business environment requires an examination of the corporate tax burden of the company, reduction in the corporation effective tax rate and abolishment of the Special Reconstruction Corporation Tax a year earlier than scheduled and implementation of other corporation tax incentives.

Other tax initiatives include introduction of a Local Corporation Tax in connection with reduction of local Inhabitant Tax rates and reduction of the maximum employment income deduction.

### ¶1-133 2015 Tax Reform Report

Tax reform legislation for 2015 is focused on shifting away from deflation toward economic revitalisation. To accomplish this, legislation will include corporate tax reform designed to stimulate growth. Specifically, the effective corporate tax rate will be reduced in 2 stages from the current 34.62% to 32.11% in 2015 and 31.33% in 2016. The corporate tax base will be broadened by reducing loss carryforwards, decreasing the deduction for dividends received from some less than 100% owned corporations, and increasing the portion of the factor-based enterprise tax based on capital and value added from the current 25% to 50% over 2 years.

To assist in economic revitalization, the implementation date of the Consumption Tax rate hike to 10% will be delayed until 1 April 2017 and the tax will be extended to cover cross-border supplies of electric commerce.

A Junior NISA (Nihon Individual Savings Account) program will be started enabling persons less than 20 years of age to open tax-exempt investment accounts.

An exit tax will be implemented assessing a capital gains tax on financial assets when a resident of Japan departs from Japan (becomes a non-resident) or transfers assets to a non-resident of Japan.

Measures will also be taken to invigorate the housing market through early transfer of assets from older to younger generations and to support marriage and childcare and to improve business facilities of local businesses.

### ¶1-134 2016 Tax Reform Report

Tax reform legislation for 2016 continues the focus on shifting away from deflation towards economic revitalization. Specific topics addressed in 2016 tax reform legislation include the following:

- (1) Growth-oriented corporation tax reform including moving the effective corporation tax rate below 30%.

- (2) Promotion of global investment and economic exchange.
- (3) Support for capital spending by local medium- and small-sized businesses.
- (4) Review of the personal income tax to reduce barriers to working choices for mothers in view of the declining birthrate.
- (5) Social security tax-related measures, including measures to promote individuals to switch from prescription drugs to over-the-counter medicines.
- (6) Addressing uneven distribution of local corporation taxes.
- (7) Introduction of a Consumption Tax multiple tax rate system providing reduced rates for food and drinks, etc, along with other measures accompanying the increase in the standard rate to 10% on 1 April 2017 (on 1 June 2016, Prime Minister Abe announced that he will seek legislation to postpone the increase to a rate of 10% until 1 October 2019).
- (8) Elimination of the automobile acquisition tax.
- (9) Improvements in procedures for tax payments including use of the "My Number" system and electronic processing (eTAX).

### ¶1-135 2017 Tax Reform Report

On February 2017, the Ministry of Finance released a draft of tax reform legislation for 2017 (*Shotokuzeiho nado no Ichibu wo Gaiseisuru nado no Horitsuan – 所得税法等の一部を改正する等の法律案*). Main points of the draft include the following:

- (1) Increase in the upper limit of income allowed for purposes of qualifying for the spousal deduction (see ¶3-265).
- (2) A new type of NISA (Japanese Individual Savings Account) tax deferred account will be established allowing savers the option of investing each year up to ¥400,000 with a 20-year tax deferral period (see ¶3-232 and ¶3-330).
- (3) Limitations on use of the business succession tax system for deferring Inheritance Tax on closely held business stock will be relaxed by eliminating the requirements for successor companies that they may only be small- and medium-sized unlisted companies (see ¶6-511). In addition, the employment security requirement in the business succession tax system will be relaxed for companies that have been affected by natural disasters.
- (4) An heir who has Japanese nationality but who is without a domicile in Japan and who receives property located outside of Japan from a donor or deceased person will be subject to Japanese Inheritance Tax or Gift Tax if either that person or the donor/decedent had a domicile in Japan within 10 years (formerly 5 years) before the date of the gift or inheritance (see ¶6-110). Also, persons who do not have Japanese nationality who by gift or inheritance receive property located outside of Japan from a person who has had a domicile in Japan within 10 years before the date of the gift or inheritance will be subject to Japanese Inheritance Tax or Gift Tax on the transfer of property.



### Commuter allowance (*tsūkin teate* – 通勤手当)

Commuting cost allowances and commuting tickets provided to employees and directors by employers may be excluded from income up to certain limits (ITL Art 9(5)):

- **Train or bus expense.** Allowances or tickets for use on trains or buses are tax free to an employee up to a maximum of ¥150,000 per month (¥100,000 per month prior to 1 January 2016). The commute must be by the most direct and economical route. For example, commuting by *Shinkansen* (bullet train) is included but would not include the extra cost to use the Japan Rail Green Cars.
- **Use of personal automobile or bicycle.** Allowances for use of personal automobiles or bicycles are limited based on the one-way mileage of the daily commute according to the following table (ITL-EO Art 20-2).

Table 4: Limit on allowance for personal automobile or bicycle (1 April 2014 and after)

Commuting distance	Monthly limit
Less than 2 km	No allowance
2 km or more, but less than 10 km	¥4,200
10 km or more, but less than 15 km	¥7,100
15 km or more, but less than 25 km	¥12,900
25 km or more, but less than 35 km	¥18,700
35 km or more, but less than 45 km	¥24,400
45 km or more, but less than 55 km	¥28,000
55 km or more	¥31,600

Source: National Tax Agency, April 2021.

### Employer paid education and training costs (*shiyōnin naō ni kyūfu sareru gakushi-kin* – 使用人等に給付される学資金)

An employee or director may exclude from salary certain costs paid by an employer to acquire work-related skills and knowledge. Provided the skills and knowledge are directly related to the work, costs may be incurred for individual study, for study at institutes to obtain licences and other qualifications, and for study at universities (ITL Art 9(1)(xv); ITL Basic Circular 9-15).

### Commemorative items and service awards

Items to commemorate long service of employees or anniversaries of the company may be excluded from income under certain conditions. Items commemorating anniversaries of the company must be commemorative items in the normal sense, i.e. each item must not have a cost greater than ¥10,000, and must not commemorate periods less than 5 years (ITL Basic Circular 36-22). Service awards may be in the form of a commemorative item, or arrangements for travel or attendance at

theatres. The service period should be at least 10 years, and at least 5 years should pass between awards to the same person (ITL Basic Circular 36-21). If the conditions for commemorative items and service awards are not met, or if cash is given in lieu of a commemorative or award item, the value is treated as salary income.

### Meals provided to employees

The value of meals provided by employers to employees or directors may be excluded from the recipient's income if the employee or director bears at least half the cost of the meals and the excess of the value of the meals provided in a month over the cost borne by the employee or director does not exceed ¥3,500 (ITL Basic Circular 36-38-2). The value of meals is the cost paid to an outside provider or the direct costs of the meals to the employer, such as the costs of materials and seasonings, if the meals are provided in an employee dining facility (ITL Basic Circular 36-38). Meals provided during overtime work, night watch or day duty (*nichoku* 日直) may be excluded from salary income (ITL Basic Circular 36-24).

### Company provided housing

The value of housing provided to an employee by a company may be excluded from salary if the employee pays a certain amount of rent each month. The basic rent in this case is calculated as the total of the following 3 items:

- 2% of the basis of the building for purposes of the Fixed Assets Tax (*Kotei Shisan Zei* 固定資産税)
- $$¥12 \times \frac{\text{Total floor space of the building (sq meters)}}{3.3 \text{ sq meters}}$$
- And
- taxable basis of the ground site of the building for purposes of the  $\times 0.22\%$  Fixed Assets Tax

If the employee receives the housing free of charge, the basic rent is included in salary. If the employee pays a low rent, the difference between the rent paid and the basic rent is included in salary. However, no amount is included in salary if the rent paid by the employee is at least half of the basic rent (ITL Basic Circular 36-47) or if the housing is required due to the nature of the employment, such as for a nurse or security guard.

### Employee travel for recreation or training

The value of company sponsored travel for recreation may be excluded from salary if the trip is not more than 4 nights and 5 days and at least half the number of employees in the company, factory or office take part in the trip. Travel for training directly related to the company's business is not included in salary but, if the travel is part business-related and part personal in nature, the portion of the travel costs applicable to the personal travel is included in salary.



### Low interest loans

If a company provides a loan to an employee or director, bearing a rate of interest less than 4.1%, the difference between the rate of interest paid by the employee or director and 4.1% is treated as salary income (ITL Basic Circulars 36-15(3), 36-49). However, no salary income is imputed if the loan is for an emergency or if the interest rate is considered reasonable or if the amount of forgiven interest is less than ¥5,000 per year (ITL Basic Circular 36-28). If a company borrows the funds lent to the employee or director, any excess of the rate of interest paid by the company and that is charged to the employee or director gives rise to salary income without regard to whether the rate charged is less than 4.1%.

### ¶3-235B Stock options (*Hakkō hōjin kara atae rareta kabushiki o shutoku suru kenri no jōto ni yoru shūnyū kingaku* – 発行法人から与えられた株式を取得する権利の譲渡による収入金額)

The *Special Taxation Measures Law* was amended in 1998 to allow Japanese stock companies to issue tax-free stock options to employees and directors. Pursuant to 2019 legislation, highly qualified persons other than employees and directors engaged by a company with respect to a new business field development plan, certified under the Law for Strengthening Management of Small- and Medium-sized Businesses, etc (*Chūshōkigō-tō keiei kyōka-hō* 中小企業等経営強化法, Law No 18 of 1999) may also receive tax-free options.

**Non-qualified options** (*zeisei hi tekikaku sutokku opushon* – 税制非適格ストック・オプション). Non-qualified options are not taxed when issued, but the excess of the value of the option over the amount paid for the option is generally taxed as salary income at time of exercise (ITL-EO Art 84; ITL Basic Circular 23~35-6). Any gain on sale of the underlying security is taxed as capital gains at the time of transfer.

**Qualified options** (*zeisei tekikaku sutokku opushon* – 税制適格ストック・オプション). If the option qualifies, there is no Income Tax or Inhabitants Tax at the time the option is issued or exercised and the sale of the stock is taxed as separate assessment income at the rate applicable to stock sales (STML Art 29-2; STML-EO Art 19-3). Gain on the sale of the stock is calculated as the amount realised on the sale less the option's paid-in price (strike price).

Qualified options may not be exercised within 2 years of the date of the shareholder's resolution authorizing the option or later than 10 years from the date of the resolution (STML Art 29-2(1)(i)). The amount of options exercised by any employee in a year may not exceed ¥12 million (STML Art 29-2(1)(ii)). The exercise price may not be less than the fair value of the stock at the time of grant (STML Art 29-2(1)(iii)). Qualified options may not be issued to any person who owns, directly or indirectly at the time of grant, 10% or more of the company stock (one-third or more if the company is not listed or traded over-the-counter) (STML-EO Art 19-3(3)).

The legislation in 2012 requires that a report (*Gaikoku oyagaisha-tō ga kokunai no yakuin'nado ni kyōyo-tō o shita keizai-teki rieki ni kansuru chōsho* – 外国親会社等が国内の役員等に供与等をした経済的利益に関する調書) be filed by the Japanese company by 31 March of the year following payment of stock-based compensation or the exercise of stock options by a Japanese resident who is an officer or employee of a Japanese company at least 50% owned by a foreign corporation that granted the option or paid the compensation (or the Japanese branch of such a foreign corporation) (ITL Art 228-3-2). The legislation in 2016 expanded the reporting requirement to include stock-based compensation of officers or employees of a Japanese subsidiary or branch of a foreign company who are Japanese residents or who are non-residents of Japan but whose stock-based income is sourced in Japan.

Effective for transfers on or after 1 April 2014, if stock options are transferred back to the issuing company, any gain arising to the transferor from the transfer is not treated as capital gains but instead is treated as business income, employment income, retirement income, occasional income or miscellaneous income (ITL Art 41-2; 2014 Income Tax Reform Act Supplementary Provisions Art 5).

**Qualified stock options issued by start-up companies.** The exercise period for qualified stock options issued by start-up companies is extended to 15 years by legislation in 2023. For start-up companies, qualified options may not be exercised within years of the date of the shareholder's resolution authorizing the option or later than 15 years from the date of the resolution (STML Art 29-2). A start-up company for this purpose is one that has been established for less than 5 years as of the date of the option grant resolution and is not listed on a financial exchange.

**Law:** Art 2(1)(xv) of the *Corporation Tax Law*; Art 9, Art 9(5), Art 28(1), Art 28(2), Art 28(3), Art 36, Art 57-2, Art 57-2(3), Art 57-2(4) and Art 228-3-2 of the *Income Tax Law*; Art 29 and Art 29-2 of the *Special Taxation Measures Law*; Art 20-2 and Art 167-5 of the *Income Tax Law Enforcement Order*; Art 19-2 of the *Special Taxation Measures Law Enforcement Order*; Art 11-2 of the *Special Taxation Measures Law Enforcement Regulations*

### ¶3-236A Capital gains (*jōto shotoku* – 譲渡所得)

Capital gains arise from transfers of property (ITL Art 33). Capital gains income does not include income from transfers of inventory, forest property or property continuously transferred in business.

**Method of calculating capital gains income (*jōto shotoku no kingaku* – 譲渡所得の金額)**

Capital gains profit is equal to the excess of the short-term capital gains proceeds over the basis of the property transferred and costs of the transaction plus the excess of the long-term capital gains proceeds over the basis of the property transferred and costs of the transaction (ITL Art 33(3)). Capital gains income is equal to the capital gains profit less the special deduction amount (ITL Art 33(3), Art 33(4)).



### ¶3-236B Special "angel taxation" for sales of stocks of qualified ventures (*enjiru zeisei* — エンジェル税制)

The "angel taxation" system provides tax incentives for investments in small and medium-sized enterprises (SMEs) described in the *Temporary Measures Law for the Promotion of the Creative Business Activity of Small and Medium-Sized Enterprises* (Law No 47, 1995).

To qualify for special taxation, the company must have been established within the last 10 years. It also must have incurred minimum levels of expenditure on research and market development, etc (more than 3% of revenues for companies in their first 5 years and more than 5% thereafter). During its first year, the number of persons engaged in research, etc, in a qualified company must be at least 2 persons and comprise at least 10% of the total number of employees. At the time of the investment, at least one-sixth of the stock of the qualified company must be held by persons who are not members of related stockholders groups. A related stockholder group is a shareholder and persons or corporations with a special relationship to that shareholder who own at least 30% of the company. The qualified company may not be a listed company, a company registered to be traded over-the-counter, or a company owned directly or indirectly 50% or more by a company with capital of ¥100 million or more.

Beginning 1 April 2004, the scope of qualified companies was increased to include investments in stock through the Japan Securities Dealers Association (JSDB) "green sheet market" of unlisted emerging companies and investments through certain investment business limited partnerships (*toshi jigyo yugen sekinin kumiai* (STML Art 37-13)).

Tax benefits available to investors under the angel taxation system include the following:

- Qualified investments by individuals may be deducted from taxable gains on stocks realised in the year of the qualified investment (STML Art 37-13).
- If qualified stocks are held for more than 3 years and then transferred within 3 years following the listing of the stock on a securities market (or transferred pursuant to a merger or acquisition before such a listing), only one-fourth of the gain is taxed (one-half of the regular one-half of gains from stocks that are taxed as capital gains) (STML Art 37-13-3). This gain reduction rule was scheduled to expire on 31 March 2007, but has been extended to 31 March 2009.
- Losses from transfers of qualified stocks before the stock is listed may be carried over for 3 years if the loss is reported on a tax return in the year incurred (STML Art 37-13-2).

Under the 2007 legislation, the angel taxation system rules specifying required numbers of research personnel and expenditures on research are relaxed. Under the new rules, the number of persons engaged in research or development and

persons responsible for marketing, etc, in a qualified company must be at least 2 persons and comprise at least 10% of the total number of employees. In years 2 through 5, the annual rate of growth of sales must be at least 25% (calculated as the percentage change from the second prior year to the prior year or the average change from inception through the prior year).

Table 5: Angel taxation system: Number of persons required to be engaged in research, etc

Angel taxation system: Number of persons required to be engaged in research, etc		
Years since establishment of the company	Before 2007 amendments	After 2007 amendments
Less than 1 year	At least 2 persons and at least 10% of the total number of employees are engaged in research	At least 2 persons and at least 10% of the total number of employees are engaged in research or development, or are persons responsible for marketing, etc
At least 1 year, but less than 2 years	Expenditure for research constitutes more than 3% of sales revenues	Same as above
At least 2 years, but less than 5 years	Same as above	The annual rate of growth of sales must be at least 25%

#### Revision of angel taxation system

Under the 2008 legislation, beginning 1 April 2008, the gain reduction provision of the existing angel taxation system that provides for taxation on only half of the otherwise taxable capital gains from stocks has been terminated (former STML Art 37-13-3). The other provisions regarding the carryover of losses and deduction of qualified investments from capital gains on stocks realised in the year of investment are retained (2008 Tax Reform Act Supplementary Provisions Art 48).

A new provision effective 1 April 2008 has been put in place for a deduction against ordinary income (*sōshotoku kingaku* — 総所得金額) for the amount of an investment in the current year in a venture designated by the Ministry of Economy, Trade and Industry. The amount of the investment is reduced by ¥5,000 in computing the deduction and the maximum amount of the deduction is limited to the lesser of 40% of ordinary income or ¥10 million (¥8 million for tax years beginning after 2020) (STML Art 41-19). The cost basis of the stock received must be reduced by the amount of the deduction (STML Art 41-19). The taxpayer may elect to use either the existing provision for deduction of the investment from capital gains or the new provision allowing a deduction against ordinary income. This provision is designed to provide an investment incentive to persons who may not be able to benefit from the existing deduction against capital gains. A designated venture for this purpose will be an SME that is either in its first year since establishment or is in its second or third year and has experienced negative



Persons subject to the Tax on Overseas Transfer. A resident of Japan is subject to the Tax on Overseas Transfer if both of the following requirements are satisfied:

- (1) The resident owns at least ¥100 million of financial assets as of the date of departure from Japan.
- (2) The resident had a domicile (*jūsho* – 住所) or residence (*idokoro* – 居所) in Japan (see ¶2-220) for time periods totalling at least 5 years during the 10 years preceding the departure from Japan.

Exception for foreign residents of Japan. Time spent in Japan by a foreign resident in one of the visa statuses listed in the Appended Table I of the Immigration Control and Refugee Recognition Law (Cabinet Order No 319 of 1951) does not count as time spent in Japan for purposes of the 5 year test described in (2) above. These visa statuses are:

- (1) Diplomat, Official, Professor, Artist, Religious Activities, Journalist
- (2) Highly Skilled Professional, Investor/Business Manager, Legal/Accounting Services, Medical Services,  
Researcher, Instructor, Engineer, Specialist in Humanities/International Services,  
Intra-company Transferee, Entertainer, Skilled Labour and Technical Intern Training
- (3) Cultural Activities, Temporary Visitor
- (4) College Student, Pre-college Student, Trainee, Dependent
- (5) Designated Activities.

Target financial assets. Financial assets subject to the Tax on Overseas Transfer include securities described in the Income Tax Law, interests in a Commercial Code anonymous association (*tokumei kumiai* – 匿名組合) (see ¶2-400), and non-settled derivative, margin, or hedging trades. Beginning in 2016, stock options producing income sourced in Japan are not subject to the Tax on Overseas Transfer.

Timing of taxation. The Tax on Overseas Transfer is imposed as of the time of departure from Japan. If a tax payment administrator is designated before the date of departure, the tax is based on the value of the financial assets as of the date of departure. Otherwise the tax is based on the value of the financial assets as of the date 3 months prior to the date of departure.

Grace period. A grace period for payment of the tax (*yūyo* – 猶予) (see ¶8-212) is available for 5 years, with extensions upon application for up to 10 years, if the resident provides the tax office with security equal to the amount of the tax and maintains within Japan a tax payment administrator (ITL Art 137-2, Art 137-3). The tax becomes due 4 months following the expiration of the grace period. If the value of the assets has declined during the grace period, a reduction in the tax due may be obtained by filing a request for correction (*kōsei no seikyū* – 更正の請求) (see ¶8-213). If some or all of the financial assets subject to the Tax on Overseas Transfer are disposed of during the grace period, the portion of the Tax on Overseas

Transfer attributable to the assets disposed of becomes due. If the amount realised from the disposition is less than the value of the assets at the date of departure, the tax may be reduced by filing a request for correction. A foreign tax credit is available in Japan for foreign taxes arising from a disposition subject to the Japanese Tax on Overseas Transfer.

Return to Japan. If the resident returns to Japan within 5 years from the date of departure without disposing of the financial assets previously subject to the Tax on Overseas Transfer, the resident may apply for a refund by filing a request for correction.

Double taxation relief. A foreign tax credit is available in Japan for foreign taxes arising from a disposition subject to the Japanese Tax on Overseas Transfer. If financial assets subject to the Tax on Overseas Transfer have previously been subject to a foreign Tax on Overseas Transfer, the foreign tax is added to the cost basis of the assets for purposes of determining the gain subject to Japanese Income Tax.

Inheritance and gift taxes. If a resident of Japan subject to the Tax on Overseas Transfer disposes of financial assets by gift, inheritance or bequest to a non-resident of Japan, the Tax on Overseas Transfer becomes due on the date of the transfer without regard as to whether the transferor has left Japan.

See also ¶9-242 – Declaration of overseas assets.

### ¶3-238 Occasional income (*ichiji shotoku* – 一時所得)

Occasional income is income of a non-recurring nature which is not derived from services or labour or from transfers of assets and is not included in any of the other categories of aggregate assessment income (ie is not interest, dividends, lease income, business income, employee compensation, retirement income, forestry income or capital gains) (ITL Art 34). Examples of occasional income include:

- prizes wagering and lottery income
- returns from horse racing and bicycle racing other than as a continuous enterprise
- lump-sum payments of life insurance (other than business related) and refunds of casualty insurance at maturity
- money and goods received as gifts from corporations (other than business related or those received continuously), and
- rewards for finding lost articles.

#### Calculation of occasional income (ITL Art 34(2), Art 34(3))

$$\text{Occasional income} = \text{Amount received} - \text{Costs expended to obtain the income} - \text{Special deduction (maximum ¥500,000)}$$



### Taxation of occasional income

Only one-half of occasional income is included with the other categories of aggregate assessment income when the tax on aggregate assessment income is computed (ITL Art 22(2)(ii)). However, aggregate assessment income taxation is not available for occasional income that is subject to withholding at source at a rate of 20.315% (15.315% national tax [which includes the Special Reconstruction Income Tax 0.315%] and 5% local tax), including deposits and savings associated with prizes and marginal profits arising from lump-sum insurance payments (STML Art 41-9).

**Law:** Art 22(2)(ii), Art 34, Art 34(2) and (3) of the *Income Tax Law*

### ¶3-239 Miscellaneous income (*zasshotoku* – 雑所得)

Miscellaneous income consists of income not included in any other category of aggregate assessment income and includes:

- amounts received as public or private pensions and annuities
- manuscript fees and royalties received by persons other than professional authors
- lecture fees, and
- broadcasting gratuities.

For tax years beginning in 2022 and later, taxpayers who have reported more than ¥10 million of miscellaneous income in the second prior year must attach a statement of miscellaneous income and expense to the tax return. Taxpayers who have reported more than ¥3 million of miscellaneous income in the second prior year must maintain records of receipts and disbursements (ITL Art 232). Taxpayers who have reported not more than ¥3 million of miscellaneous income in the second prior year may use the cash receipts and disbursements method for accounting for miscellaneous income (ITL Art 67).

#### Calculation of miscellaneous income (ITL Art 35(2))

$$\begin{array}{rcl} \text{Miscellaneous} & & \text{Public pension income} \\ \text{income} & = & \text{less the public pension} \\ & & \text{deduction} \\ & & + \\ & & \text{Miscellaneous income other} \\ & & \text{than public pensions less} \\ & & \text{necessary expenses} \end{array}$$

#### Public pension deduction (*kōteki nenkin tō kōjo* – 公的年金等控除)

Public pensions are generally pensions received under the provisions of the National Pension Law, Employees' Pension Insurance Law, Mutual Aid Association Law for Civil Servants, etc, pensions paid by companies for prior service and pensions based on systems of insurance or mutual aid based on foreign laws and regulations which are similar to those in Japan.

The amount of the public pension included in miscellaneous income (*kōteki nenkin-tō ni kakaru zasshotoku* – 公的年金等に係る雑所得) is reduced by the

amount of the public pension deduction, which is based on the amount of the pension received and the age of the recipient, according to the following table (ITL Art 35(4); STML Art 41-15-3(1)).

Table 7: Calculation of amount of public pension deduction

Recipient's age	(a) Amount of pension received is at least:	Deduction is sum of (b) and (c)	
		(b) % of pension received	(c) plus fixed amount (The notes (1), (2) & (3) are applicable beginning in 2020: (1) If total income amount ( <i>gōkei shotoku kingaku</i> – 合計所得金額) other than the amount of the public pension included in miscellaneous income does not exceed ¥10m. (2) If total income amount exceeds ¥10m but does not exceed ¥20m. (3) If total income amount exceeds ¥20m.
Under 65	Below ¥1.3m	¥700,000 (limited to pension income) (1) ¥600,000 (2) ¥500,000 (3) ¥400,000	
	¥1.3m, but less than ¥4.1m	25%	¥375,000 (1) ¥275,000 (2) ¥175,000 (3) ¥75,000
	¥4.1m, but less than ¥7.7m	15%	¥785,000 (1) ¥685,000 (2) ¥585,000 (3) ¥485,000
	¥7.7m or more	5%	¥1,555,000 (1) ¥1,455,000 (limited to ¥1,955,000) (2) ¥1,355,000 (limited to ¥1,855,000) (3) ¥1,255,000 (limited to ¥1,755,000)
65 or over	Below ¥3.3m	¥1,200,000 (limited to pension income) (1) ¥1,100,000 (2) ¥1,000,000 (3) ¥900,000	
	¥3.3m, but less than ¥4.1m	25%	¥375,000 (1) ¥275,000 (2) ¥175,000 (3) ¥75,000



(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 contracts (*chōki ōkibo kōji* – 長期大規模工事)

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

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 (*Uketori haitō* – 受取配当)

Dividends received by a domestic Japanese corporation from other Japanese domestic corporations (other than public interest corporations or non-judicial 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%

#### Reduction in book value of stock after dividends received (*kogaisha kabushiki hōka gengaku tokurei* – 子会社株式簿価減額特例)

2020 tax legislation effective for dividends received in tax years beginning on or after 1 April 2020 provides rules to prevent tax avoidance that can occur when subsidiary shares are transferred at a loss after dividends are received. Targeted dividends are those received during the tax year from a specially related subsidiary. If targeted dividends exceed 10% of the book value of the stock on which the dividends were paid, the book value of that stock will be reduced by the amount of the dividend excluded under the dividend exclusion rule (CTL-EO ART 119-3, ART 119-4).

**Specially related subsidiary.** A specially related subsidiary for this purpose is a corporation whose stock or voting rights is owned directly or indirectly at least 50% by the taxpayer or persons specially related to the taxpayer.

**Non-targeted dividends.** The following dividends are not treated as targeted dividends:

- 1) Dividends from a specially related subsidiary that is an ordinary domestic corporation (*naikoku futsū hōjin* – 内国普通法人) (see ¶2-310) whose stock has been continuously owned from the time of incorporation through the time it became a specially related subsidiary at least 90% by other ordinary domestic corporations, Japanese cooperatives, etc, or Japanese resident individuals.
- 2) Dividends from a specially related subsidiary if (a)+(d)-(b) ≥ (c) + (e):
  - (a) Amount of retained earnings recorded on the balance sheet of the specially related subsidiary for the last tax year ended before the resolution date, etc of the dividends.
  - (b) The total amount of dividends received from the specially related subsidiary by the shareholders from the day following the end of the



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)).

#### Acts of concealment (*inpei kasōkōi* – 隠蔽仮装行為)

Effective for tax years beginning on or after 1 January 2023, if a corporation files a final tax return containing an act of concealment of costs or fails to file a final tax return, the cost of sales and amount of expenses such as selling, general and administrative expenses and loss amount for the fiscal year related to that final tax return will not be allowed unless they can be substantiated through records maintained by the taxpayer (exceptions apply in the case of a disaster or other unavoidable cases) or the relevant transaction can be verified through an examination by the tax office of the other side to the transaction (CTL Art 55). This rule does not apply to the direct costs of assets obtained for sale or transfer.

**Law:** Art 29(1) of the *Corporation Tax 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 (*hōshū* – 報酬), bonuses (*shōyō* – 賞与) or retirement payments (*taishoku kyūyo* – 退職給与). 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).

#### Incentive-based compensation (*gyōseki rendō kyūyo* – 業績連動給与) (CTL Art 34)

When incentive-based compensation is determined by a company's compensation committee, executive officers (*gyōmu shikkō yakuin* – 業務執行役員) may not participate in the decisions of that committee affecting their own compensation. A majority of the compensation committee must consist of independent outside directors when incentive-based compensation is considered, and all of these independent outside directors must approve decisions regarding incentive-based compensation.

#### 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 one month after the end of the period	Period in which the announcement is made
Others	Period when paid

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



## ¶4-430 Officers' compensation

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

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

### Officers' salary (*hōshū* – 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). 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 (*shōyo* – 賞与)

**Pre-2006 rules.** Officers' bonuses (*shōyo*) 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 (*gyōseki rendō kyūyo* – 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 rendō kyūyo* – 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 (STML Art 66-11-2, Art 68-95-2).

- (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 3 months from the beginning of the accounting year (4 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.

#### Specified investment managers (*tokutei tōshi un'yō gyōsha* – 特定投資運用業者)

A specified investment manager is a company that derives at least 75% of its revenues from investment management business such as financial instruments business operators, special businesses for qualified institutional investors, etc., or special business for overseas investors. A specified investment manager that does not ordinarily file securities reports may, in tax years beginning on or after 1 April 2021 but not after 31 March 2026, satisfy the requirement described in (5) above, by disclosing the required information on the website provided by the Financial Services Agency (STML Art 66-11-2, Art 68-95-2).

#### Restricted shares (*jōto seigen-tsuki 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 (*tokushu shihai dōzokugaisha no yakuin kyūyo* – 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 (*gyōmu shusai yakuin* – 業務主権役員) of a specially controlled family corporation ("individually owned company")

could not be deducted in computing taxable income to the extent it exceeds ¥6 million (¥8 million 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 ¶3-235A) 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 (*shōkyaku-hi* – 償却費)

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

#### ¶4-441 Acquisition cost of depreciable assets (*gankashōkyaku shisan no shutoku kagaku* – 減価償却資産の取得価額)

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 that extend the useful life or enhance the value of the property are included in the acquisition cost (CTL Basic Circulars 7-8-1-6).



**Law:** Art 2(1)(xiv), Art 9(1), Art 9(2), Art 9(2)(ii), Art 9(4), Art 9(5), Art 9(6), Art 12-2, Art 12-3, Art 12-4 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 enterprise

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 ¥10 million (¥30 million before 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 ¥10 million (¥30 million before 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 2 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 ¥10 million (¥30 million before 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 2 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 3-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).

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

## ¶7-312 Special rules for corporate mergers

**Mergers:** amalgamation by absorption (*kyūshū 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 (Former Commercial Code (*Shōhō* – 商法 Law No 48 of 1899) Art 409).

### Merger in the current year

If the transferee (merging) corporation in a merger has not more than ¥10 million (¥30 million before 1 April 2004) of taxable sales during the base period and the transferor (merged) corporation has more than ¥10 million (¥30 million before 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 ¥10 million (¥30 million before 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 (Former Commercial Code Art 410).

### Incorporation in the current year

If any of the transferor (merged) corporations have more than ¥10 million (¥30 million before 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 2 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 ¥10 million (¥30 million before 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 ¥10 million (¥30 million before 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 Former Commercial Code; Art 11(1), Art 11(2), Art 11(3) and Art 11(4) of the *Consumption Tax Law*.



October 2023 may specify a desired effective date of registration if that date is at least 15 days after the registration application is submitted. A request to cancel a registration must be submitted by 15 days before the start of the following tax period.

Contents of a qualified invoice. A qualified invoice will include:

- name and registration number of the qualified invoice issuer
- date of the transfer
- contents of the property or service transferred (including any items eligible for the reduced tax rate)
- tax-inclusive or tax-exclusive amount of the transfers and applicable tax and tax rates. A qualified simplified invoice may include only the applicable tax rates for the items
- amount of Consumption Tax
- name of the recipient of the qualified invoice. The name may be omitted in a qualified simplified invoice.

Table 6: Schedule of enforcement of invoice system rules

	Until 30 September 2019	1 October 2019 to 30 September 2023	Beginning 1 October 2023
Tax rate	8%	10% regular rate and 8% reduced rate	
Invoice system	Pre-invoice system of maintaining invoice records ( <i>seikyū-sho-tō hozon hōshiki</i> – 請求書等保存方式)	Categorised invoice maintenance system (simplified system) ( <i>kubun kisai seikyū-sho-tō hozon hōshiki</i> – 区分記載請求書等保存方式)	Qualified invoice maintenance system ( <i>tekikaku seikyū-sho-tō hozon hōshiki</i> – 適格請求書等保存方式)
Calculation of tax	Taxable purchases multiplied by the tax rate ( <i>warimodoshi keisan</i> – 割戻し計算) (see ¶7-613)	Either the previously allowed taxable purchases method ( <i>warimodoshi keisan</i> – 割戻し計算) or a calculation based on the accumulated taxes included in qualified invoices, etc ( <i>tsumiage keisan</i> – 積上げ計算)	
Invoice content requirements	Name of issuer and receiver, date of transaction and description and value of items (tax included)	Additionally, categorised items by applicable tax rate	Additionally, registration number and tax rate categorised items and tax

	Until 30 September 2019	1 October 2019 to 30 September 2023	Beginning 1 October 2023
Tax rate	8%	10% regular rate and 8% reduced rate	
Duty of the invoice issuer	No particular duty (current system)		Duty to issue invoice
Requirements to qualify for the credit for taxable purchases	Pre-invoice system of maintaining invoice records		Qualified invoice maintenance system
Special procedures for calculating tax on sales		Simplified calculation of sales by tax rate (みなし計算)	
Special procedures for calculating tax on purchases	Simplified tax system (see ¶7-620)	Simplified calculation of purchases by tax rate (みなし計算) The simplified tax system may be elected after the fact	

Compliance with the invoice system rules is necessary in order to qualify for the credit for taxable purchases. An invoice system requires enterprises to maintain copies of tax invoices for all purchased inputs in order to claim the credit. Maintenance of at least one of the following documents is required in order to be eligible for the credit.

- 1 A qualified invoice (*tekikaku seikyū-sho* – 適格請求書)
- 2 A qualified simplified invoice (*tekikaku kan'i seikyū-sho* – 適格簡易請求書)
- 3 An electronic record of a qualified invoice
- 4 Documents containing the information that would be included in a qualified invoice that have been authorised by a qualified invoice issuer
- 5 Documents received from an intermediary or agent in the wholesale market, agricultural or fishery cooperatives businesses dealing with agricultural or fishery products.

Sample of a qualified invoice. The image below depicts a sample partial invoice totalling ¥20,000 and a total Consumption Tax of ¥1,800. A food item qualified for the reduced 8% rate is indicated with the ※ symbol (not all items are included in the partial invoice) and the total of items at the 10% and 8% rates are indicated at the bottom of the sample partial invoice.



Effective 1 October 2021, application for approval (*shōnin shinsei-sho* – 承認申請書) to use an alternative taxable sales ratio must be filed by the last day in the tax period for which the alternative taxable sales ratio will be applied and the taxpayer must receive approval of the application no later than one month following that last day of the tax period when the application was filed. If approved, the alternative method may be used in the tax period in which the application was submitted. Prior to 1 October 2021, the taxpayer was required to receive approval no later than the last day in the tax period for which the alternative taxable sales ratio would be applied and the approval was effective beginning in the tax period in which the approval was received.

### Proportional method

Where the itemised method cannot be used, the credit for taxable purchases is determined under the proportional method by multiplying the amount of Consumption Tax on taxable purchases and taxable property removed from a bonded area by the taxable sales ratio.

#### Example 5: Proportional method (national tax only using pre-2014 rates)

All figures in ¥1,000

Purchases relate to:	Returns amount (¥)
Taxable sales	13,000
Common (taxable and non-taxable sales)	1,500
Non-taxable sales	1,000
Total	15,500

The taxable sales ratio is .94061 (see prior example)

Consumption Tax on purchases relating to:

$$\text{All sales: } ¥15,500 \times \frac{4}{105} = ¥590$$

$$\text{Credit for taxable purchases} = ¥590 \times .94061 = ¥555$$

### Adjustments for returns, etc

If an enterprise returns, or receives a refund of all or part of the amounts paid for property used in the calculation of the credit for taxable purchases, the credit must be reduced by the portion attributable to the refund (*Consumption Tax Law Art 32*).

#### Percentage of taxable sales is at least 95%

If the percentage of taxable sales in the tax year is at least 95%, the amount of Consumption Tax on the returns, etc, is deducted from the total Consumption Taxes on taxable purchases (*Consumption Tax Law Art 32(1)(i)*).

#### Percentage of taxable sales is less than 95%

If the percentage of taxable sales in the tax year is less than 95%, the amount of Consumption Tax on the returns, etc, is determined using the method originally used to determine the credit for taxable purchases, ie the itemised method or the proportional method:

**Itemised method.** If the itemised method is used, the Consumption Tax attributable to the refund is equal to the sum of the Consumption Tax on refunds of purchases related to taxable sales plus the Consumption Tax on refunds of purchases related to common taxable and non-taxable sales multiplied by the taxable sales ratio (*Consumption Tax Law Art 32(1)(ii)*).

**Proportional method.** If the itemised method is not used, the Consumption Tax attributable to the refund is equal to the Consumption Tax on the refund multiplied by the taxable sales ratio (*Consumption Tax Law Art 32(1)(iii)*).

**Purchases of gold or platinum bullion.** Copies of personal identity documents must be obtained from persons from whom gold or platinum bullion is purchased and these documents must be retained by businesses in order to qualify the purchases for the credit for taxable purposes (*Consumption Tax Law Art 30(11)*; *Consumption Tax Law Enforcement Regulations Art 15-4(1)*). In order to reduce gold and platinum smuggling, effective for purchases on or after 1 October 2021 a passport or residence card, etc, of a person without an address in Japan will no longer qualify for this purpose. This change limits the ability of Japanese businesses to purchase gold or platinum from foreign visitors.

**Law:** Art 30, Art 30(1), Art 30(2), Art 32, Art 32(1)(i), Art 32(1)(ii) and Art 32(1)(iii) of the *Consumption Tax Law*; Art 48 and Art 48(1) of the *Consumption Tax Law Enforcement Order*

## ¶7-620 Simplified tax system (*Kan'i kazei seido* – 簡易課税制度)

A simplified method of calculating the amount of Consumption Tax on taxable purchases is provided in order to reduce the administrative burden on medium- and -sized businesses (*Consumption Tax Law Art 37*). Under the simplified system, the cost of purchases is estimated as a percentage of the sales price using a “deemed purchase ratio”, which varies depending on the type of enterprise. Only enterprises with taxable sales during the base period (the tax year 2 years before the current tax year) not exceeding ¥50 million (¥200 million for tax years beginning before 1 April 2004) may use the simplified system.

### Reduction in scope of enterprises eligible for the simplified system

When the Consumption Tax was originally enacted in 1988, enterprises with base period sales not exceeding ¥500 million were eligible to use the simplified system. The sales limit was first reduced to ¥400 million and then to ¥200 million for tax years beginning on or after 1 April 1997.

### 2004 tax years

For tax years beginning on or after 1 April 2004, only enterprises with base period sales not exceeding ¥50 million may use the simplified system. Sole proprietors came under the new rule beginning with the 2005 calendar year. Corporations with a 31 March year end were subject to the new rule for the first time in the tax year beginning 1 April 2004 and ending on 31 March 2005.



- 2 the enterprise had no transfers of taxable property other than those exempted from Consumption Tax under the *Consumption Tax Law* or other law or treaty.

### Deadline for tax payments

The legal deadline for payment (*hōtei nōki-gen* – 法定納期限) of Consumption Tax by individual enterprises is 31 March of the year following the tax year.

**Simplified extension request.** A simplified procedure for requesting an extension of time for filing the Consumption Tax return and making payment for the 2021 tax year is provided by writing in the upper right margin of the tax return "Application for Extension of Tax Return Due to New Coronavirus" (新型コロナウイルスによる申告・納付期限延長申請). This would be written above "GK0304" on the sample form shown in ¶7-721.

**Extended deadline for 2021 year.** For those who have difficulty reporting the Consumption Tax due to the effects of the COVID-19 pandemic by the deadline of 31 March 2022, an extension of time is available until 15 April 2022. The deadline for 2021 tax year payments for those who have extended the filing and payment deadline and are using transfer tax payment (*furikae nōzei* – 振替納税) is 26 May 2022 for those who filed between 1 April and 15 April 2022. Persons filing after 15 April will be contacted individually by the tax office regarding the transfer date.

Law: Art 45(1) of the *Consumption Tax Law*

## ¶7-724 Interim tax returns (*Chūkan Shinkoku* – 中間申告)

Enterprises must file interim Consumption Tax returns and make interim tax payments if the amount of Consumption Tax on their return for the prior year exceeds certain limits summarised in the table below (*Consumption Tax Law* Art 42(1), Art 42(4), Art 42(6)):

Table 9: Interim tax payment

Final Consumption Tax for the prior tax year	Amount of interim tax payments and requirement for interim returns for the tax year Interim returns and payments are due within 2 months after the day following the end of the interim payment period		
	First 3-month period	Second 3-month period	Third 3-month period
More than ¥48m	1/12 of the prior period Consumption Tax is required to be paid monthly 11 interim returns are required, one for each interim payment month and the final tax return for the year		

Final Consumption Tax for the prior tax year	Amount of interim tax payments and requirement for interim returns for the tax year Interim returns and payments are due within 2 months after the day following the end of the interim payment period		
	First 3-month period	Second 3-month period	Third 3-month period
More than ¥4m, but not more than ¥48m	¼ of the prior period Consumption Tax Interim return is required for each 3-month interim payment period	¼ of the prior period Consumption Tax Interim return is required for each 3-month interim payment period	¼ of the prior period Consumption Tax Interim return is required for each 3-month interim payment period
More than ¥480,000, but not more than ¥4m	Interim tax payment of ½ of the prior period Consumption Tax Interim return is required only for the first 3-month period (due at the end of August)		
Not more than ¥480,000	No interim tax payment or interim return required, but there is an optional interim return system available		

Law: Art 42(1), Art 42(4), Art 42(6) of the *Consumption Tax Law*

## ¶7-725 Tax return for foreign goods removed from a bonded area

If an enterprise intends to remove foreign goods from a bonded area, it must submit a tax return to the customs director stating the name and quantity of the goods, the amount of the tax base and the Consumption Tax on the removal of the goods from the bonded area (*Consumption Tax Law* Art 47(1)). Consumption Tax due on the goods must be paid to the customs director with jurisdiction over the bonded area before the goods are removed from the bonded area (*Consumption Tax Law* Art 50(1)). An extension of time to pay Consumption Tax of up to 3 months may be granted by the customs director if the person removing the goods files a request for extension of time and furnishes security in an amount equal to the amount of deferred tax (*Consumption Tax Law* Art 51(1)).

Law: Art 47(1), Art 50(1) and Art 51(1) of the *Consumption Tax Law*

## ¶7-730 Notification filing requirements

The following table summarises various notification filing requirements under the *Consumption Tax Law*.



Automatic assessment ( <i>jidō kakutei</i> – 自動確定).....	¶8-211
Self-assessment system ( <i>shinkoku nōzei hoshiki</i> – 申告納税方式).....	¶8-212
Correction ( <i>kōsei</i> – 更正) and determination ( <i>kettei</i> – 決定).....	¶8-213
Estimation assessment ( <i>Suikei Kazei</i> – 推計課税).....	¶8-214
Penalty taxes – administrative assessment ( <i>fuka kazei Hōshiki</i> – 賦課課税方式).....	¶8-220
Penalty taxes ( <i>Kasanzei</i> – 加算税).....	¶8-221
Criminal tax penalties ( <i>sozei bassoku</i> – 租税罰則).....	¶8-222
Delinquency Tax and Interest Tax ( <i>entaizei oyobi rishizei</i> – 延滞税及び利子税).....	¶8-230
Penal provisions ( <i>Bassoku</i> – 罰則).....	¶8-231
Advance ruling system ( <i>Jizen Shōkai</i> – 事前照会).....	¶8-240
Collection of national taxes ( <i>Kokuzei No Chōshū</i> – 国税の徴収)	
Collection of national taxes ( <i>Kokuzei No Chōshū</i> – 国税の徴収).....	¶8-300
Tax representative system ( <i>nōzei kanrinin seido</i> – 納税管理人制度).....	¶8-301
Notification ( <i>Kokuchi</i> – 告知).....	¶8-310
Demand ( <i>Tokusoku</i> – 督促).....	¶8-311
Advance demand ( <i>Kurigami seikyū-sho</i> – 繰上請求書).....	¶8-312
Delinquency proceedings ( <i>Tainō shobun</i> – 滞納処分).....	¶8-313
Seizure of property ( <i>Sashiosae</i> – 差押え).....	¶8-320
Demand for delivery ( <i>Kōfu Yōkyū</i> – 交付要求).....	¶8-321
Participatory seizure ( <i>sanka sashiosae</i> – 参加差押え).....	¶8-322
Conversion of seized property to cash ( <i>kanka</i> – 換価).....	¶8-323
Relief from conversion ( <i>kanka no yūyo</i> – 換価の猶予).....	¶8-324
Distribution ( <i>haitō</i> – 配当).....	¶8-325
Priority of tax claims ( <i>kokuzei yūsen</i> – 国税優先).....	¶8-326
Extension of tax obligations to others ( <i>nōzeigimu no kakuchō</i> – 納税義務の拡張).....	¶8-330
Tax Refunds ( <i>Kanpu</i> – 還付)	
Tax refunds ( <i>Kanpu</i> – 還付).....	¶8-400
The Tax Appeal System ( <i>Fufuku Shinsa</i> – 不服審査)	
The tax appeal system ( <i>fufuku shinsa</i> – 不服審査).....	¶8-500
Administrative review ( <i>fufuku mōshitata</i> – 不服申立).....	¶8-510
Request for re-examination ( <i>sai chōsa no seikyū</i> – 再調査の請求 (prior to 1 April 2016 this was a “request for reinvestigation” ( <i>Igi Mōshitata</i> – 異議申立て)).....	¶8-511
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## Procedural Tax Rules

### ¶8-100 Procedural tax rules

Japan's substantive tax rules, including the *Income Tax Law*, *Corporation Tax Law*, *Consumption Tax Law* and *Inheritance Tax Law*, etc, define how the substance of various transactions and events will give rise to tax obligations. There are also procedural rules which provide the “process” that a tax matter will go through, ie they determine how the enforcement of substantive rules will occur.

The main divisions of procedural tax rules are:

- **Assessment.** Procedures to determine the amount of tax owed by a taxpayer.
- **Tax collection.** Procedures relating to how taxes are paid and collected.
- **Dispute resolution.** Procedures for resolution of disputes between taxpayers and tax administrators.

Law: *Consumption Tax Law*; *Corporation Tax Law*; *Income Tax Law*; *Inheritance Tax Law*

### ¶8-101 Procedural tax statutes

The *Constitution* of Japan grants the power to administer national finances to the Diet (Japan *Constitution* (*Nihon-Koku Kenpō* – 日本國憲法, enacted on 3 May 1947)).

Article 83. The power to administer national finances shall be exercised as the Diet shall determine.

Article 84. No new taxes shall be imposed or existing ones modified except by law or under such conditions as law may prescribe.

The key statutes enacted by the Diet under the authority granted by the *Constitution* for administration of taxation are:

- The *General Law of National Tax (GLNT)* (*Kokuzei Tsūsoku-hō* – 国税通則法, Law No 66, 2 April 1962). The *General Law of National Tax* contains procedural and administrative rules for implementation of the tax rules. Under the legislation proposed to be effective from 1 January 2012, but not adopted, the *General Law of National Tax* would have been renamed as the *General Law Concerning National Tax Procedures and Taxpayers' Rights and Duties* (*Kokuzei ni Kansuru Kyotsutekina Tetsudzuki narabini Nozeisha no Kenri oyobi Gimu nikansuru Horitsu* – 国税に係る共通的な手続並びに納税者の権利及び義務に関する法律). This name change was intended to reflect the spirit of change in administrative rules consistent with the introduction of the Taxpayers' Charter.

- The *National Tax Collection Law (NTCL)* (*Kokuzei Chōshū-hō* – 国税徴収法, Law No 147, 20 April 1959). The *National Tax Collection Law* was superseded in part by the enactment of the *General Law of National Tax* in 1962, but still contains rules for certain types of tax collections, such as collections of delinquent taxes.



### Place where delivered

Tax documents are delivered to the home address or business address of the taxpayer (GLNT Art 12(1)).

### Delivery

Tax documents sent by the tax office, etc, are presumed delivered at the usual time of delivery (*tsūjō tōtatsu* – 通常到達) when they are sent by regular mail (GLNT Art 12(2)). The head of the tax office is to keep a record of the name of the document, the taxpayer's name, address and date of mailing (GLNT Art 12(3)).

### Personal service (*kōfusōtatsu* – 交付送達)

Personal service is achieved when the tax office, etc, delivers the documents to the recipient (taxpayer) directly and obtains the recipient's signature and seal (*shomeiain* – 署名押印) (GLNT Art 12(4)). If the addressee is not present at the delivery address, the document may be delivered to an employee or family member at the address who is not a minor and who understands the significance of the delivery (GLNT Art 12(5)(i)). If no one is available to accept delivery or if delivery is unreasonably refused, the documents may be left at the address (GLNT Art 12(5)(ii)).

### Effective time of delivery

Delivery is effective when, according to socially accepted norms, the document is placed within the recipient's control (GLNT Basic Circular 12(10)). Return of the document by the recipient has no effect on delivery.

### Delivery by notification (*kōshiki sōtatsu* – 公式送達)

Delivery by notification is used when the recipient's address is unknown or there are difficulties in delivering to an address outside of Japan. Delivery is effected by posting the name of the taxpayer and the intent to make delivery on the notice board of the tax office (GLNT Art 14(2)). Delivery by notification is effective 7 days after the notice is posted (GLNT Art 14(3)).

**Law:** Art 12(1), Art 12(2), Art 12(3), Art 12(4), Art 12(5)(i), Art 12(5)(ii), Art 14(2) and Art 14(3) of the *General Law of National Tax*; Art 1 of the *General Law of National Tax Enforcement Regulations*

## ¶8-113 Submission of documents (*shorui No teishutsu* – 書類の提出)

A person who submits to the tax office a tax return or an application or notification, etc, must include his or her name, address and seal imprint. This information must also be provided for the representative of a corporation or other taxpayer (GLNT Art 124).

### Effective time of submission

The general rule is that a document is considered submitted as of the time when it arrives at the tax office. But various tax documents are considered submitted at

the time they are postmarked by the post office. If there is no postmark, or if the postmark is illegible, the ordinary time to deliver is assumed in determining the time submitted.

**Law:** Art 124 of the *General Law of National Tax*

## ¶8-113A Electronic records maintenance system (*denshi chōbo-tō hozon seido* – 電子帳簿等保存制度)

The “*Electronic Book Preservation Law*” (*Denshi Keisanki o Shiyō shite Sakusei suru Kokuzei Kankei Chōbo Shorui no Hozon Hōhō-tō no Tokurei ni Kansuru Hōritsu* – 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別に関する法律, Law No 25 of 1998) allows the preservation of all or part of financial records such as journals and invoices, etc, in electronic data form. Based on the digitization of the economy and society, in order to contribute to the improvement of productivity by digitizing accounting, promotion of telework and improvement of the quality of bookkeeping by utilizing cloud accounting software, etc, the requirements will be drastically simplified beginning January 2022.

Before 1 January 2022, prior approval of the head of the tax office is required for use of an electronic records maintenance system and only highly reliable systems with a search function that will show the history or corrections deletions to the records are allowed. Users of low-cost cloud accounting software etc are required to preserve paper records. Beginning 1 January 2022, the pre-approval requirement is abolished and electronic books and records that meet minimum requirements will be permitted. Penalties and incentives will be provided to encourage proper use of the new system.

**Transition rules.** Transition rules applicable from 12 January 2022 through 31 December 2023 permit deviations from the requirements of the *Electronic Book Preservation Law* in cases of either unavoidable circumstances preventing compliance or where output documents, limited to those in an orderly format and clear state, can be provided upon request.

For electronic transactions conducted on or after 1 January 2024, the transition rules are modified to permit storage of electromagnetic records that do not meet the storage requirements by those who have a reasonable reason for the failure provided:

- (1) the tax office acknowledges the reasonable grounds for the failure and
- (2) the taxpayer responds to any request to download the electromagnetic records based on the tax office's right to question and inspect and to present or submit the output documents of the electromagnetic records which must be in an orderly format and in a clear state.

**Time stamp certification.** A “time stamp” is information proving that electronic data existed at a certain point in time and that the data have not been tampered



*Specially related individuals*

Specially related individuals include:

- (1) an individual's relatives
- (2) a spouse pursuant to an unregistered marriage
- (3) an individual's employees
- (4) persons other than those described in (1) through (3) who are dependent upon the individual for a substantial portion of their daily support, and
- (5) relatives of those mentioned in (2), (3) and (4) who share a common livelihood with them.

*Indirect ownership*

For purposes of determining whether a brother-sister special relationship is present, an individual or corporate shareholder is deemed to own indirectly all of the stock owned directly or indirectly by any corporation in which the shareholder (and any specially related individual in the case of an individual shareholder) holds a 50% or more stock interest.

**Substantial control special relationship**

Corporations may be deemed to have a special relationship if either of the corporations can substantially control the other because it is able to completely or partially determine the other corporation's business policies (STML-EO Art 39-12(1)(iii)). Substantial control may occur from interlocking directorates, or business, financial or technological dependence.

*Interlocking directorates*

Interlocking directorates occur where at least 50% of the directors (or a representative director) of one corporation are also directors or employees of the other corporation.

*Business dependence*

Business dependence occurs if a substantial part of a corporation's business is conducted with the other corporation.

*Financial dependence*

Financial dependence occurs if a substantial part of the funds needed by a corporation to conduct business are borrowed from the other corporation or are acquired pursuant to guarantees provided by that other corporation.

*Technological dependence*

Technological dependence occurs if a substantial part of the technology necessary for a corporation to conduct its business, such as patents, utility model rights, design rights, trademarks or other industrial property rights, or know-how, etc, are provided by the other corporation.

**Enhanced indirect control rules**

For years beginning on or after 1 April 2005, enhanced indirect control rules will cause a foreign corporation to be treated as a foreign-related person if either:

- (1) a foreign corporation is associated with a Japanese corporation through a chain of substantial control relationships or by a chain of substantial control and stock ownership relationships, or
- (2) a foreign corporation is associated with a Japanese corporation because both companies are directly or indirectly controlled by the same person through a chain of substantial control relationships or by a chain of substantial control and stock ownership relationships.

Law: Art 66-4(1) of the *Special Taxation Measures Law*; Art 39-12(1) and Art 39-12(1)(iii) of the *Special Taxation Measures Law Enforcement Order*

**¶9-530 Arm's length price (*Dokuritsu Kigyōkan Kakaku* – 独立企業間価格)**

Different rules for determining an arm's length price apply depending on whether the foreign-related transaction is a sale or purchase of inventory, or any other foreign-related transaction (STML Art 66-4(2)).

**Sale or purchase of inventory**

An arm's length price for the sale or purchase of inventory may be determined using one of the 4 following methods. The legislation effective for tax years beginning on or after 1 October 2011 conforms to the OECD Transfer Pricing Guidelines (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010) by eliminating the priority of application among methods. In each case, the method most appropriate to the circumstances should be used (STML Art 66-4(2); STML-EO Art 39-12(8)).

- (1) *Comparable uncontrolled price method* (*dokuritsu kakaku hijunhō* – 独立価格比準法): a price that would be determined by an unrelated seller and buyer of the same kind of property under conditions involving similar levels of transactions.
- (2) *Resale price method* (*saihanbai kakaku kijunhō* – 再販売価格基準法): determined by deducting a normal amount of profit from the price at which the inventory is resold to a person who is not a specially related person.
- (3) *Cost plus method* (*genka kijunhō* – 原価基準法): determined by adding a normal amount of profit to the amount of the costs incurred by the seller to acquire the inventory in question by purchase, manufacture or by other acts.
- (4) *Other methods corresponding to (1) to (3) and methods described in regulations*. Methods included in regulations issued under this provision include the following methods (STML-EO Art 39-12(8)):
  - (A) The profit split method (*rieki bunkatsuhō* – 利益分割法)
    - (i) Comparable profit split method (*hikaku riei bunkatsuhō* – 比較利益分割法)



Name, etc, of foreign-related persons			
Lease payments for the use of tangible property			
Amount received:			
Amount paid:			
Method of calculation:			
Royalties for use of intangible property			
Amount received:			
Amount paid:			
Method of calculation:			
Interest on loans			
Amount received:			
Amount paid:			
Method of calculation:			
[Blank: use to report other transactions]			
Amount received:			
Amount paid:			
Method of calculation:			
Are there any existing advanced pricing agreements?	Yes No	Yes No	Yes No

**Law:** Art 66-4(15) of the *Special Taxation Measures Law*; Art 39-12(1) or Art 39-112(1) of the *Special Taxation Measures Law Enforcement Order*

### ¶9-541 Base erosion and profit shifting (BEPS) information reporting (*tokutei takokusekikigyō gurūpu ni kakaru kunibetsu hōkoku jikō no teikyō* – 特定多国籍企業グループに係る国別報告事項の提供)

Japan has enacted information reporting rules to conform to the transfer pricing documentation rules in the OECD BEPS Project report *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report* (5 October 2015). The OECD guidance requires multinational enterprises (MNEs) to provide tax administrations 3 files and reports: (1) an annual country-by-country (CbC) report, (2) a “master file”, and (3) a “local file” specific to each country (STML Art 66-4-4).

**Multinational enterprises (MNEs).** A multinational enterprise is a group of companies that file consolidated financial statements and have permanent establishments or the equivalent in 2 or more tax jurisdictions (STML Art 66-4-4(4)(ii); STML-EO Art 39-12-4(3)).

**Country-by-country (CbC) report (*kunibetsu hō kokusho* – 国別報告書).** Country-by-country reports must be submitted to the tax office for each fiscal

year of the group’s parent company beginning on or after 1 April 2016. The report must be prepared in English (STML-EO Art 22-10-4(4)). It must be filed with the district tax office within one year from the end of the parent company’s year by e-tax filing. An MNE with consolidated gross earnings less than ¥100 billion in the preceding year is exempt from Japanese CbC information reporting. A penalty up to ¥300,000 may apply to failure to provide the report timely without good reason. The report is prepared by the parent company and reports for the parent and each subsidiary for each tax jurisdiction in which they do business the businesses and activities in the tax jurisdiction including:

- Gross income, net income and income tax
- Amount of capital
- Financing information
- Amount of tangible assets
- Main business.

**Master file (マスターファイル、) (*jigyō gaikyō hōkoku jikō* – 事業概況報告事項).** Master files must be submitted to the tax office for each fiscal year of the group’s parent company beginning on or after 1 April 2016 (STML Art 66-4-5). The file must be prepared in either Japanese or English (STML-EO Art 22-10-5(2)). It must be filed with the district tax office within one year from the end of the parent company’s year by e-tax filing. An MNE with consolidated gross earnings less than ¥100 billion in the preceding year is exempt from Japanese BEPS master file information reporting. A penalty up to ¥300,000 may apply to failure to provide the report timely without good reason. The report is prepared by the parent company on general conditions and activities of the business group and high-level information regarding their global business operations and transfer pricing policies including:

- An organization chart of the business group
- A summary of the business
- Information on intangible assets held by members of the group
- Information on inter-group financing activity and the overall financing situation for the group as well as information on tax payments.

**Local file (ローカルファイル) (*dokuritsu kigyō-kan kakaku o santei suru tame ni hitsuyō to mitome rareru shorui* – 独立企業間価格を算定するために必要と認められる書類).** Local files must be prepared and maintained for each fiscal year beginning on or after 1 April 2017 by the parent and each of the subsidiaries (STML Art 66-4-6). The file contains detailed information regarding the calculation of arm’s length prices among related persons. It should be retained by the Japanese company for 7 years (STML-EO Art 22-10(2)). It will identify material related party transactions, the amounts involved, and an analysis of the transfer pricing determinations related to those transactions. Foreign related transactions with a foreign related party totaling less than ¥5 billion in the prior year (or the current year if there is no prior year) and intangible



attachments or other documents as needed (Commissioner's Directive on Mutual Agreement Procedures 10). Documents to be attached include the following:

- if a tax issue has arisen or is expected to arise in Japan or a treaty partner country – copies of the tax assessment or other documents that describe the issue, an outline of the facts and a summary of the applicant's or the foreign-related person's position in the case
- if the application is related to an issue which is subject to an administrative appeal or lawsuit – documentation of the filing of the appeal or lawsuit and a summary of the position of the taxpayer or the foreign-related person in the case
- if the application concerns taxation of transfer pricing in Japan or a treaty partner country – documents indicating the direct or indirect capital relationship or the extent of actual control between the parties involved in the transactions which are the subject of the request
- materials explaining issues involving dual residency, if applicable
- copies of any documents filed with the treaty party country by the applicant or the foreign-related person requesting mutual agreement procedures, and
- any other materials relevant to the mutual consultations.

## Use of Foreign Corporations as Tax Havens

### (*Takkusu Heibun Gassan Zeisei* – タックスヘイブン合算税制)

#### ¶9-600 Foreign subsidiaries combined tax system (*gaikoku kogaisha gassan zeisei* – 外国子会社合算税制)

Under both the *Income Tax Law* and the *Corporation Tax Law*, countermeasures have been established to prevent Japanese taxpayers from using certain foreign-related corporations, known as specified (*tokutei gaikoku kankei kaisha* – 特定外国関係会社) or applicable (*taishō gaikoku kankei kaisha* – 対象外国関係会社) foreign-affiliated corporations, as tax havens (STML Art 40-4, Art 66-6). Under these rules, the income of these foreign-affiliated corporations must be included in the income of its Japanese shareholders.

**Law:** Art 40-4 and Art 66-6 of the *Special Taxation Measures Law*

#### ¶9-605 Foreign-affiliated corporation (50% test)

A foreign-affiliated corporation subject to the tax haven rules is a foreign corporation that is more than 50% owned, directly or indirectly, by Japanese

residents and that is located in a jurisdiction where either there is no corporate income tax or the foreign corporate income tax burden is 25% or less of income (STML Art 40-4(1), Art 66-6(1)). Effective for tax years of the foreign corporation beginning on or after 1 April 2010, the "trigger rate" is reduced to a foreign corporate income tax burden of 20% (30% for paper companies) or less (STML Art 40-4(5), Art 68-90(5)). This change was deemed necessary in order to avoid discouraging Japanese direct investment in developing countries with low tax rates such as China, Korea, Malaysia and Vietnam (Ministry of Finance, Outline of 2010 Tax Reform, 22 December 2009). The trigger rate has been modified to *less than* 20% beginning 1 April 2015 to take into account the reduction of corporate tax rate in the United Kingdom to 20% on that date. If the foreign jurisdiction imposes tax on corporations using graduated rates, the highest graduated rate may be used when determining if the 20% test is satisfied (STML-EO Art 39-14(2)(iii)). For tax years of a Japanese corporation ending on or after 1 April 2019 in connection with tax years of a foreign-affiliated corporation beginning on or after 1 April 2018, calculation of foreign taxes attributed to a foreign-affiliated corporation is made without adjustments for consolidated tax or pass-through entity rules.

Regulations issued under the 2011 legislation deem the trigger rate to be the nominal tax rate (*hyōmen zeiritu* – 表面税率) in the foreign jurisdiction if the foreign corporation has zero income for the year (STML-EO Art 39-14(2)(iv)).

Indirect ownership through foreign intermediaries. For tax years of foreign-affiliated corporation beginning on or after 1 April 2018, direct or indirect ownership of more than 50% of the foreign-affiliated corporation is determined by attributing ownership through another foreign company to the Japanese shareholders only if the Japanese shareholder owns more than 50% of the shares of the intermediary foreign company.

Deemed satisfaction of the 50% test. Beginning for tax years of the foreign-affiliated corporation beginning on or after 1 April 2018, 50% test for ownership will be deemed satisfied if Japanese shareholders have a claim to almost all of the residual assets of the foreign-affiliated corporation regardless of their actual stock ownership (STML Art 40-4, Art 40-5, Art 40-7, Art 40-8, Art 66-6, Art 66-7, Art 66-8).

#### Discretionary tax rates

The legislation applicable to taxes paid on or after 30 June 2011, treats only the tax under the minimum rate as a foreign tax for purposes of the Japan foreign tax credit and the 20% trigger rate test for a foreign-affiliated corporation if the rate of tax paid by a company to a foreign jurisdiction is higher than the minimum rate available to the company (STML-EO Art 25-19(2)(iv), Art 39-14(2)(iv)). This change was prompted by the 3 December 2009 Japan Supreme Court "*Guernsey case*" (Japan Supreme Court, 3 December 2009, No 2070, page 45). In that case, the court held that, in the absence of an express provision to the contrary, taxes paid pursuant to an agreement between the subsidiary of a Japanese company and the Guernsey tax authorities at a rate of 26%, instead of the otherwise applicable rate of 25%, satisfied the 25% trigger rate test and allowed the subsidiary to avoid the tax haven treatment.



in the country where its home office is located. But dividends received by a foreign-affiliated corporation from another foreign-affiliated corporation whose income has been included in the income of the Japanese parent company are deductible by the foreign-affiliated corporation receiving the dividend.

If a 10% Japanese shareholder receives dividends from a foreign-affiliated corporation that are not eligible for the foreign dividend exemption (see ¶4-633A), the dividends are not included in its income to the extent the dividend is paid out of the amount subject to tax included in the income of the 10% Japanese shareholder during the 10 years prior to the beginning of the taxable year the dividend was received.

#### Foreign dividend deduction or credit limited to dividend income attributable to income subject to adjustment under the controlled foreign corporation rules

For tax years beginning on or after 1 April 2021, the amount of foreign withholding tax allowed as a deduction or credit is limited to the portion corresponding to the amount subject to double tax adjustment under the special taxation of income related to foreign affiliated companies (the “combined tax system of foreign subsidiaries” (¶9-600) (*gaikoku kogaisha gassan zeise* – 外国子会社合算税制) (STML Art 66-8, Art 66-9-4, Art 68-92, Art 68-93-4).

1. **Deduction of foreign taxes for companies eligible for the foreign dividend exemption system** (see ¶4-633A). A deduction is allowed for dividends received from a foreign subsidiary if the recipient corporation has held at least 25% of the foreign subsidiary’s stock for at least 6 months prior to the date the obligation to pay the dividend arises (ie, eligible for the foreign dividend exemption system) but the deduction is limited to amount that is subject to adjustment for double taxation under the combined tax system of foreign subsidiaries rules.
2. **Foreign tax credit allowed for other companies.** For companies not described in the preceding item (1.) a foreign tax credit is allowed for dividends received from a foreign subsidiary, limited to the amount that is subject to adjustment for double taxation under the combined tax system of foreign subsidiaries rules.

**Example.** The Liberal Democratic Party Tax Commission provides an example of a Japanese company that receives 150 as a dividend from a foreign subsidiary where 15 foreign withholding tax was paid. One hundred was included in the Japanese income of the Japanese company under the combined tax system of foreign subsidiaries rules and 100 of the dividend is excluded from Japanese income of the Japanese company as a double taxation adjustment.

**Case 1.** Foreign dividend exemption system applies (25% of the shares of the foreign subsidiary have been held for at least 6 months). Prior to 1 April 2021, a full deduction was allowed for the foreign withholding tax (15). Beginning 1 April 2021, only the foreign withholding tax subject to the double taxation adjustment (10) is deductible.

Foreign subsidiary		Japanese company		
Dividends 150 (Foreign withholding tax 15)		95% dividend exemption (50x95% = 47.5)	Foreign withholding tax (15)	
			Before 1 April 2021	Beginning 1 April 2021
	Specified taxable income under the combined tax system rules: 100 (taxable in Japan)	Dividend excluded from income (double taxation adjustment) 100	Full deduction 15	Non-deductible 5 Deductible 10

**Case 2.** Foreign dividend exemption system does not apply. Prior to 1 April 2021, a full deduction was allowed for the foreign withholding tax (15). Beginning 1 April 2021, a foreign tax credit is allowed for the foreign withholding tax (5) attributable to the dividend included in taxable income (50).

Foreign subsidiary		Japanese company		
Dividends 150 (Foreign withholding tax 15)		Dividend included in taxable income 50	Foreign withholding tax (15)	
			Before 1 April 2021	Beginning 1 April 2021
	Specified taxable income under the combined tax system rules: 100 (taxable in Japan)	Dividend excluded from income (double taxation adjustment) 100	Full deduction 15	Foreign tax credit 5 No foreign tax credit 10

**Law:** Art 23-2(1) of the Corporation Tax Law; Art 22-4(2) of the Corporation Tax Law Enforcement Order; Art 66-6(1) and Art 66-7(1) of the *Special Taxation Measures Law*

## ¶9-621 Deduction for previously taxed dividends

Dividends paid by a foreign-affiliated corporation to a Japanese shareholder are generally included in income in the same way as other dividends and a direct or indirect foreign tax credit is allowed for foreign taxes on the dividends under the regular rules (CTL Art 69(4)). To avoid double taxation of income previously taxed under the tax haven rules, a deduction is allowed for dividends paid out of retained earnings of the foreign-affiliated corporation that have previously been taken into income by a Japanese resident individual or Japanese corporation (STML Art 40-5, Art 66-8). The deduction is calculated by subtracting the income of the current year before Corporation Income Tax of the foreign-affiliated corporation from the amount of dividends paid and multiplying the result by the percentage of shares of the foreign-affiliated corporation owned directly or indirectly by the Japanese 10% shareholder (STML-EO Art 39-19(2)). The deduction is allowed for dividends from a foreign-affiliated corporation to the extent of the foreign-affiliated corporation’s