KPMG

# Taxation in Japan 2022

KPMG Tax Corporation

# Taxation in Japan Preface

This booklet is intended to provide a general overview of the taxation system in Japan. The contents reflect the information available up to 31 October 2022.

While the information contained in this booklet may assist in gaining a better understanding of the tax system in Japan, it is recommended that specific advice be taken as to the tax implications of any proposed or actual transactions.

Further information on matters in this booklet can be obtained from KPMG Tax Corporation either through your normal contact at the firm or using the contact details shown below.

KPMG Tax Corporation

Tokyo Office
Izumi Garden Tower,
1-6-1 Roppongi, Minato-ku,
Tokyo 106-6012, Japan
Tel: +81 (3) 6229 8000
Fax: +81 (3) 5575 0766
E-mail: info-tax@jp.kpmg.com

Osaka Office
Osaka Nakanoshima Building 15F,
2-2-2 Nakanoshima, Kita-ku,
Osaka 530-0005, Japan
Tel: +81 (6) 4708 5150
Fax: +81 (6) 4706 3881

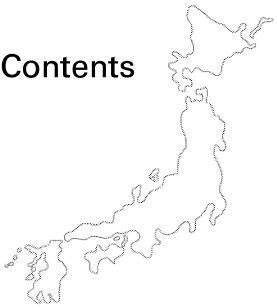
Nagoya Office
Dainagoya Building 26F,
3-28-12, Meieki, Nakamura-ku,
Nagoya 450-6426, Japan
Tel: +81 (52) 569 5420
Fax: +81 (52) 551 0580

Kyoto Office
Nihon Seimei Kyoto Yasaka Building 7F,
843-2 Higashi Shiokoji-cho,
Shiokoji-dori Nishinotoin-higashiiru,
Shimogyo-ku,
Kyoto 600-8216, Japan
Tel: +81 (75) 353 1270
Fax: +81 (75) 353 1271

Hiroshima Office
Hiroshima Kogin Building 7F,
2-1-22 Kamiya-cho, Naka-ku,
Hiroshima 730-0031, Japan
Tel: +81 (82) 241 2810
Fax: +81 (82) 241 2811

Fukuoka Office
Kamiyo Watanabe Building 4F,
1-12-14 Tenjin, Chuo-ku,
Fukuoka 810-0001, Japan
Tel: +81 (92) 712 6300
Fax: +81 (92) 712 6301

# Contents



# 1 Taxation of Companies

## 1.1 Introduction

Japanese corporate income taxes consist of the following:

- corporation tax (national tax)
- business tax (local tax)
- prefectural and municipal inhabitant taxes (local tax)

The relevant tax rates and details of the respective taxes are discussed later in this chapter.

In addition to the normal corporate income taxes, certain closely held companies known as Specified Family Companies can be subject to additional taxation on undistributed retained earnings (please see 1.3.4).

## 1.2 Tax Status of Companies

### 1.2.1 Residence

In determining the residency of a company for tax purposes, Japan utilizes the 'place of head office or main office' concept, not the 'effective place of management' concept. A Japanese company is defined as a company whose head office or main office is located in Japan in the tax law.

### 1.2.2 Branch of a Foreign Company vs. Japanese Company

Generally, there is no material difference between a branch of a foreign company and a Japanese company when computing taxable income. Tax deductible provisions and reserves, the limitation of certain allowable expenses such as entertainment expenses and donations, and the corporate income tax rates are the same for both a branch and a Japanese company.

However, a branch and a Japanese company have differing legal characteristics and this results in differences in tax treatment in certain areas including the following:

- Scope of taxable income: please see 1.5.

- Special Tax Due by Specified Family Company (discussed in 1.3.4): not applied to a branch of a foreign company

- Consolidated Tax Return Filing System (discussed in 1.14): not applied to a branch of a foreign company

- Japanese Group Relief System (discussed in 1.15): not applied to a branch of a foreign company

- Foreign Dividend Exclusion (discussed in 4.1): not applied to a branch of a foreign company

- Thin Capitalization Regime (discussed in 4.4): not applied to a branch of a foreign company

- Controlled Foreign Company (CFC) Regime (discussed in 4.6): not applied to a branch of a foreign company

### 1.2.3 Permanent Establishment (PE)

Even where a foreign company has not established a registered branch in Japan, it can be treated as having a de facto branch or PE in Japan in certain circumstances. The Japanese Corporation Tax Law provides the definition of a PE for Japanese tax purposes.:

(1) Fixed Place PE

A fixed place of business in Japan through which the business of a foreign company is carried on including the following facilities:

- a place of management, a branch, an office, a factory or a workshop

- a mine, an oil or gas well, a quarry or any other place of extracting natural resources.

(2) Construction PE

A construction or installation project or services in the supervising or superintending of such projects in Japan, which a foreign company carries on for a period of over 1 year

Where a period of a contract for a construction or installation project or services discussed above is shorter than 1 year by splitting a contract into two or more contracts and one of the principal purposes for the splitting was to avoid construction PE status, the period of the project or services should be determined by aggregating the periods of all the split contracts, unless there are reasonable grounds for not doing so.

(3) Agent PE

A person who habitually concludes the following contracts in Japan on behalf of a foreign company or habitually plays the principal role leading to the conclusion of the following contracts in Japan on behalf of a foreign company that are routinely concluded without material modification by the foreign company:

(i) a contract concluded in the name of the foreign company, or

(ii) a contract for the transfer of the ownership of, or for the granting of the right to use, property owned by that foreign company or that the foreign company has the right to use, or

(iii) a contract for the provision of services by that foreign company.

Where a person acting on behalf of a foreign company in Japan carries on its business independently from the foreign company in the ordinary course of that business, the person is treated as an independent agent which does not constitute a PE for the foreign company. However, if the person acts exclusively or almost exclusively on behalf of its closely related companies, that person is not considered as an independent agent.

(4) Specific Activity Exemptions

Notwithstanding the provisions in (1) Fixed Place PE, the following places will not constitute a PE for a foreign company, provided that the following activity (or the overall activity of the fixed place of business in the case of (vi)) is of a preparatory or auxiliary character:

(i) a facility used solely for the purpose of storage, display or delivery of goods or merchandise belonging to the foreign company

(ii) a place for the maintenance of a stock of goods or merchandise belonging to the foreign company solely for the purpose of storage, display or delivery

(iii) a place for the maintenance of a stock of goods or merchandise belonging to the foreign company solely for the purpose of processing by another enterprise

(iv) a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the foreign company

(v) a fixed place of business solely for the purpose of carrying on, for the foreign company, any other activity

(vi) a fixed place of business solely for any combination of activities mentioned in subparagraphs (i) to (v).

Similar rules are also provided for (2) Construction PE and (3) Agent PE.

Furthermore, anti-fragmentation rules (rules to prevent a foreign company or a group of closely related companies from fragmenting a cohesive business operation into several small operations in order to avoid PE status) are provided.

## 1.3 Tax Rates

### 1.3.1 Corporation Tax

Corporation tax is imposed on taxable income of a company at the following tax rates:

<table>
<tr><th rowspan="2">Tax base</th><th colspan="2">Tax rates</th></tr>
<tr><th>Small and medium-scale companies[1]</th><th>Other than small and medium-scale companies</th></tr>
<tr><td>Taxable income up to JPY8 million in a year</td><td>19%<br>(15%[2])</td><td rowspan="2">23.2%</td></tr>
<tr><td>Taxable income in excess of JPY8 million</td><td>23.2%</td></tr>
</table>

(1) A small and medium-scale company is a company whose stated capital is JPY100 million or less, except for either of the following cases:

- where 100 percent of the shares of the company are directly or indirectly held by one large company (a company whose stated capital is JPY500 million or more).

- where 100 percent of the shares of the company are directly or indirectly held by two or more large companies in a 100 Percent Group defined in 1.13.1.

(2) 15 percent is applied to fiscal years beginning prior to 31 March 2023. Note that 15 percent will not be applied to a small and medium-scale company whose average taxable income for the preceding 3 years is over JPY1.5 billion.

### 1.3.2 Business Tax

Business tax is basically imposed on taxable income of a company. However, if the amount of stated capital is over JPY100 million, size-based business tax is also levied. Moreover, if a company conducts electricity/gas supply business or insurance business, business tax is imposed on the adjusted gross revenue instead of its taxable income.

Please note the following:

- Part of business tax levied on taxable income/adjusted gross revenue is collected as special business tax by the national government and is allocated to local governments in order to decrease the gap in tax revenue between urban and rural areas.

- Business tax and special business tax are tax deductible expenses when tax returns for such taxes are filed.

- Business tax rates indicated below are the standard tax rates. Specific rates are determined by local tax jurisdictions within the maximum tax rates.

(1) Companies with Stated Capital in Excess of JPY100 Million (other than companies indicated in (3))

■ Business tax levied on taxable income

[Fiscal years beginning from 1 October 2019 to 31 March 2022]

| Business tax (Income component) | | | Special business tax | |
|---|---|---|---|---|
| Taxable base (taxable income) | | Standard tax rates(*) | Taxable base | Tax rate |
| In excess of | Up to | | | |
| - | JPY4 million | 0.4% | Taxable income x Standard rate of Business Tax | 260% |
| JPY4 million | JPY8 million | 0.7% | | |
| JPY8 million | - | 1.0% | | |

(*) Only the highest rate of 1.0 percent is applied where a company has offices in at least three different prefectures.

[Fiscal years beginning on or after 1 April 2022]

| Business tax (Income component) | | Special business tax | |
|---|---|---|---|
| Taxable base | Standard tax rates | Taxable base | Tax rate |
| Taxable income | 1.0% | Taxable income x Standard rate of Business Tax | 260% |

■ Size-based business tax

Size-based business tax consists of two components and the tax bases of each component are as follows:

| Components | Taxable base |
|---|---|
| Added value component | (a) Labor costs<br>+ (b) Net interest payment<br>+ (c) Net rent payment<br>+ (d) taxable income/tax loss for current year |
| Capital component | Larger amount of the following:<br>• Stated capital + Capital surplus for tax purposes<br>• Stated capital + Capital reserve for accounting purposes |

Where (a) (labor costs) is larger than 70 percent of the total of (a), (b) and (c), the tax base of the added value component will be reduced by the excess portion.

Moreover, there are temporary measures to reduce the tax base of the added value component if the condition (i) for the tax credits for acceleration of securing human resources, etc. discussed in 1.11.4 (for fiscal years beginning between 1 April 2021 and 31 March 2022) or the condition (i) (for companies whose number of regular employees is 1,000 or more with stated capital of JPY1 billion or more, the condition (i) and the requirement for the management declaration on multi-stakeholders) for the tax credits for promotion of salary increases discussed in 1.11.5 (for fiscal years beginning between 1 April 2022 and 31 March 2024) is satisfied.

Size-based business tax rates are as follows:

| Components | Standard tax rates |
|---|---|
| Added value component | 1.2% |
| Capital component | 0.5% |

(2) Companies with Stated Capital of JPY100 Million or Less (other than companies indicated in (3))

■ Business tax levied on taxable income

| Business tax (Income component) | | | Special business tax | |
|---|---|---|---|---|
| Taxable base (taxable income) | | Standard tax rates(*) | Taxable base | Tax rate |
| In excess of | Up to | | | |
| - | JPY4 million | 3.5% | Taxable income x Standard rate of Business Tax | 37% |
| JPY4 million | JPY8 million | 5.3% | | |
| JPY8 million | - | 7.0% | | |

(*) Only the highest rate of 7.0 percent is applied where a company has offices in at least three different prefectures and stated capital of at least JPY10 million.

■ Size-based business tax

Not applicable.

(3) Companies Conducting Electricity/Gas Supply Business or Insurance Business

By virtue of the 2020 tax reform, size-based business tax or business tax levied on taxable income depending on the amount of stated capital was partly introduced in the taxation system for business tax applied to retail electricity business or power generation business among companies conducting electricity supply business for fiscal years beginning on or after 1 April 2020. Simultaneously, special business tax rates applied to the above businesses were raised. By virtue of the 2021 tax reform, the above taxation system is also applied to specific wholesale supply business for fiscal years ending on or after 1 April 2022.

By virtue of the 2022 tax reform, size-based business tax is partly introduced in the taxation system for business tax applied to specific gas supply business among companies conducting gas supply business for fiscal years beginning on or after 1 April 2022. Furthermore, companies conducting general gas supply business are excluded from this category (3) and are covered under the previous categories (1) and (2) for fiscal years beginning on or after 1 April 2022.

(i) Companies other than (ii), (iii) and (iv)

■ Business tax levied on revenue

| Business tax (Revenue component) | | Special business tax | |
|---|---|---|---|
| Taxable base | Standard tax rate | Taxable base | Tax rate |
| Adjusted gross revenue | 1.0% | Adjusted gross revenue x Standard rate of Business Tax | 30% |

■ Size-based business tax

Not applicable.

(ii) Companies with Stated Capital in excess of JPY100 million among companies conducting retail electricity business, power generation business or specific wholesale supply business

■ Business tax levied on revenue

| Business tax (Revenue component) | | Special business tax | |
|---|---|---|---|
| Taxable base | Standard tax rate | Taxable base | Tax rate |
| Adjusted gross revenue | 0.75% | Adjusted gross revenue x Standard rate of Business Tax | 40% |

■ Size-based business tax

| Components | Standard tax rates |
|---|---|
| Added value component | 0.37% |
| Capital component | 0.15% |

(iii) Companies with Stated Capital of JPY100 million or less among companies conducting retail electricity business, power generation business or specific wholesale supply business

■ Business tax levied on revenue

| Business tax (Revenue component) | | Special business tax | |
|---|---|---|---|
| Taxable base | Standard tax rates | Taxable base | Tax rate |
| Adjusted gross revenue | 0.75% | Adjusted gross revenue x Standard rate of Business Tax | 40% |
| Taxable income | 1.85% | | |

■ Size-based business tax

Not applicable.

(iv) Companies conducting specific gas supply business

■ Business tax levied on revenue

| Business tax (Revenue component) | | Special business tax | |
|---|---|---|---|
| Taxable base | Standard tax rate | Taxable base | Tax rate |
| Adjusted gross revenue | 0.48% | Adjusted gross revenue x Standard rate of Business Tax | 62.5% |

■ Size-based business tax

| Components | Standard tax rates |
|---|---|
| Added value component | 0.77% |
| Capital component | 0.32% |

### 1.3.3 Prefectural and Municipal Inhabitant Taxes

Prefectural and municipal taxes consist of two elements; (1) an income tax calculated based on national corporation tax and (2) a per-capita tax. Specific rates are determined by local tax jurisdictions within the maximum tax rates.

(1) Inhabitant Tax Levied on Corporation Tax

Part of inhabitant tax levied on corporation tax is collected as local corporation tax by the national government, which is allocated to local governments in order to decrease the gap in tax revenue between urban and rural areas.

■ Inhabitant tax

<table>
<tr><th colspan="3">Inhabitant tax</th><th colspan="2">Local corporation tax</th></tr>
<tr><th>Taxable base</th><th colspan="2">Tax rates</th><th>Taxable base</th><th>Tax rate</th></tr>
<tr><td rowspan="6">Corporation tax (National tax)</td><td rowspan="3">Standard tax rate</td><td>Prefectural 1.0%</td><td rowspan="6">Corporation tax (National tax)</td><td rowspan="6">10.3%</td></tr>
<tr><td>Municipal 6.0%</td></tr>
<tr><td>Total 7.0%</td></tr>
<tr><td rowspan="3">Maximum tax rate</td><td>Prefectural 2.0%</td></tr>
<tr><td>Municipal 8.4%</td></tr>
<tr><td>Total 10.4%</td></tr>
</table>

(2) Per-Capita Tax

Per-capita prefectural tax is levied according to a published scale which varies based upon the capital amount(*) of the company.

Per-capita municipal tax is similarly levied according to a published scale which varies based upon the capital amount(*) of the company and the number of the company's employees within the municipality.

(*) The capital amount means the larger amount of the following:
- Stated capital + Capital surplus for tax purposes
- Stated capital + Capital reserve for accounting purposes

### 1.3.4 Special Tax Due by Specified Family Company

A Specified Family Company is liable to a special tax on retained earnings for each fiscal year.

A 'Specified Family Company' is defined as a Japanese company that is still a Controlled Company (defined below) even if its shareholders that do not fall within the definition of Controlled Companies are excluded at the time of the judgment. Note that a Specified Family Company does not include a small and medium-scale company as defined in 1.3.1.

If a Japanese company is directly or indirectly controlled by one shareholder and related persons of the shareholder, the company is a 'Controlled Company.' For the purposes of this rule, if one shareholder and its related persons hold more than 50 percent of the total outstanding shares or more than 50 percent of the voting rights of another company, the company is treated as 'controlled' by the shareholder and its related persons. 'Related persons' are (i) the shareholder's family relatives, (ii) a company controlled by the shareholder and (iii) a company commonly controlled by a person which controls the shareholder.

The taxable retained earnings (the portion of taxable income which remains as retained earnings) of a fiscal year are the excess of undistributed profits over the largest of the following three amounts:

- JPY20 million (reduced proportionately where fiscal year is less than 12 months)
- 40 percent of the taxable income for the fiscal year
- 25 percent of the stated capital less the accumulated retained earnings at the end of the fiscal year not including the earnings for that fiscal year

The additional corporation tax is computed at the following rates per year:

| Excess retained earnings | Tax rates |
|---|---|
| Up to JPY30 million | 10% |
| Excess over JPY30 million and up to JPY100 million | 15% |
| Excess over JPY100 million | 20% |

Inhabitant tax is also payable on the above corporation tax.

### 1.3.5 Effective Statutory Corporate Income Tax Rate

Given the potential use of graduated rates in the calculation of both corporation and business taxes, the differing local tax rates utilized and per-capita liabilities on prefectural and municipal taxes, effective statutory tax rates vary from taxpayer to taxpayer. In addition, the effective statutory tax rate for companies with stated capital in excess of JPY100 million, which are subject to size-based business tax, is partly determined by a number of factors other than taxable income.

For illustrative purposes, the simplified effective statutory tax rate based upon the maximum rates in Tokyo is as follows:

| | Companies with Stated Capital in excess of JPY100 million | Companies with Stated Capital of JPY100 million or less |
|---|---|---|
| Corporation tax | 23.2% | 23.2% |
| Business tax[1] | 1.18% | 7.48% |
| Special business tax | 2.6%<br>(1.0% x 260%) | 2.59%<br>(7.0% x 37%) |
| Inhabitant tax | 2.413%<br>(23.2% x 10.4%) | 2.413%<br>(23.2% x 10.4%) |
| Local corporation tax | 2.390%<br>(23.2% x 10.3%) | 2.390%<br>(23.2% x 10.3%) |
| Total | 31.783% | 38.073% |
| Effective statutory tax rate[2] | 30.62% | 34.59% |

(1) In addition, companies with stated capital in excess of JPY100 million are subject to size-based business tax which increases the overall effective statutory tax rate.

(2) The effective statutory tax rate is calculated after taking into account the tax deductible nature of business tax and special business tax payments.

## 1.4 Taxable Year of Companies

The taxable year of a company is in line with the company's accounting period (i.e. fiscal year). A taxable year cannot exceed 12 months in duration but can be less than 12 months.

## 1.5 Taxable Income

### 1.5.1 Japanese Companies

Taxable income represents the net of gross revenue less costs, expenses and losses, in general, on an accrual basis in accordance with fair accounting standards and as adjusted in accordance with the requirements of the tax laws.

Generally speaking, a Japanese company is subject to Japanese corporate income taxes on its worldwide income. In order to eliminate double taxation on income, the foreign taxes levied on a Japanese company may be credited against Japanese corporation tax and local inhabitant tax under the foreign tax credits system as discussed in 4.2. Note that dividends received from Foreign Subsidiaries are exempt in calculation of a Japanese company's taxable income under the foreign dividend exclusion (FDE) system as discussed in 4.1.

### 1.5.2 Foreign Companies Having a PE in Japan

A foreign company operating in Japan through a PE is liable for corporate income taxes only on the income attributable to the PE under the domestic tax laws. (Please note that certain Japanese source income not attributable to the PE in Japan (e.g. capital gains from sales of real estate located in Japan and shares in certain Japanese companies) should still be subject to corporate income taxes basically in the same way as for a foreign company not having a PE in Japan.)

The rules including the following are applied in calculating income attributable to a PE in line with the Authorized OECD Approach (AOA)[1]:

- Income attributable to a PE is the income that the PE would have earned if it were a distinct and separate enterprise from its head office.

- Profits/losses derived from internal dealings are recognized at an arm's length price in general. (Note that internal interest for non-financial institutions and internal royalties on intangibles are not recognized if a tax treaty including a provision equivalent to the pre-amended Article 7[2] is applied.)

- When the amount of capital of a PE is smaller than the capital attributable to the PE (capital to be attributable to the PE if the PE were a distinct and separate enterprise from its head office), interest expenses corresponding to such deficient portion are not allowed in calculating income attributable to the PE.

[1] 'AOA' is an approach to calculate income attributable to a PE set out in the 'Report on the Attribution of Profits to Permanent Establishments' released by the OECD in 2008 and 2010.

[2] 'The pre-amended Article 7' is Article 7 of the OECD Model Tax Convention before the 2010 amendment. As the AOA was fully adopted in Article 7 of the OECD Model Tax Convention when it was amended in 2010, the pre-amended Article 7 adopted only partially the AOA. Thus, the tax treatment may differ depending on which type of Article 7 is included in the applicable tax treaty.

## 1.6 Capital Gains

Capital gains from the sale of land, securities, etc. are subject to normal corporate income taxes in the same manner as ordinary trading income regardless of holding period.

### 1.6.1 Capital Gain Rollover Rules

Taxation of income realized from assets within the categories listed below may be deferred by reducing the value of newly acquired fixed assets by the amount of that income. Note that there are a number of additional conditions with regard to accounting procedures and timing of acquisition and type of new fixed assets which must be met for this relief to apply.

- government subsidies
- insurance loss payments
- exchange of properties
- acquisition of replacement property which is located in specific districts or falls under specific categories

### 1.6.2 Special Rule for Land Acquired in 2009 and 2010

In addition to the above, there is a special rule for land acquired in 2009 and 2010, which was introduced in the 2009 tax reform.

Where a company sells their land in Japan acquired in 2009 and 2010 after they have owned it for more than 5 years as of 1 January of the selling year, a special deduction can be applicable. The amount of the special deduction is the lower of JPY10 million or the amount of the capital gain.

This special deduction also applies to individual taxpayers (please see 3.3.2).

## 1.7 Treatment of Excess Tax Losses

### 1.7.1 Tax Loss Carry-Forwards

Where a tax loss is realized in a given fiscal year, provided the company has blue-form tax return filing status (please see below), that loss may be carried forward by the company for use in sheltering taxable profits of a future fiscal year.

The maximum deductible amount of tax loss carry-forwards is up to 50 percent of taxable income of the fiscal year.

By virtue of the 2021 tax reform, in consideration of the unprecedented situation caused by COVID-19, temporary special measures were introduced for tax loss carry-forwards based on certain amendments to the Industrial Competitiveness Enhancement Act. The measures allow a company satisfying certain conditions to utilize the tax loss carry-forward system for tax losses incurred in fiscal years including the day during the period from 1 April 2020 to 1 April 2021 in principle, up to 100 percent of current taxable income to the extent of the amount of investment stated in a certified plan under the amended Industrial Competitiveness Enhancement Act (e.g. business rebuilding or reorganizations) over the period up to 5 years.

There are exceptional rules whereby tax loss carry-forwards can be offset against the total amount of taxable income of the fiscal year, which are applied to the following companies:

- Small and medium-scale companies defined in 1.3.1.
- Tax qualifying Tokutei Mokuteki Kaisha (TMKs) and Toushi Houjin (THs), etc.
- Companies which commenced rehabilitation procedures, etc.

  This rule is applicable for fiscal years with days falling within

a 7-year period from the day on which the rehabilitation plan was confirmed. If the company is re-listed on a Financial Instruments Exchange, the company will not be eligible for the fiscal years ending on or after the date when the company is re-listed.

- Newly established companies

  This rule is applicable for fiscal years with days falling within a 7-year period from the establishment date. If the company is listed on a Financial Instruments Exchange, the company will not be eligible for the fiscal years ending on or after the date when the company is listed.

  Note that this rule is applicable except for the following companies:

  - a company in which 100 percent of the shares are directly or indirectly held by one large company (a company whose stated capital is JPY500 million or more)

  - a company in which 100 percent of the shares are directly or indirectly held by two or more large companies in a 100 Percent Group defined in 1.13.1.

  - a parent company established under a Share-Transfer (Kabushiki-Iten) transaction

Tax loss carry-forwards can be utilized against taxable income for the following periods depending on when the tax losses are suffered:

- 9 succeeding years - tax losses incurred in fiscal years ending on or after 1 April 2008 and beginning before 1 April 2018

- 10 succeeding years - tax losses incurred in fiscal years beginning on or after 1 April 2018

It should be noted that there is no distinction between losses of a revenue or capital nature for these purposes.

Obtaining blue-form tax return filing status confers a number of benefits upon a company, the most important of which being the ability to carry forward tax losses as explained above. The conditions for obtaining blue-form tax return filing status are not onerous, however it is important that a timely application is made (i.e. submission of an application by whichever is the earlier, either 3 months from the establishment of the company or the end of the first fiscal year) to ensure tax losses are not extinguished.

Please see 1.16.2 for the treatment of pre-reorganization losses incurred in the case of corporate reorganization.

### 1.7.2 Tax Loss Carry-Back

The Japanese Corporation Tax Law also provides for a tax loss carry-back system at the option of the taxpayer company. This tax loss carry-back system, under which a company suffering a tax loss can get a refund of the previous fiscal year's corporation tax by offsetting the loss against the income for the previous fiscal year, has been suspended since 1 April 1992 except for certain limited circumstances, including the following:

- small and medium-scale companies defined in 1.3.1
- fiscal years including the date of dissolution
- fiscal years ending during liquidation procedures

Note that, in response to the spread of the COVID-19, the 'Act on Temporary Special Provisions for National Tax Laws to Respond to COVID-19' allows companies with stated capital of JPY1 billion or less (excluding companies in which 100 percent of shares are directly or indirectly held by a company with stated capital in excess of JPY1 billion, etc.) to utilize the tax loss carry-back system for tax losses generated in fiscal years

ending between 1 February 2020 and 31 January 2022.

### 1.7.3 Change of Control

Where an ownership change occurs for a company which has tax losses incurred in prior fiscal years or assets having built-in losses, if one of certain specified events occurs within 5 years from the date of the ownership change, utilization of the tax losses of the company may be restricted.

An ownership change for the purposes of this rule occurs when a new shareholder directly or indirectly acquires more than 50 percent of the outstanding shares in a company except for acquisitions through certain events such as a tax-qualified merger.

The specified events include the following:

(i) (a) Where a company was a dormant company just before the ownership change, (b) the company starts its business after the ownership change.

(ii) (a) Where a company ceased (or plans to cease) its business carried on just before the ownership change after the ownership change, (b) the company receives loans or capital contributions, the amount of which exceeds five times the previous business scale.

(iii) In the case of (i)(a) or (ii)(a), the company is merged into another company under a tax-qualified merger.

In the above cases, deduction of built-in losses of assets of the company may be restricted as well.

## 1.8 Deduction of Expenses

### 1.8.1 Valuation of Inventories

The cost of inventories must include the entire actual cost of acquisition of such inventories. Purchase or manufacturing cost variances are required to be adjusted and recorded in the books of account. If not so adjusted, the variances, particularly those which are allocable to the year-end inventories, must be taken up as an adjustment in the tax return.

Valuation of inventories at the end of each fiscal year must be made in accordance with the method(s) reported for each class of inventory to the tax office by the company. The valuation methods allowable for tax purposes are cost method (specific identification, FIFO, weighted average, moving average, recent purchase, or retail price discount method) or lower of cost or market value method.

The valuation method selected by the company must be applied consistently. If a company wishes to change the current method, an application for change of method must be submitted to the tax office prior to the commencement date of the fiscal year in which the change is to be effected.

At the end of each fiscal year, a physical inventory must be taken and a list thereof must be prepared (if not at the year-end, a reconciliation between the physical inventory and the year-end inventory will be required).

### 1.8.2 Valuation of Marketable and Investment Securities

The acquisition cost of securities is the total of the price paid and incidental expenses in the case of acquisition by purchase or by subscription. However, where shares are subscribed for at a value below market price (except where such subscription is made equally by existing shareholders), generally market value is treated as acquisition cost regardless of the price actually paid.

Valuation of securities at the end of each fiscal year must be made in accordance with the following method(s):

| Kind of securities | Valuation methods |
|---|---|
| Securities held for trading purposes | Mark-to-market valuation method |
| Other securities | Cost method(*)<br>(weighted average or moving average) |

(*) In order to prevent tax avoidance by creating tax losses from the transfer of shares in a subsidiary following dividends received from that subsidiary, the tax book value of shares in the subsidiary is reduced by the amount equivalent to non-taxable dividend income received from the subsidiary if a parent company received dividends from the subsidiary which meet certain conditions (e.g. the amount of dividend received from a specific relationship subsidiary in a fiscal year is greater than 10 percent of tax book value of shares in the specific relationship subsidiary, etc.).

The transfer cost of securities is calculated in accordance with the method(s) reported for each class of securities to the tax office by the company. Subsequent changes to the adopted method must be made in a similar manner as discussed under valuation of inventories above. Note that amortization or accumulation is required in respect of securities which are to be held to maturity.

### 1.8.3 Provision for Bad Debts

The allowable amount of a provision for bad debts is the total of (i) and (ii) below:

(i) Specific doubtful receivables provision

A provision for a limited range of doubtful receivables, as specifically identified under the tax law (up to the relevant limits specified under the tax law)

(ii) General bad debt provision

A provision for potential bad debts among existing receivables (other than those falling under (i) above) based upon the actual bad debt ratio for the preceding 3 years

The amount of (ii) is calculated using the formula below:

$$\text{Outstanding accounts receivable at the year end (other than those under (i))} \times \frac{\text{Average amount of bad debts for the prior 3 years}}{\text{Average outstanding accounts receivable for prior 3 years}}$$

Provisions for bad debts are allowable only for companies categorized into (A) or (B) below for tax purposes. Moreover, for companies categorized into (B), provision for bad debts for tax purposes is limited to only certain receivables.

| | (A) | (B) |
|---|---|---|
| Companies | • Small and medium-scale companies defined in 1.3.1<br>• Banks, insurance companies and similar companies | Certain companies which hold certain monetary claims (e.g. receivables incurred in finance lease transactions) |
| Receivables subject to the provision(*) | Monetary claims | Finance lease receivables, etc. |

(*) Accounts receivable from companies in a 100 Percent Group defined 1.13.1 are excluded for fiscal years beginning on or after 1 April 2022.

For a small and medium-scale company defined in 1.3.1 (excluding a company whose average taxable income for the preceding 3 years is over JPY1.5 billion), as an alternative to the formula above, the statutory provision rate of bad debts for each industry may be applied against the company's outstanding accounts receivable. The statutory provision rates are as shown below:

| Industry sector | Statutory provision rates |
|---|---|
| Wholesale and retail | 1.0% |
| Manufacturing | 0.8% |
| Finance and insurance | 0.3% |
| Installment retailer | 0.7% |
| Other | 0.6% |

### 1.8.4 Bad Debt Expenses

If the following facts have occurred, the following amounts are treated as tax deductible bad debt expenses in the fiscal year the facts arise:

| Facts | Bad debt expense amount |
|---|---|
| Approval of rehabilitation plans in accordance with the Corporate Rehabilitation Law or the Civil Rehabilitation Law | The amount determined to be written off |
| Approval of special liquidation proceedings under the Companies Act | The amount determined to be written off |
| Resolution at creditors' meetings or a contract between related parties by arrangement by governments or banks | The amount determined to be written off |
| A notice issuance to a debtor who has been insolvent for a certain period | The amount declared to be written off in the notice |

Also, a company can record a bad debt for a receivable from a debtor in its accounting books when it becomes certain that the debtor cannot pay off the receivable considering the financial situation and insolvency of the debtor.

Moreover, for receivables incurred from continuous sales transactions, when 1 year has passed since the last transaction with a debtor (a sales transaction to the debtor or a collection from the debtor, whichever is later) or when expected costs to collect money exceed the outstanding receivables, a company can write off the receivables with a remaining balance of JPY1 in its accounting books.

### 1.8.5 Directors' Compensation

If compensation (excluding retirement/severance allowances, which are discussed in 1.8.6) paid to company directors (e.g. members of the board of directors, officers and statutory auditors) falls under one of the following three categories, (1) (2) or (3) below, the compensation is allowable as a deduction for corporation tax purposes, except for cases where the amount is unreasonably high or it is paid by concealing facts or disguising the accounting books.

(Please note that the keywords in this section are explained in (4).)

(1) Fixed Amount Periodical Compensation

'Fixed amount periodical compensation' means compensation which is regularly paid on a monthly/weekly/daily basis with a fixed amount through a fiscal year.

If the amount of the compensation is revised for the following reasons, regularly paid compensation of which the amounts before the change are stable and regularly paid compensation of which the amounts after the change are stable are treated as fixed amount periodical compensation:

- annual revision (revision made within 3 months from the beginning of the fiscal year, in principle)

- extra-ordinary revision due to unavoidable reasons (e.g. reorganizations)

- revision to decrease base compensation due to significant deterioration in the company's financial situation

Fringe benefits where they are continuously provided and the value of the benefits is generally stable on a monthly basis are also categorized as fixed amount periodical compensation.

(2) Fixed Compensation Notified in Advance

'Fixed compensation notified in advance' is compensation satisfying all of the following three conditions:

(i) It is paid at a fixed time by a fixed amount of cash (or by a fixed number of shares/stock options or by specified restricted stock/specified stock options in exchange of a fixed amount of monetary claims for compensation).

(ii) It falls under neither 'fixed amount periodical compensation' discussed in (1) nor 'performance-based compensation' discussed in (4)(iv).

(iii) Advance notification stating details of the compensation is filed with the competent tax office.

(This requirement is not imposed on certain types of compensation (e.g. compensation paid to non-executive directors of a non-family company).)

(3) Deductible Performance-Based Compensation

'Deductible performance-based compensation' means performance-based compensation discussed in (4)(iv) that meets all of the following four conditions:

(i) It is paid to a managing director (a director involved in execution of the business operations of a company) by a non-family company or a family company that is wholly owned by a non-family company.

(ii) The amount of cash compensation, the number of shares/stock options issued/granted as compensation or the number of cancelled stock options is calculated based on performance-linked parameters and the calculation method satisfies the following:

- The ceiling of the compensation is pre-determined.

- The calculation method for the managing director is similar to that for other managing directors.

- The calculation method must be determined by the Compensation Committee prescribed by the Companies Act or equivalent procedures within the prescribed periods.

- The calculation method is disclosed in a timely manner in a Securities Report or certain similar reports.

(iii) The compensation is paid or expected to be paid to the director within the prescribed periods.

(iv) The company records the compensation as an expense in its accounting books when it is paid out or the company reverses a provision for directors' compensation in its accounting books.

(4) Definitions of Keywords

(i) Specified restricted stock: please see 1.8.7.

(ii) Specified stock options: please see 1.8.8.

(iii) Shares (including specified restricted stock) issued as compensation must be listed shares and stock options (including specified stock options) granted as compensation must be those where the holder is entitled to obtain listed shares at the time of exercise. Moreover, they must be issued or granted by a company receiving services performed by the individual or by a company holding directly or indirectly more than 50 percent of the company receiving services.

(iv) Performance-based compensation is compensation falling under either of the following:

- cash or shares/stock options the amount or number of which is determined based on performance of the company receiving services or its related companies

- specified restricted stock/specified stock options the number of which cancelled fluctuates based on any factor other than the length of the period of services

(v) Performance-linked parameters are broadly as follows:

- parameters indicating profitability (e.g. profits, EBITDA, ROE and ROA) disclosed in a Securities Report

- parameters reflecting share market value

- parameters reflecting sales proceeds disclosed in a Securities Report (only when they are used together with either of the above two parameters.)

### 1.8.6 Retirement/Severance Allowances for Directors

Costs for retirement/severance allowances paid to company directors are treated as follows:

<table>
<tr><th colspan="2">Retirement/severance allowances</th><th>Tax treatment</th></tr>
<tr><td colspan="2">Not ‘performance-based compensation’ discussed in 1.8.5 (4)(iv) (1)</td><td>Deductible(2)</td></tr>
<tr><td rowspan="2">‘Performance-based compensation’</td><td>‘Deductible performance-based compensation’ discussed in 1.8.5 (3)</td><td>Deductible(2)</td></tr>
<tr><td>Not ‘deductible performance-based compensation’</td><td>Non-deductible</td></tr>
</table>

(1) Where compensation by specified restricted stock or specified stock options is accounted for as an expense over the service period, such compensation does not fall under Not 'performance-based compensation' even if the end date of the transfer restriction period of specified restricted stock or the start date of the exercisable period of specified stock options is the resignation date of a director so that the compensation is treated as retirement income for individual income tax purposes.

(2) Note that it could be non-deductible if the amount is unreasonably high, or it is paid by concealing facts or disguising the accounting books.

### 1.8.7 Restricted Stock

Where a company issues specified restricted stock to individuals as compensation for services performed by them, costs for such services are deductible in the fiscal year when the transfer restrictions on the stock are determined to be released.

Restricted stock is defined as stock which is subject to restrictions on transferability for a certain period of time and forfeiture upon certain trigger events. Restricted stock is treated as specified restricted stock in certain cases including where an employee/director of a company contributes monetary claims for their compensation to the company in order to obtain restricted stock from the company (i.e. a contribution-in-kind).

Costs for specified restricted stock issued to company directors are deductible if such compensation falls under 'fixed compensation notified in advance' discussed in 1.8.5 (2), except for cases where the amount is unreasonably high, etc.

Please see 3.4.2 (8) for the individual income tax treatment of restricted stock.

### 1.8.8 Stock Options

When a company grants specified stock options to individuals as compensation for services performed by them, costs for such services are deductible at the time of exercise of the stock options.

Stock options that are subject to restrictions on transferability for a certain period of time are treated as specified stock options in certain cases including where an employee/director of a company contributes monetary claims for their compensation to the company in exchange for stock options. Tax-qualified stock options for Japanese individual income tax purposes are not treated as specified stock options.
Costs for specified stock options granted to company directors are deductible where such compensation falls under 'fixed compensation notified in advance' discussed in 1.8.5 (2) or 'deductible performance-based compensation' discussed in 1.8.5 (3), except for cases where the amount is unreasonably high, etc.

Please see 3.4.2 (7) for the individual income tax treatment of stock options, including conditions for tax-qualified stock options.

### 1.8.9 Devaluation Loss

A write-down of assets, other than a write down to market value in the case of damage due to disaster or obsolescence of inventories or fixed assets, should generally be disallowed for tax purposes.

### 1.8.10 Corporate Taxes, etc.

Corporation tax, prefectural and municipal inhabitant taxes, local corporation tax, interest on delinquent taxes, penalties, fines, etc. should be disallowed for tax purposes. Note that business tax and special business tax are deductible basically

when a tax return for such taxes is lodged.

Japanese withholding taxes and foreign withholding taxes are generally creditable (or deductible if not credited against corporation tax). Foreign withholding taxes on a dividend from a Foreign Subsidiary are not creditable. Neither are they deductible if the foreign dividend exclusion (FDE) is applied to the dividends. Please see 4.1 for the definition of a Foreign Subsidiary and the FDE system.

### 1.8.11 Donations

Donations are partially deductible as follows:

| Donations | Deductible limit (per annum) |
|---|---|
| • To national/local governments<br>• Designated by the national government | All |
| To Specified Public Interest Facilitating Corporations | 3.125% of taxable income + 0.1875% of stated capital and capital reserve(*) |
| Other than above | 0.625% of taxable income + 0.0625% of stated capital and capital reserve(*) |

(*) Instead of capital reserve, capital surplus is used for fiscal years beginning before 1 April 2022.

If the amount of donations to Specified Public Interest Facilitating Corporations exceeds the above limit, the excess amount is treated as ordinary donations and contributions in the third category.

Note that where a company pays donations to its Related Overseas Company defined in 4.3.2, the full amount of such donations is not deductible except for cases where the

donations are treated as income attributable to a PE in Japan of the Related Overseas Company.

Under the corporate version of the hometown tax regime, when a blue-form tax return filing company pays contributions to local governments with respect to designated businesses stated in a certified regional revitalization plan under the Regional Revitalization Act for the period from 20 April 2016 to 31 March 2025, the company will be able to take tax credits (generally, 20 percent of the contribution for business tax purposes and 40 percent of the contribution for inhabitant tax purposes). Thus, the tax burden of the company could be reduced by approximately 90 percent of such contributions; i.e. (i) 30 percent of the contributions by taking a deduction for the contributions to local governments (assuming that the effective corporate tax rate for the company is 30 percent) and (ii) 60 percent of the contributions by using the above tax credit rules (assuming that the maximum amount is creditable).

If assets are sold at a lower price than the fair market value, the difference between them is treated as a donation, which has only limited deductibility as discussed above. Since the donee is also required to recognize taxable income equal to the amount of the undervalue, this often results in additional net taxable income arising.

If a company makes a payment, details of which are not disclosed, such payment is disallowed for corporation tax purposes by the paying company, and a surtax of 40 percent of the payment amount is levied as a penalty for making such improper payments in addition to regular corporate taxes.

Please see 1.13.5 for donations between Japanese companies within a 100 Percent Group.

### 1.8.12 Entertainment Expenses

Entertainment expenses for a year in excess of the following deductible limits are disallowed:

| Size of company | | Deductible limit |
|---|---|---|
| A small and medium-scale company defined in 1.3.1 | | Higher of JPY8 million or 50% of eating and drinking expenses |
| Other than small and medium-scale company | Company with stated capital of JPY10 billion or less | 50% of eating and drinking expenses |
| | Company with stated capital in excess of JPY10 billion | 0 |

Social and entertainment expenses include expenses generally disbursed for the purposes of reception, entertainment, consolation, gifts, etc. However, it does not include expenses falling under contributions, discounts and rebates, welfare expenses, personnel costs, etc. which are treated differently for tax purposes.

A company with stated capital of JPY10 billion or less is required to keep relevant documents indicating details of eating and drinking expenses in order to have such expenses to be subject to the 50 percent deduction. The following items are excluded from eating and drinking expenses subject to the 50 percent deduction:

- eating and drinking expenses solely for the company's directors/employees and relatives of them

- eating and drinking expenses which are not treated as entertainment expenses, such as:

- expenses for business meetings

- expenses for welfare activities

- expenses whose cost is JPY5,000 or less per person that are justified by relevant records (excluding those solely for the company's directors/employees and relatives of them).

### 1.8.13 Interest: Thin Capitalization Regime/Earnings Stripping Regime

Please see 4.4 and 4.5 for details.

### 1.8.14 Translation into Japanese Currency (Yen) of Assets/Liabilities in Foreign Currencies

With respect to foreign currency receivables and payables, a company may select either: (i) the method of translation based on the exchange rate at the time such receivables or payables were created, or (ii) the method of translation based on the exchange rate at the end of each fiscal year. The default translation method for short-term receivable/payable is (ii) while that for long-term receivable/payable is (i).

If a company wishes to select a non-default translation method, the company is required to submit a report on the selected method of translation to the competent tax office by the due date of the first relevant corporation tax return. If a company wishes to change the method, an application for the change must be submitted to the tax office prior to the commencement date of the fiscal year in which the change is to be effected.

If a company has a forward contract on receivables and payables in foreign currencies at the end of a fiscal year, the Yen amount fixed under such forward contract is generally used for translation purposes instead of the Yen amount translated at historical exchange rates or the spot rates at the

end of the fiscal year. If this is the case, exchange gains and losses caused by application of a forward exchange rate are generally dealt with as follows:

- If a forward contract is concluded before a transaction, the difference between the forward rate and the spot rate at the transaction is spread proportionately over the period from the transaction date to the settlement date and included within taxable income/loss of the relevant fiscal year.

- If a forward contract is concluded after a transaction, the difference between the forward rate and the spot rate at the date of concluding the forward contract is spread proportionately over the period from the date of concluding the forward contract to the settlement date and included within taxable income/loss of the relevant fiscal year.

### 1.8.15 Management Service Fees

If a foreign parent company is operating in Japan through a subsidiary or a joint venture (JV) formed with a Japanese partner, there would be situations in which the foreign parent company provides management services to the subsidiary or JV in Japan, for example by dispatching expatriate staff to the operation in Japan, sending marketing, technical, financial and administrative information useful for the Japanese operations and training Japanese staff members. A management service fee paid pursuant to such services should be a deductible expense for Japanese tax purposes. However, to ensure full deductibility, the management service fee levied should be reasonable in view of the nature and extent of services provided and should not be used for the purposes of shifting profits from the Japanese subsidiary to the foreign parent company.

Japanese tax law contains transfer pricing provisions aimed at preventing tax avoidance by companies through transactions with their Related Overseas Companies (please see 4.3.2). This

transfer pricing legislation is applicable not only to the sale or purchase of goods but also to rendering of services, charging of interest and royalties, and to any other transactions with Related Overseas Companies that do not meet the arm's-length concept; further, the legislation obliges the taxpayer to justify the reasonableness of transfer prices. Accordingly, arrangements between a foreign parent or affiliates and related Japanese entities should be carefully reviewed to determine whether such arrangements and associated fees can be supported.

### 1.8.16 Allocation of Head Office Expenses

Where common costs incurred for businesses of both a PE in Japan and the head office are allocated to the PE in Japan based on reasonable allocation keys, such allocated costs are allowable in the hands of the PE in Japan provided that a document regarding the cost allocation is preserved by the company.

## 1.9 Tax Depreciation

### 1.9.1 Fixed Assets and Depreciation

(1) Acquisition Cost

The entire purchase or manufacturing cost, or in the case of acquisition other than by purchase or manufacture, the fair market value, as well as incidental expenses incurred directly in connection with acquisition of fixed assets or in making the fixed assets available for use, must be included in the acquisition cost.

Minor assets whose acquisition cost is less than JPY100,000 or which are used up within 1 year are not required to be taken up as fixed assets and the cost of such assets can be expensed. For assets whose acquisition cost is JPY100,000 or more but less than JPY200,000, the cost can be amortized over 3 years.

(2) Ordinary Depreciation

In principle, a company may generally select either the straight-line method or the declining-balance method for computing depreciation of each respective class of tangible fixed assets located at different business places. However, buildings (acquired on or after 1 April 1998) and attachments to buildings and structures (acquired on or after 1 April 2016) must be depreciated using the straight-line method whilst intangible assets must also generally be amortized using this method. Moreover, certain leased assets must be depreciated using the modified straight-line method. The default depreciation method for most assets other than these assets is the declining-balance method.

The depreciation and amortization allowable for tax purposes must be computed in accordance with the rates corresponding to the statutory useful lives provided in the Ministry of Finance Ordinance.

The calculation methods and depreciation rates vary depending on when the tangible fixed assets are acquired as discussed below.

■ Tangible fixed assets acquired on or after 1 April 2007 but before 1 April 2012

| Depreciation rates | | | | |
|---|---|---|---|---|
| Useful life | Straight-line method | Declining-balance method | | |
| | Depreciation rate (A) | Depreciation rate (X) | Modified depreciation rate (Y) | Minimum annual depreciation rate (Z) |
| 2 | 0.500 | 1.000 | ----- | ----- |
| 3 | 0.334 | 0.833 | 1.000 | 0.02789 |
| 4 | 0.250 | 0.625 | 1.000 | 0.05274 |
| 5 | 0.200 | 0.500 | 1.000 | 0.06249 |
| 6 | 0.167 | 0.417 | 0.500 | 0.05776 |
| 7 | 0.143 | 0.357 | 0.500 | 0.05496 |
| 8 | 0.125 | 0.313 | 0.334 | 0.05111 |
| 9 | 0.112 | 0.278 | 0.334 | 0.04731 |
| 10 | 0.100 | 0.250 | 0.334 | 0.04448 |
| : | : | : | : | : |

| Calculation methods | Annual depreciable amount |
|---|---|
| Straight-line method | Acquisition cost x Depreciation rate (A) |
| Declining-balance method | (i)For the period where:<br>Tax book value at the beginning of the fiscal year x Depreciation rate (X) > Acquisition cost x Minimum annual depreciation rate (Z)<br>Tax book value at the beginning of the fiscal year x Depreciation rate (X) |
| | (ii) For the period where:<br>Tax book value at the beginning of the fiscal year x Depreciation rate (X) < Acquisition cost x Minimum annual depreciation rate (Z)<br>Tax book value at the beginning of the first fiscal year when it falls in (ii) x Modified depreciation rate (Y) |

(Minimum residual value: JPY1)

Under the declining-balance method, for the first few years (e.g. 7 years for an asset whose statutory useful life is 10 years) an asset is depreciated using Depreciation rate (X), which is 250 percent of the depreciation rate under the straight-line method, and for the remaining years (e.g. the last 3 years for an asset whose statutory useful life is 10 years) the asset is depreciated equally using Modified depreciation rate (Y).

■ Tangible fixed assets acquired on or after 1 April 2012

| Depreciation rates | | | | |
|---|---|---|---|---|
| Useful life | Straight-line method | Declining-balance method | | |
| | Depreciation rate (A) | Depreciation rate (X) | Modified depreciation rate (Y) | Minimum annual depreciation rate (Z) |
| 2 | 0.500 | 1.000 | ----- | ----- |
| 3 | 0.334 | 0.667 | 1.000 | 0.11089 |
| 4 | 0.250 | 0.500 | 1.000 | 0.12499 |
| 5 | 0.200 | 0.400 | 0.500 | 0.10800 |
| 6 | 0.167 | 0.333 | 0.334 | 0.09911 |
| 7 | 0.143 | 0.286 | 0.334 | 0.08680 |
| 8 | 0.125 | 0.250 | 0.334 | 0.07909 |
| 9 | 0.112 | 0.222 | 0.250 | 0.07126 |
| 10 | 0.100 | 0.200 | 0.250 | 0.06552 |
| : | : | : | : | : |

The calculation methods for assets under this category are the same as those acquired on or after 1 April 2007 but before 1 April 2012.

The depreciation rate (X) is calculated as 200 percent of the depreciation rate under the straight-line method.

■ Intangible Fixed Assets

Intangible assets are amortized over statutory useful lives under the straight-line method without a depreciable limit.

(3) Reports on Depreciation Methods

The depreciation method(s) needs to be reported to the tax office in a timely manner if the company wishes to select a non-default method. Such selection must be submitted by:

- the filing due date of the corporation tax return for the first fiscal year in the case of a newly established company; and

- the filing due date of the corporation tax return for the fiscal year in which assets of a different classification were acquired, if the selected depreciation method for such classification has not been selected previously (i.e. if the depreciation method for furniture and fixtures has been selected and trucks were newly acquired, then a report on the depreciation method for the trucks is required).

The depreciation method must be applied consistently. If the company wishes to change the method, an application for the change must be submitted to the tax office prior to the commencement date of the fiscal year in which the change is to be effected.

(4) Statutory Useful Lives

A company is generally required to follow the statutory useful lives provided in the Ministry of Finance Ordinance.

Under extraordinary circumstances such as a 24-hour operation in the case of machinery and equipment at factories, an application may be submitted to the tax office for approval of shortening of useful lives or taking extra depreciation.

With regard to second-hand property if it is difficult to estimate the remaining useful life, the useful life for tax purposes can be calculated using the following formula (subject to a minimum of 2 years):

| | |
|---|---|
| If statutory useful life ≤ number of years elapsed (A) | Statutory useful life x 20% |
| If statutory useful life > number of years elapsed (A) | Statutory useful life - (A) + 20% of (A) |

(5) Accounting and Tax Treatment

The depreciation and amortization must be recorded in the books of account. If the amount of such charge is more than the allowable limit for tax purposes as computed above (known as 'excess depreciation'), the excess portion is required to be added back to accounting profit on the tax return pending allowance in subsequent fiscal years.

If the amount of the deductions is less than the allowable limit for tax purposes (known as 'short depreciation'), the resulting tax treatment of the depreciation allowance is an effective extension of the useful life of the assets concerned, since the allowable charge for each fiscal year for tax purposes is limited to the amount recorded in the books of account.

(6) Special Measures for Depreciation

Special depreciation by means of either increased first year depreciation or accelerated depreciation is available for companies filing blue-form tax returns in relation to certain fixed assets as specified under the law. Such reliefs merely accelerate the timing of depreciation rather than increasing the amount of depreciation which can be taken.

Since the special depreciation allowance is intended to help promote political objectives of the government, restrictions are placed upon the companies or assets qualifying for such benefit.

In contrast to the treatment for ordinary depreciation, short depreciation arising in respect of the special depreciation

allowance may be carried forward for 1 year, and excess depreciation in such a year can be set off against the short depreciation.

### 1.9.2 Deferred Charges

Expenditures made by a company that have a useful period of more than 1 year from the date of the disbursement should be treated as deferred charges and subject to amortization for tax purposes.

The following expenditures fall under the category of deferred charges, which can be amortized freely for tax purposes up to the amount of amortization for accounting purposes:

- organization expenses

- pre-operating expenses incurred specifically in connection with commencement of operations

- development expenses incurred specifically in connection with application of new technology or a new operating system, or development of resources

- expenses relating to issuance of new shares

- expenses relating to issuance of bonds

The following expenses are also treated as deferred charges and usually amortized over the period of the economic benefit:

- expenses, the benefit of which relates to a period of more than 1 year, such as the cost of installation of equipment, etc. for public use, key money for leasing of property, cost of fixed assets provided to customers for advertising and sales promotion purposes, lump-sum payment for know-how, etc.

The amortization of deferred charges is computed by applying the straight-line method. Deferred charges of less than JPY200,000 per item may be expensed immediately.

## 1.10 Revenue to be excluded from Taxable Income

### 1.10.1 Dividends Received from Japanese Companies

Dividends received by a company from other Japanese companies are excludable in calculating taxable income as indicated below:

| Categories of shares | Ownership requirements | Excludable ratios |
|---|---|---|
| Shares in 100% subsidiaries | 100% throughout the calculation period (the maximum period: 1 year up to the end of the calculation period) | Dividends received x 100% |
| Shares in related companies | more than 1/3 throughout the calculation period [1] (the maximum period: 6 months up to the end of the calculation period) | (Dividends received - Interest on debts [2]) x 100% |
| Other shares | (more than 5% but 1/3 or less) | Dividends received x 50% |
| Non-controlling shares | 5% or less as of the record date [1] | Dividends received x 20% (40% for insurance companies) |

[1] Ownership requirements are determined based on the total number of shares held by the dividend recipient companies in a 100 Percent Group defined in 1.13.1 for fiscal years beginning on or after 1 April 2022.

(2) Interest on debts is calculated by the following formula, not on an actual basis, for fiscal years beginning on or after 1 April 2022:

Amount of dividends from related companies x 4 percent (Upper limit: Amount of interest on debts in the fiscal year x 10 percent)

If dividends are received on shares which were acquired 1 month prior to the end of the fiscal year of the issuing company and sold within 2 months after the end of the same fiscal year, those dividends are not excluded from gross income.

### 1.10.2 Revaluation Gain on Assets

It is not permissible for tax purposes to recognize revaluation gains on assets except in certain limited cases such as on a revaluation performed under the Corporation Reorganization Law.

### 1.10.3 Refunds of Corporate Taxes, etc.

Refunds of non-deductible items (corporation tax, prefectural and municipal inhabitant taxes, local corporation tax, interest on delinquent taxes, penalties, fines, etc.) are not taxable if refunded. Note that refunds of business tax and special business tax constitute taxable income since payments of these taxes are tax deductible.

## 1.11 Tax Credits

### 1.11.1 Withholding Income Tax Credits

Income tax withheld in Japan from interest and domestic dividends received by a taxpayer company is generally creditable against corporation tax. The excess of such withholding tax over the corporation tax liability, if any, is refundable.

Withholding tax on bond interest received by a taxpayer company is fully creditable regardless of the holding period.

If a recipient company holds shares for the full period of the dividend calculation period, the withholding tax on the dividend is fully creditable. If not held for the entire calculation period, the recipient company needs to calculate creditable withholding tax by one of the following two methods:

| | | | |
|---|---|---|---|
| Principal method | | | |
| Withholding tax on dividends | x | No. of months in holding period of the respective shares of dividends / No. of months in calculation period for the respective dividends | |
| Simplified method | | | |
| Withholding tax on dividends | x | No. of shares held at the beginning of the calculation period for dividends (B) / No. of shares held at the end of the calculation period for dividends (A) | + {(A) - (B)} x 1/2 |

Note that special reconstruction income tax will be imposed on withholding tax at 2.1 percent from 2013 to 2037. Such special reconstruction income tax is creditable/refundable in a similar way as discussed above.

### 1.11.2 Foreign Tax Credits

Please see 4.2 for details.

### 1.11.3 Tax Credits for Research and Development (R&D) Costs

(1) Tax Credit for General R&D Costs

A company filing a blue-form tax return is eligible for R&D tax credits based on total R&D costs. For a fiscal year beginning between 1 April 2021 and 31 March 2023(*), the creditable amount is calculated as follows:

(*) Note that the tax credit system for R&D costs is a permanent measure.

- Large-sized companies (companies other than small and medium-sized companies)

| Increase-decrease R&D ratio | Tax creditable amount |
|---|---|
| More than 9.4% | Total R&D costs x {10.145% + (Increase-decrease R&D ratio - 9.4%) x 0.35} (Upper limit: Total R&D costs x 14%) |
| 9.4% or less | Total R&D costs x {10.145% - (9.4% - Increase-decrease R&D ratio) x 0.175} (Lower limit: Total R&D costs x 2%) |

The maximum creditable amount is 25 percent of the corporation tax liability for the fiscal year. If a company satisfies certain conditions, the maximum creditable amount will be increased as follows:

- 40 percent of the corporation tax liability for the fiscal year, where a company meets the definition of certain venture R&D companies

- 30 percent of the corporation tax liability for the fiscal year, where a company increases investment in R&D in spite of a certain degree of decrease in sales

Where the R&D ratio exceeds 10 percent, the tax creditable ratio, which total R&D costs are multiplied by, will be increased up to 14 percent based on the R&D ratio. The maximum creditable amount will also be increased up to 35 percent of the corporation tax liability.

■ Small and medium-sized companies

| Increase-decrease R&D ratio | Tax creditable amount |
|---|---|
| More than 9.4% | Total R&D costs x {12% + (Increase-decrease R&D ratio – 9.4%) x 0.35} (Upper limit: Total R&D costs x 17%) |
| 9.4% or less | Total R&D costs x 12% |

The maximum creditable amount is 35 percent of the corporation tax liability for the fiscal year in the case where the Increase-decrease R&D ratio is more than 9.4 percent or 25 percent of the corporation tax liability for the fiscal year in the case where the Increase-decrease R&D ratio is 9.4 percent or less. In addition, if a company increases investment in R&D in spite of a certain degree of decrease in sales, 5 percent of the corporation tax liability for the fiscal year is added to the maximum creditable amount in each case above.

Where the R&D ratio exceeds 10 percent, the tax creditable ratio, which total R&D costs are multiplied by, will be increased up to 17 percent based on the R&D ratio. The maximum creditable amount will also be increased up to 35 percent of the corporation tax liability.

(2) Tax Credit for Specified R&D Costs

A blue-form tax return filing company conducting joint/consignment R&D is eligible for R&D tax credits for the specified R&D costs, separately from the tax credits for general R&D costs. The creditable amount is calculated as follows:

| Specified R&D costs x 20% or 25% or 30% |
|---|

The maximum creditable amount is 10 percent of the corporation tax liability for the fiscal year.

(3) Definitions of Keywords

(i) A small and medium-sized company means (a) or (b) below:

(a) Companies with stated capital of JPY100 million or less, except for either of the following cases:

- at least 50 percent of the shares are held by one large-scale company (e.g. a company whose stated capital is over JPY100 million)

- at least two-thirds of the shares are held by two or more large-scale companies

(b) Companies with no capital whose number of regular employees is 1,000 or less

Note that a company whose average taxable income for the preceding 3 years is over JPY1.5 billion will be excluded from an eligible company.

(ii) Increase-decrease R&D ratio = (a)/(b)

(a): [Total R&D costs in a fiscal year] - [annual average of R&D costs for the preceding 3 fiscal years]
(if the figure is negative, the negative figure is used.)

(b): Annual average of R&D costs for the preceding 3 fiscal years

(iii) R&D ratio = (a)/(b)

(a): Total R&D costs in a fiscal year

(b): Annual average of sales proceeds for the preceding 3 fiscal years and the current fiscal year (Average Sales Proceeds)

(iv) Specified R&D costs means costs for joint/consignment R&D activities with/to universities, national R&D organizations, etc. under certain conditions.

***

Note that large-sized companies are subject to a restriction for applying tax credits for R&D costs (discussed in 1.11.6).

### 1.11.4 Tax Credits for Acceleration of Securing Human Resources, etc.

Tax credits for acceleration of securing human resources, etc., were aimed at promoting the increase of salary payments and education and training costs for newly hired employees.

The tax credits are applicable for a company filing a blue-form tax return, which is not a small and medium-sized company (defined in 1.11.3), for fiscal years beginning between 1 April 2021 and 31 March 2022 under following conditions:

(1) Conditions:

| | |
|---|---|
| (i) | [Salary payments for newly hired employees in the current fiscal year]<br>≥ [Salary payments for newly hired employees in the preceding fiscal year] x 102% |

| | |
|---|---|
| (ii) | [Education and training costs in the current fiscal year] ≥ [ Education and training costs in the preceding fiscal year] x 120% |

(2) Tax Credits:

| | |
|---|---|
| Where condition (i) is satisfied but (ii) is not satisfied | [Salary payments for newly hired people in the current fiscal year(*)] x 15% |
| Where conditions (i) and (ii) are satisfied | [Salary payments for newly hired people in the current fiscal year(*)] x 20% |

(*) Upper limit: [salary payments in the current fiscal year] – [salary payments in the preceding fiscal year]

The maximum total creditable amount is 20 percent of the corporation tax liability for the fiscal year.

(3) Definitions of Keywords

(i) 'Salary payments' means salary paid to domestic employees which is deductible in calculating the company's income for each fiscal year.

(ii) 'Newly hired employees' mean domestic employees who have worked for a year or less since the start of working at a domestic office of a company.

***

Note that the tax credits for salary growth are available for a small and medium-sized company for fiscal years beginning between 1 April 2021 and 31 March 2022 under different conditions.

### 1.11.5 Tax Credits for Promotion of Salary Increases

By virtue of the 2022 tax reform, tax credits for acceleration of securing human resources, etc. (discussed in 1.11.4) were reformed to the tax credits for promotion of salary increases from the viewpoint of promoting substantial salary increases for each employee based on a long-term perspective and encouraging returns to various stakeholders including not only shareholders but also employees and business partners.

The tax credits are applicable for a company filing a blue-form tax return, which is not a small and medium-sized company (defined in 1.11.3), for fiscal years beginning between 1 April 2022 and 31 March 2024 under following conditions:

(1) Conditions:

| | |
|---|---|
| (i) | [Salary payments for continuously employed people in the current fiscal year]<br>≥ [Salary payments for continuously employed people in the preceding fiscal year] x 103% |
| (ii) | [Salary payments for continuously employed people in the current fiscal year]<br>≥ [Salary payments for continuously employed people in the preceding fiscal year] x 104% |
| (iii) | [Education and training costs in the current fiscal year]<br>≥ [ Education and training costs in the preceding fiscal year] x 120% |

- Requirements for the management declaration on multi-stakeholders

For companies, whose number of regular employees is 1,000 or more, with stated capital of JPY1 billion or more at the end of the fiscal year, this measure is applicable only when they have notified the Minister of Economy, Trade and Industry ('METI') that they have made public announcements about the policy of

salary increases, the policy of building appropriate relationships with subcontractors and other business partners, and other matters through the internet, and attach copies of the notification receipt issued by the METI to their final tax returns, etc. for the fiscal year.

(2) Tax Credits:

| | |
|---|---|
| Where only condition (i) is satisfied | {[Salary payments in the current fiscal year] - [Salary payments in the preceding fiscal year]} x 15% |
| Where condition (ii) is satisfied | {[Salary payments in the current fiscal year] - [Salary payments in the preceding fiscal year]} x 25% |
| Where conditions (i) and (iii) are satisfied | {[Salary payments in the current fiscal year] - [Salary payments in the preceding fiscal year]} x 20% |
| Where conditions (ii) and (iii) are satisfied | {[Salary payments in the current fiscal year] - [Salary payments in the preceding fiscal year]} x 30% |

The maximum total creditable amount is 20 percent of the corporation tax liability for the fiscal year.

(3) Definitions of Keywords

(i) 'Salary payments' is the same as 1.11.4.

(ii) 'Continuously employed people' means domestic employees who worked for the full period of the current fiscal year and the full period of the preceding fiscal year.

***

Note that the tax credits for promotion of salary increases are available for a small and medium-sized company for fiscal years beginning between 1 April 2022 and 31 March 2024 under different conditions.

### 1.11.6 Restriction on Eligible Companies for Applying Tax Credits

With the aim of promoting sustainable pay-raises and domestic capital investment for large-sized companies (companies other than small and medium-sized companies (defined in 1.11.3)), a large-sized company that satisfies neither condition (i) nor (ii) in (1) will not be allowed to apply tax credits related to the five special tax measures indicated in (2) below for fiscal years beginning between 1 April 2018 and 31 March 2024.

(1) Conditions

| | |
|---|---|
| (i) | [Salary payments for continuously employed people in the current fiscal year]<br>> [Salary payments for continuously employed people in the preceding fiscal year] |
| (ii) | [Total acquisition costs of depreciable assets located in Japan in the current fiscal year]<br>> [Total depreciation costs of depreciable assets recorded in the current fiscal year] x 30% |

By virtue of the 2022 tax reform, the condition (i) is strengthened for companies whose number of regular employees is 1,000 or more with stated capital of JPY1 billion or more at the end of the fiscal year and the preceding fiscal year's income exceeds zero as follows:

| | |
|---|---|
| Fiscal years beginning between 1 April 2022 and 31 March 2023 | [Salary payments for continuously employed people in the current fiscal year]<br>> [Salary payments for continuously employed people in the preceding fiscal year] x 100.5% |

| | |
|---|---|
| Fiscal years beginning between 1 April 2023 and 31 March 2024 | [Salary payments for continuously employed people in the current fiscal year] > [Salary payments for continuously employed people in the preceding fiscal year] x 101% |

The meanings of 'salary payments' and 'continuously employed people' are the same as 1.11.4 and 1.11.5.

(2) Scope of Tax Credits to be Restricted

- Tax credits for Research and Development (R&D) costs (discussed in 1.11.3)

- Tax credits for promotion of future investment in communities

- Tax credits for promotion of investment in 5G technology

- Tax credits for promotion of investment in digital transformation

- Tax credits for promotion of investment for carbon neutrality

Note that this restriction is not applied for fiscal years where the current fiscal year's income is equal to or smaller than the preceding fiscal year's income even if the company cannot satisfy the conditions in (1) above.

## 1.12 Administrative Overview

### 1.12.1 Tax Returns and Tax Payments

(1) Final Tax Returns

A company is required to file final returns (a corporation tax return to the relevant tax office and inhabitant/business tax

returns to the local governments) within 2 months after the end of its fiscal year, whether or not it has positive income for that fiscal year.

The filing extension rules which are applicable by submitting an application form are provided as follows:

- For a company not using the Consolidated Tax Return Filing System discussed in 1.14 or the Japanese Group Relief System discussed in 1.15

| Cases | Extension periods |
|---|---|
| Where it is reasonable to conclude, from the Articles of Incorporation, etc. or due to special circumstances, that an ordinary general shareholders meeting is not held within 2 months after the end of each fiscal year | 1 month |
| Where a company is subject to audit by an independent accounting auditor and it is reasonable to conclude, from the Articles of Incorporation, etc., that an ordinary general shareholders meeting is not held within 3 months after the end of each fiscal year | Number of months designated by the relevant tax office, up to 4 months |
| Where it is reasonable to conclude, due to special circumstances, that an ordinary general shareholders meeting is not held within 3 months after the end of each fiscal year | Number of months designated by the relevant tax office |

■ For a company using the Consolidated Tax Return Filing System discussed in 1.14 or the Japanese Group Relief System discussed in 1.15

| Cases | Extension periods |
|---|---|
| Where it is reasonable to conclude, from the Articles of Incorporation, etc. or due to special circumstances, that an ordinary general shareholders meeting is not held within 2 months after the end of each fiscal year | 2 months |
| Where it is reasonable to conclude that it is difficult to file a tax return within 2 months after the end of each fiscal year because it takes time to complete it | |
| Where a company is subject to audit by an independent accounting auditor and it is reasonable to conclude, from the Articles of Incorporation, etc., that an ordinary general shareholders meeting is not held within 4 months after the end of each fiscal year | Number of months designated by the relevant tax office, up to 4 months |
| Where it is reasonable to conclude, due to special circumstances, that an ordinary general shareholders meeting is not held within 4 months after the end of each fiscal year or that it is difficult to file a tax return within 4 months after the end of each fiscal year because it takes time to complete it | Number of months designated by the relevant tax office |

The final tax liability for the fiscal year must be paid to the tax office and local governments within 2 months after the end of the fiscal year regardless of whether a filing extension has been obtained.

A final corporation tax return must be accompanied by the company's balance sheet, profit and loss statement, statement of changes in net assets, details of accounts, statement of outline of business activities and, depending upon circumstances, certain other prescribed documents.

(2) Interim Tax Returns

A company, the fiscal year of which is longer than 6 months, should file interim tax returns within 2 months of the end of the first 6 months of the fiscal year. If the amount of the annual corporation tax for the preceding fiscal year multiplied by six and divided by the number of months of the preceding fiscal year is JPY100,000 or less, the company is generally not required to file interim tax returns. However, a company subject to the size-based business tax or business tax imposed on gross revenue rather than net income is always required to file an interim tax return with respect to business tax regardless of the amount of the corporation tax for the preceding fiscal year.

The amounts of taxes to be reported in interim tax returns are chosen by the company from 2 methods:

(i) tax for the preceding fiscal year multiplied by six and divided by the number of months of the preceding fiscal year

(ii) tax computed on the basis of the provisional results for the first 6-month period of the present fiscal year

In case of either of the following, it is not possible to file an interim tax return based on provisional results:

- the amount calculated under (i) $\leq$ JPY100,000
- the amount calculated under (i) < the amount calculated under (ii)

The tax reported on the interim tax returns should be paid to the tax office and local governments within the time limit for filing interim tax returns.

(3) Electronic Tax Filing Obligations

The following companies are obliged to file their final tax returns and interim tax returns through online systems (e-Tax):

- a Japanese company whose stated capital is over JPY100 million at the beginning of the fiscal year
- a Japanese company which is a mutual company, a Toushi Houjin (J-REIT) or a Tokutei Mokuteki Kaisha (TMK)
- Japanese companies in an Aggregation Group discussed in 1.15

### 1.12.2 Tax Audits and the Statute of Limitation

The Japanese corporate tax filing system utilizes a self-assessment basis. The tax authorities may then carry out a tax audit of returns filed and make any necessary adjustments within the limitations laid down by the law. The basic statutory time limits for such adjustments are as follows:

| Nature of adjustments | Limitation period |
|---|---|
| Relating to underreporting of taxable income | 5 years |
| Relating to amendment of excess tax losses | 10 years[(1)] |
| Relating to taxation on transfer pricing/internal dealings for a PE in Japan of a foreign company | 7 years[(2)] |
| Relating to fraud | 7 years |

(1) 9 years for tax losses incurred in fiscal years beginning on or before 31 March 2018.

(2) 6 years for taxation on transfer pricing/internal dealings for a PE of a foreign company in Japan incurred in fiscal years beginning on or before 31 March 2020.

## 1.13 Group Taxation Regime

The Group Taxation Regime is provided in order to make the Japanese taxation system more in line with a business environment where business operations are managed on a unified basis across a corporate group.

Although the Japanese Group Relief System discussed in 1.15 (the Consolidated Tax Return Filing System discussed in 1.14 for fiscal years beginning on or before 31 March 2022 (hereinafter, same in 1.13)) is applied to Japanese companies that have made an election for the system, the Group Taxation Regime automatically is applied to certain transactions carried out by companies belonging to a 100 Percent Group, including an Aggregation Group discussed in 1.15 (a Tax Consolidated Group for fiscal years beginning on or before 31 March 2022 (hereinafter, same in 1.13)).

### 1.13.1 100 Percent Group

A 100 Percent Group under the Group Taxation Regime is a group comprising companies having a 100 Percent Control Relationship, which is:

- relationship in which a person holds directly or indirectly 100 percent of the outstanding shares in a company; or

- relationship in which 100 percent of the outstanding shares in a company and 100 percent of the outstanding shares in another company are directly or indirectly held by the same person.

A 'person' as described above should include not only a Japanese company but also a foreign company or an individual. Even if foreign companies are interposed between Japanese companies, they could have 100 Percent Control Relationships. Note that, however, the Group Taxation Regime is applicable only to the transactions between Japanese companies in a 100 Percent Group, in principle.

When determining whether a 100 Percent Control Relationship exists, the number of shares owned by an employee stock ownership plan or the number of shares owned by employees and directors that were acquired through exercises of stock option plans can be disregarded if the total number of those shares is less than 5 percent of the total number of outstanding shares.

A structure diagram showing 100 Percent Control Relationships should be attached to corporation tax returns.

### 1.13.2 Dividends Received Deduction (DRD)

(1) Dividends from a 100 Percent Japanese Subsidiary

When a Japanese company receives dividends from a 100 percent Japanese subsidiary, such dividends should be fully excluded from taxable income without deducting interest expenses attributable to such dividends.

This rule is also applicable to a Japanese branch of a foreign company when it receives dividends from a 100 percent Japanese subsidiary.

A 100 percent Japanese subsidiary for the purposes of this rule is defined as follows:

- In the case of a dividend other than deemed dividends

  A Japanese company that had a 100 Percent Control Relationship with the company receiving the dividend for the whole of the calculation period for the dividend

- In the case of a deemed dividend

  A Japanese company that had a 100 Percent Control Relationship with the company receiving the dividend on the day prior to the effective date of the deemed dividend

***

The same rule is included in the Japanese Group Relief System. This rule is applicable for companies not electing for the Japanese Group Relief System.

(2) Determination on Categories of Shares in Related Companies/Non-Controlling Shares

By virtue of the 2020 tax reform, categories of 'shares in related companies' and 'non-controlling shares' defined in 1.10.1 are determined based on the total number of shares held by the dividend recipient companies in a 100 Percent Group for fiscal years beginning on or after 1 April 2022.

### 1.13.3 Deferral of Capital Gains/Losses

(1) Deferral of Capital Gains/Losses

When a Japanese company transfers certain assets to another Japanese company having a 100 Percent Control Relationship with the first mentioned company, capital gains/losses arising from the transfer should be deferred.

(2) Assets Covered by This Rule

Assets covered by this rule are fixed assets, land (if land is not treated as a fixed asset), securities, monetary receivables and deferred charges, excluding those whose tax book value just before the transfer is less than JPY10 million, and securities held for trading purposes for either the transferor company or the transferee company.

(3) Realization of Capital Gains/Losses

The deferred capital gains/losses on a transfer of an asset under this rule will be realized in the hands of the transferor company, for example, when the transferee company transfers the asset to another person.

The following table shows the main trigger events for realization of deferred capital gains/losses and the amount of realized capital gains/losses:

| Trigger events | Amount of realized capital gains/losses |
|---|---|
| Transfer of the asset by the transferee company | Amount of deferred capital gains/losses |
| The asset becoming a bad debt, or retirement/revaluation and similar events related to the asset by the transferee company | Amount of deferred capital gains/losses |
| Depreciation or amortization of the asset by the transferee company (Depreciable assets or deferred charges) | Amount of deferred capital gains/losses<br>$\text{x} \frac{\text{Depreciation or amortization amount included in deductible expenses of the transferee company}}{\text{Acquisition cost of the asset}}$<br>Instead of the above, it is possible for the transferor company to realize the amount of deferred capital gains/losses over the useful life being applied to the asset in the transferee company (Simplified Method). |
| Losing the 100% Control Relationship between the transferor company and the transferee company | Amount of deferred capital gains/losses |

(4) Notification

- When assets subject to this rule are transferred within a 100 Percent Group, the transferor company should notify the transferee company of that fact (including the intention that the transferor company will use the Simplified Method for

depreciable assets/deferred charges, if this is the case) after the transfer without delay.

- When the transferred assets are the securities held for trading purposes by the transferee company, the transferee company should notify the transferor company about that fact, after the above notification without delay. Also if the transferor company has said that it intends to use the Simplified Method for depreciable assets/deferred charges, the transferee company should notify the transferor company of the useful lives for such assets, after the above notification without delay.

- If an event to realize deferred capital gains/losses happens, the transferee company should notify the transferor company about that fact and the day of the event (including tax deducted depreciation/amortization amount, if the transferor company does not use the Simplified Method) as soon as possible after the closing date of the fiscal year in which the event happens.

***

This rule is almost the same as the rule provided for under the Japanese Group Relief System. This rule is applicable for transfers of assets for companies not electing for the Japanese Group Relief System.

### 1.13.4 Provision for Bad Debts

By virtue of the 2020 tax reform, account receivables from a company in a 100 Percent Group are excluded from the calculation of the allowable amount of a provision for bad debts for fiscal years beginning on or after 1 April 2022.

### 1.13.5 Donations

(1) Donations

When a Japanese company pays donations to another Japanese company which has a 100 Percent Control Relationship (excluding such relationship controlled by an individual), the donations are treated as non-deductible for the donating company and non-taxable for the recipient company.

Donations under the Japanese Corporation Tax Law have a broader meaning than simply donations to charitable entities/political parties.

(2) Adjustments to Tax Book Value of Shares

In order to prevent a shareholder company of the donating/recipient company from conducting tax-avoidance through a transfer of value of the shares in these companies by taking advantage of the rule for donations within a 100 Percent Group, the shareholder company is required to make adjustments to the value of the shares as follows:

- If a company has a 100 Percent Control Relationship with the donating company, the shareholder company should decrease the tax book value of the shares in the donating company by the amount of the donation attributable to the direct holding ratio of the shareholder company.

- If a company has a 100 Percent Control Relationship with the recipient company, the shareholder company should increase the tax book value of the shares in the recipient company by the amount of the receipt attributable to the direct holding ratio of the shareholder company.

Although the above adjustments should be applied to indirect shareholders in the 100 Percent Group in theory, in consideration of the administrative burden, the adjustments are

required only for direct shareholders. If the shareholder company belongs to an Aggregation Group to which the donating company or the recipient company belongs, instead of this rule, another rule for adjustments to the value of shares under the Japanese Group Relief System is applied.

### 1.13.6 Non-Recognition of Capital Gains/Losses from Transfers of Shares to the Share Issuing Company

Where a Japanese company (shareholder company) receives money or assets other than money from another Japanese company (share issuing company) having a 100 Percent Control Relationship with the first mentioned company for the following reasons or surrenders the shares in the share issuing company for the following reasons (including a case where it becomes certain that the share issuing company has no residual assets after its dissolution), the shareholder company does not recognize any capital gains/losses from the shares.

- non tax-qualified merger
- non tax-qualified horizontal type corporate division
- non tax-qualified Share-Dividend
- return of capital or distribution of residual assets due to dissolution
- acquisition of shares by a company issuing the shares
- retirement of investments
- change of the corporate type of a company (when assets other than shares in the company are distributed to shareholders)

Under this rule, for example, when a Japanese company is liquidated, a shareholder company having a 100 Percent Control Relationship with the liquidated company does not recognize capital gains/losses from shares. (Note that, however, tax losses incurred by the liquidated company may be transferred to the shareholder company subject to certain conditions.)

### 1.13.7 Valuation Losses of Liquidating Companies /Merged Companies

Valuation losses of shares in a Japanese company in a 100 Percent Group are not deductible by its shareholder companies in the same group if the Japanese company is:

- in the process of liquidation,
- expected to be dissolved (excluding dissolution by merger), or
- expected to be dissolved due to a tax qualified merger within a 100 Percent Group.

## 1.14 Consolidated Tax Return Filing System

The Consolidated Tax Return Filing System is a mechanism to tax group companies as a single tax unit. This system was introduced in 2002 in order to enhance corporate reorganizations and contribute to the maintenance and strengthening of international competitiveness of Japanese companies and structural reform of the economy.

By virtue of the 2020 tax reform, the Consolidated Tax Return Filing System was revised fundamentally to the new so-called 'Japanese Group Relief System' discussed in 1.15, which is applied for fiscal years beginning on or after 1 April 2022, from the viewpoint of simplification of the system to reduce the administrative burden and to provide neutrality and fairness. he The Tax Consolidated Group under the Consolidated Tax Return Filing System is automatically shifted to the Aggregation Group under the Japanese Group Relief System from fiscal years beginning on or after 1 April 2022. Note that the Tax Consolidated Group is able to shift to the Single Tax Return Filing System provided that the consolidated parent company submits the application form to the director of the Tax Office by the date before the beginning date of the first fiscal year beginning on or after 1 April 2022.

### 1.14.1 Applicable Company

The Consolidated Tax Return Filing System is applied by election (ordinarily irrevocable) to a Japanese domestic parent company and all of its Japanese subsidiaries having a 100 percent control relationship without foreign companies or certain ineligible companies being interposed (Tax Consolidated Group).

The 100 percent control relationship is a relationship in which a Japanese domestic company holds directly 100 percent of the outstanding shares in another Japanese domestic company (except for certain ineligible companies (same as below)).

Where (i) a Japanese domestic company and one or more companies which have the 100 percent control relationship with the Japanese domestic company or (ii) one or more companies which have the 100 percent control relationship with the Japanese domestic company hold 100 percent of the outstanding shares in the other Japanese domestic company, the Japanese domestic company is deemed to hold 100 percent of the outstanding shares in the other Japanese domestic company.

### 1.14.2 Offsetting Profits and Losses

Current year taxable profits and tax losses within the Tax Consolidated Group are offset for corporation tax purposes, which is the most beneficial treatment under the Consolidated Tax Return Filing System.

### 1.14.3 Crystallization of Built-In Gains/Losses

At the start of a tax consolidation or a subsidiary participating in the existing Tax Consolidated Group, assets of the subsidiary will be revalued to market value in principle. Crystallizing built-in gains/losses could result in either additional taxation or increase of extinguished losses described in 1.14.4.

However, certain subsidiaries of the Tax Consolidated Group including the following are not subject to this rule:

- At the start of a tax consolidation:

- a subsidiary underneath the parent company that was established by a Share-Transfer (Kabushiki-Iten)

- a subsidiary held by the parent company for more than 5 years

- a subsidiary established within the Tax Consolidated Group

- a company that has become a subsidiary of the Tax Consolidated Group through a tax-qualified Share-for-Share Exchange (Kabushiki-Kokan) and a tax-qualified squeeze-out transaction

- a company that has become a subsidiary of the Tax Consolidated Group through a tax-qualified merger whereby its parent company holding the company for more than 5 years is merged into the parent company of the Tax Consolidated Group

- At the time of participation in the existing Tax Consolidated Group:

- a subsidiary established within the Tax Consolidated Group

- a company that has become a subsidiary of the Tax Consolidated Group through a tax-qualified Share-for-Share Exchange (Kabushiki-Kokan) and a tax-qualified squeeze-out transaction

- a company that has become a subsidiary of the Tax Consolidated Group through a tax-qualified merger whereby its parent company holding the company for more than 5 years is merged into the parent company of the Tax

Consolidated Group

Assets covered by this rule are certain fixed assets, land (if land is not treated as a fixed asset), securities, monetary receivables and deferred charges. When a built-in gain/loss of an asset is less than JPY10 million or 50 percent of the total amount of stated capital and capital surplus, whichever is lower, this rule does not apply to such asset. In addition, an asset whose tax book value is less than JPY10 million will also be excluded from the scope of this rule. As a consequence, self-generated goodwill will be exempted from revaluation at market value.

### 1.14.4 Extinguishment of Pre-Consolidation Tax Losses

At the start of a tax consolidation or a subsidiary participating in the existing Tax Consolidated Group, tax losses incurred by the subsidiary prior to participating in the Tax Consolidated Group will be extinguished in principle.

However, a subsidiary that is not subject to the rule discussed in 1.14.3 is not captured by this rule, although the pre-consolidation tax losses are available only to offset against taxable income generated by the subsidiary.

### 1.14.5 Others

- The use of the Consolidated Tax Return Filing System results in certain tax related treatments being calculated based not on the status of individual companies but on the consolidated status (for example; the deductible limit of donations, R&D tax credit limit, etc.).

- Filing and payment deadlines under tax consolidated filing are in principle the same as for a normal Japanese company, however a 2-month filing extension is generally allowed. (please see 1.12.1 for more details.)

- A consolidated tax return can only be filed for national corporation tax purposes. For the purposes of local taxes, each member of the Tax Consolidated Group must continue to file their own tax returns based upon their own taxable income without offsetting losses from elsewhere in the group. In order to mitigate the administrative burden of the recalculation of taxable income solely for local tax purposes, certain items of taxable income, as calculated on a consolidated basis, can be apportioned amongst group members as a simplified basis.

## 1.15 Japanese Group Relief System

The Consolidated Tax Return Filing System was revised fundamentally to the Japanese Group Relief System under the 2020 tax reform. The Japanese Group Relief System, which is applicable for fiscal years beginning on or after 1 April 2022, allows aggregation of profits and losses or current taxable income and tax net operating losses (NOLs) of companies belonging to a 100 percent group, although each company in the group continues to calculate and file their tax returns individually.

### 1.15.1 Applicable Company

The Japanese Group Relief System will be applied by election (ordinarily irrevocable) to a Japanese domestic parent company and all of its Japanese subsidiaries having a 100 percent control relationship without foreign companies or certain ineligible companies being interposed (Aggregation Group).

The 100 percent control relationship is a relationship in which a Japanese domestic company holds directly 100 percent of the outstanding shares in another Japanese domestic company (except for certain ineligible companies (same as below)).

Where (i) a Japanese domestic company and one or more companies which have the 100 percent control relationship with

the Japanese domestic company or (ii) one or more companies which have the 100 percent control relationship with the Japanese domestic company hold 100 percent of the outstanding shares in the other Japanese domestic company, the Japanese domestic company is deemed to hold 100 percent of the outstanding shares in the other Japanese domestic company.

### 1.15.2 Offsetting Profits and Losses

Current year taxable profits and tax losses within the Aggregation Group are offset for corporation tax purposes, which is the most beneficial treatment under the Japanese Group Relief System.

The aggregation method is on a pro-rated basis, and if amendments or corrections of the taxable income or tax loss stated in corporation tax returns filed by the due date of a company are made under in a tax audit, other companies in the Aggregation Group will not be affected by the amendments or the corrections in principle.

### 1.15.3 Crystallization of Built-In Gains/Losses

(1) At the Start of the Japanese Group Relief System

The crystallization of built-in gains/losses on certain assets is required for companies other than the following companies at the start of the Japanese Group Relief System:

(i) A parent company which will be expected to maintain 100 percent control relationships with its subsidiaries after approval of the Japanese Group Relief System.

(ii) A subsidiary which will be expected to maintain a 100 percent control relationship with its parent company after approval of the Japanese Group Relief System.

(2) At the Time of Participation in the Japanese Group Relief System

The crystallization of built-in gains/losses on certain assets is required for companies which do not fall under any of the following at the time of participation in the Japanese Group Relief System:

(i) A company that has become a 100 percent owned subsidiary through a tax-qualified Share-for-Share Exchange (Kabushiki-Kokan) etc.

(ii) A newly established subsidiary within the Aggregation Group

(iii) A subsidiary that satisfies all of the following conditions[1] (where the control relationships exist at the time immediately before the participation, conditions (a)~(c) only):

(a) A 100 percent control relationship with a parent company is expected to continue after approval of the Japanese Group Relief System.

(b) Approximately 80 percent or more of the employees of subsidiary immediately before the establishment of a 100 percent control relationship are expected to engage in the business of the subsidiary.

(c) The subsidiary is expected to continue to operate the main business conducted before the establishment of a 100 percent control relationship.

(d) One of the main businesses of the subsidiary and other companies[2] conducted before the establishment of a 100 percent control relationship relevant to one of the businesses of the parent company and other

companies[3] in the Aggregation Group conducted before the establishment of a 100 percent control relationship.

(e) Each business size in the above (d) is not considerably different (within a 1:5 ratio), or all senior directors of the subsidiary, who manage the business of the subsidiary on the day before the establishment of a 100 percent control relationship, do not retire.

[1] Similar conditions for a tax-qualified corporate reorganization

[2] Companies which have a 100 percent control relationship with the subsidiary at the time immediately before the establishment of a 100 percent control relationship by the parent company with the subsidiary.

[3] Companies which have a 100 percent control relationship with the parent company at the time immediately before the establishment of a 100 percent control relationship by the parent company with the subsidiary.

(3) At the Time of Withdrawal from the Aggregation Group

Where a company withdraws from the Aggregation Group and falls under any of the cases listed in below, the withdrawing company is subject to the crystallization of built-in gains/losses on certain assets in the fiscal year immediately before the withdrawal:

(i) When the major business of the withdrawing company will not be expected to be continued (except for the case where the amount of unrealized gains is greater than or equivalent to the amount of unrealized losses at the time immediately before the withdrawal).

(ii) When it is expected that a loss on sales of assets whose book value exceeds JPY1 billion, and a loss on the sales of the shares of the withdrawing company will be recognized.

(4) Assets Subject to the Crystallization of Built-In Gains/Losses in (1)~(3)

Assets subject to the crystallization of built-in gains/losses are certain fixed assets, land (if land is not treated as a fixed asset), securities (excluding trading securities), monetary receivables and deferred charges. Among the above assets, the following assets are not subject to the crystallization of built-in gains/losses:

- Assets whose book value is less than JPY10 million (except for goodwill in case of (3) for fiscal years beginning on or after 1 April 2022)

- Assets whose unrealized gain or loss is less than the smaller amount of (i) 1/2 of the amount of stated capital of the company or (ii) JPY10 million

Other than above, the assets to be excluded from the crystallization of built-in gains/losses are defined in each provision of (1) to (3).

### 1.15.4 Write-Off of Tax NOLs and Restriction on Usage of Tax NOLs and Unrealized Losses on Certain Assets at the Time Immediately before the Start of or Participation in the Japanese Group Relief System

(1) Companies Subject to the Crystallization of Built-In Gains/Losses

Tax NOLs of a company, which is subject to the crystallization of built-in gains/losses discussed in 1.15.3 (1)(2), at the time immediately before the start of or participation in the Japanese Group Relief System will be written off.

(2) Companies NOT Subject to the Crystallization of Built-In Gains/Losses

(A) Companies which are NOT subject to the write-off of tax NOLs and the restriction on usage of tax NOLs and unrealized losses on certain assets among companies NOT subject to the crystallization of built-in gains/losses discussed in 1.15.3 (1)(2)

A company which satisfies either of the following conditions is not subject to the write-off of tax NOLs and the restriction on usage of tax NOLs and unrealized losses on certain assets:

(i) A company which had a control relationship with its parent company[1] for over 5 years

(ii) A company that satisfies the following conditions[2] '(a)(b) and (c)' or '(a) and (d)' or '(e)':

(a) One of the main businesses[3] of the company or other companies[4] conducted before the approval of the Japanese Group Relief System is relevant to one of the businesses[3] of the parent company or other companies[5] in the Aggregation Group conducted before the approval of the Japanese Group Relief System.

(b) Each business size in the above (a) is not considerably different (within a 1:5 ratio).

(c) The size of one of the main businesses[6] of the company or other companies[4] conducted before the approval of the Japanese Group Relief System is not considerably different from the size of the above main business at the latest date of the establishment of a control relationship with the parent company (within 1:2 ratio).

(d) All senior directors, who manage one of the main businesses in the above (c), do not retire after the establishment of a 100 percent control relationship.

(e) A company which satisfies either of the following:

- A subsidiary that satisfies all of the conditions in 1.15.3(2)(iii), where the 100 percent control relationship does not exist at the time immediately before the participation

- A 100% owned subsidiary that participated in the Aggregation Group as a result of a non-tax-qualified Share-for-Share Exchange (Kabushiki-Kokan) etc. and satisfies all of the conditions for a tax-qualified Share for Share Exchange, except for 'no-boot requirement' (please see 1.16.1(3))

[1] With regard to the parent company, the term 'control relationship with its parent company' shall be replaced by 'control relationship with any of the subsidiaries in the Aggregation Group'

[2] Similar conditions for a tax-qualified corporate reorganization

(3) Limited to the business conducted before the approval of the Japanese Group Relief System

(4) Companies which have a 100 percent control relationship with the company before the approval of the Japanese Group Relief System

(5) Companies which have a 100 percent control relationship with the parent company before the approval of the Japanese Group Relief System

(6) Limited to the business relevant to the business of the parent company or other companies(5) conducted before the approval of the Japanese Group Relief System

(B) Companies which are subject to the write-off of tax NOLs and the restriction on usage of tax NOLs and unrealized losses on certain assets among companies NOT subject to the crystallization of built-in gains/losses discussed in 1.15.3 (1)(2)

A company which does not fall under (A) above is subject to the write-off of a part of tax NOLs and/or the partial restriction on usage of tax NOLs and unrealized losses on certain assets depending on the following categories. The tax treatments in (a)(iii), (b) and (c) below are applied until the earlier of (i) the day on which 5 years have elapsed from the day when the control relationship occurred or (ii) the day on which 3 years have elapsed from the start of or participation in the Japanese Group Relief System:

| | |
|---|---|
| (a) In the case where a company starts a new business after the control relationship started | (i) Tax NOLs which were incurred before the control relationship started will be extinguished.<br>(ii) Tax NOLs consisting of the realized losses which are generated from certain assets held before the control relationship started and are realized before the start of or participation in the Japanese Group Relief System will be extinguished.<br>(iii)The deduction of the realized losses which are generated from certain assets held before the control relationship started and are realized after the start of or participation in the Japanese Group Relief System will be disallowed. |
| (b) In the case where the ratio of depreciation expenses to the total costs of a company exceeds 30% | Tax NOLs which were incurred in the Aggregation Group in the fiscal year that fall under the condition as shown on the left will not be included in the aggregation of profits and losses. |
| (c) In the case where a company does not fall under any of the above categories | Among tax NOLs which were incurred in the Aggregation Group, tax NOLs consisting of realized losses which are generated from certain assets held before the control relationship started will not be included in the aggregation of profits and losses. |

### 1.15.5 Aggregation Current Taxable Income and Tax NOLs

The deductible amount of tax NOLs is calculated separately depending on whether the losses are Specific Tax NOLs, which are deductible to the extent of the amount of taxable income of each company having Specific Tax NOLs, or Non-Specific Tax NOLs, which are deductible from the taxable income of the entire Aggregation Group.

Under the Japanese Group Relief System, the following tax NOLs are treated as Specific Tax NOLs:

- Tax NOLs which are not subject to the write-off by the companies (companies NOT subject to the crystallization of built-in gains/losses discussed in 1.15.4 (2)(A)).

- The part of tax NOLs which are not subject to the write-off or the partial restriction on usage of tax NOLs and unrealized losses on certain assets of the companies (companies which are subject to the restriction on usage of tax NOLs and unrealized losses on certain assets discussed in 1.15.4 (2)(B)).

- Specific Consolidated Tax NOLs attributable to a consolidated subsidiary under the Consolidated Tax Return Filing System at the time of the shift to the Japanese Group Relief System.

If amendments or corrections of the deductible amount of NOLs, etc. stated in corporation tax returns filed by the due date of a company are made in a tax audit, other companies in the Aggregation Group will not be affected by the amendments or the corrections in principle.

### 1.15.6 Tax Book Value Adjustments

- Evaluation gains or losses on the shares of a subsidiary in the Aggregation Group, and gains or losses on the sales of shares of a subsidiary in the Aggregation Group transferred to other companies in the Aggregation Group are not recognized.

- The tax book value of the shares of a company withdrawing from the Aggregation Group at the time immediately before the withdrawal is adjusted to the amount equivalent to the tax book value of the net assets of the withdrawing company. (By virtue of the 2022 tax reform, certain goodwill equivalent value included in the purchase price of the shares in the withdrawing company can be added to the tax book value of the net assets of the withdrawing company under certain conditions for fiscal years beginning on or after 1 April 2022)

- Evaluation gains or losses are recognized by the shareholder on the shares of a subsidiary which starts or participates in the Japanese Group Relief System and is not expected to continue the 100 percent control relationship with its parent company.

### 1.15.7 Others

- The Japanese Group Relief System is applied provided that blue-form tax return is filed. Consequently, the applicable companies for the Japanese Group Relief System are blue-form tax return filling companies. The companies whose blue-form tax return filing was cancelled or withdrawn, are excluded from the applicable companies for the Japanese Group Relief System.

- Companies which apply the Japanese Group Relief System are obliged to file tax returns through the e-Tax system.

- If any of the companies in the Aggregation Group is not a small and medium-scale company (please see 1.3.1)/a small and medium-sized company (please see 1.11.3), all companies in the Aggregation Group are not treated as small and medium-scale companies/small and medium-sized companies, for which certain tax benefits are provided.

- Although each company in the Aggregation Group continues to calculate and file their tax returns individually in principle, some provisions are calculated based on the consolidated status (e.g. tax credit for R&D costs, foreign tax credit).

- Local taxation maintains the basic framework of the Consolidated Tax Return Filing System (i.e. each member of the Tax Consolidated Group must continue to file their own tax returns based upon their own taxable income without offsetting losses from elsewhere in the group.).

- Although the Japanese Group Relief System is applied for fiscal years beginning on or after 1 April 2022, the transitional measures allow companies which apply the Consolidated Tax Return Filing System to shift to the Single Tax Return Filing System if they follow certain procedures.

## 1.16 Corporate Reorganizations

### 1.16.1 Tax Qualified Reorganizations

The Japanese Corporation Tax Law sets out the conditions for tax-qualified reorganizations, which are generally categorized depending on relationship of the parties of the reorganizations (i.e. 100 Percent Control Relationship, More than 50 Percent Control Relationship or 50 Percent or less relationship).

(1) Merger

The following is a general outline of the conditions required for a tax-qualified merger:

| Relationship | Conditions |
|---|---|
| (i) 100% Control Relationship | (a) Only shares in the surviving company are distributed as consideration for the transfer (No-boot requirement).<br>(b) The 100% Control Relationship is expected to remain. |
| (ii) More than 50% Control Relationship | (a) Same as (i)-(a)<br>(b) The More than 50% Control Relationship is expected to remain.<br>(c) Approximately 80% or more of directors/employees of the merged company are expected to be engaged in the business of the surviving company.<br>(d) The surviving company is expected to continue to operate the main business of the merged company. |
| (iii) 50% or less relationship | (a) Same as (i)-(a), (ii)-(c) and (d)<br>(b) One of the main businesses of the merged company has a relationship with one of the businesses of the surviving company. |

| | |
|---|---|
| | (c) The relative business size (i.e. sales, number of employees, etc.) of the related businesses is not considerably different (within a 1:5 ratio), or at least one of the senior directors from each side is expected to become a senior director of the surviving company after the merger.<br>(d) Where one of the shareholders of the merged company held more than 50% of the shares in the company before the merger, such shareholder is expected to continue to hold the shares in the surviving company received due to the merger. |

The following should be noted for the no-boot requirement discussed in (i)-(a):

- In the case of a triangular merger, if shares in the parent company that directly or indirectly holds 100 percent of the shares in the surviving company are distributed instead of shares in the surviving company, the no-boot requirement will be satisfied in principle.

- Where the surviving company held more than two-thirds of the shares in the merged company before the merger, even if minority shareholders receive boot, the no-boot requirement will not be jeopardized (the 2/3 exceptional rule).

Under a tax-qualified merger, assets and liabilities are transferred at tax book value (i.e. recognition of gains/losses is deferred) for tax purposes, while under a non-tax-qualified merger, assets and liabilities are transferred at fair market value (i.e. capital gains/losses are realized) unless the merged company and the surviving company have a 100 Percent Control Relationship.

(2) Corporate Division/Contribution-In-Kind

The following is a general outline of the conditions required for a tax-qualified corporate division or a tax-qualified contribution-in-kind:

| Relationship | Conditions |
|---|---|
| (i) 100% Control Relationship | (a) Only shares in the transferee company are distributed as consideration for the transfer (No-boot requirement).<br>(b) The 100% Control Relationship is expected to remain. |
| (ii) More than 50% Control Relationship | (a) Same as (i)-(a)<br>(b) The More than 50% Control Relationship is expected to remain.<br>(c) The main assets/liabilities of the transferred business are transferred.<br>(d) Approximately 80% or more of directors/employees who were engaged in the transferred business are expected to be engaged in the business of the transferee company.<br>(e) The transferee company is expected to continue to operate the transferred business. |
| (iii) 50% or less relationship | (a) Same as (i)-(a), (ii)-(c)(d) and (e)<br>(b) The transferred business has a relationship with one of the businesses of the transferee company.<br>(c) The relative business size (i.e. sales, number of employees, etc.) of the related businesses is not considerably different (within a 1:5 ratio), or at least one of the senior directors from each side is expected to become a senior director of the transferee company after the reorganization. |

| | |
|---|---|
| | (d) Horizontal type corporate division — where one of the shareholders of the transferor company held more than 50% of the shares in the company, such shareholder is expected to continue to hold the shares in the transferee company received due to the horizontal type corporate division.<br><br>Vertical type corporate division/ Contribution-in-kind — the transferor company is expected to continue to hold the shares in the transferee company received due to the reorganization |

The following should be noted for the no-boot requirement discussed in (i)-(a):

- In the case of a triangular corporate division, if shares in the parent company that directly or indirectly holds 100 percent of the shares in the transferee company are distributed instead of shares in the transferee company, the no-boot requirement will be satisfied in principle.

- In the case of a horizontal type corporate division, shareholders of the transferor company must receive shares in the transferee company (or the parent company of the transferee company) proportionate to their shareholding ratio in the transferor company.

If a corporate division or a contributions-in-kind is tax-qualified, assets and liabilities are transferred at tax book value (i.e. recognition of gains/losses are deferred) for tax purposes, while if it is not tax-qualified, assets and liabilities are transferred at fair market value (i.e. capital gains/losses are realized) unless the transferor company and the transferee company have a 100 Percent Control Relationship.

(3) Share-for-Share Exchange/Share-Transfer

The following is a general outline of the conditions required for a tax-qualified Share-for-Share Exchange and Share-Transfer(*):

(*) A 'Share-for-Share Exchange' (Kabushiki-Kokan) means an exchange of shares whereby a company(s) causes all of its issued shares to be acquired by another company. A 'Share-Transfer' (Kabushiki-Iten) means a transfer of shares whereby a company(s) causes all of its issued shares to be acquired by a newly established company.

Note that in the table below, the first mentioned company and the second mentioned company are referred to as the Subsidiary and the Parent Company, respectively.

| Relationship | Conditions |
|---|---|
| (i) 100% Control Relationship | (a) Only shares in the Parent Company are distributed as consideration for the transfer (No-boot requirement).<br>(b) The 100% Control Relationship is expected to remain. |
| (ii) More than 50% Control Relationship | (a) Same as (i)-(a)<br>(b) The More than 50% Control Relationship is expected to remain.<br>(c) Approximately 80% or more of directors/employees in the Subsidiary are expected to continue working for the Subsidiary.<br>(d) The Subsidiary is expected to continue to operate its own main business. |
| (iii) 50% or less relationship | (a) Same as (i)-(a),(ii)-(c) and (d)<br>(b) One of the main businesses of the Subsidiary has a relationship with one of the Parent Company's businesses (the other Subsidiaries' businesses in the case of a Share-Transfer).<br>(c) The relative business size (i.e. sales, |

| | |
|---|---|
| | number of employees, etc.) of the related businesses is not considerably different (within a 1:5 ratio), or at least one of the senior directors of the Subsidiary does not resign upon the reorganization.<br>(d) The 100% Control Relationship between the Parent Company and the Subsidiary is expected to continue after the reorganization.<br>(e) Where one of the shareholders of the Subsidiary held more than 50% of the shares in the company, such shareholder is expected to continue to hold the shares in the Parent Company received due to the reorganization. |

The following should be noted for the no-boot requirement discussed in (i)-(a) above:

- In the case of a triangular Share-for-Share Exchange, if shares in the parent company that directly or indirectly holds 100 percent of the shares in the Parent Company are distributed instead of shares in the Parent Company, the no-boot requirement will be satisfied in principle.

- Where the Parent Company held more than two-thirds of the shares in the Subsidiary before the Share-for-Share Exchange, even if minority shareholders receive boot, the no-boot requirement will not be jeopardized (the 2/3 exceptional rule).

When a Share-for-Share-Exchange and a Share-Transfer is carried out as a non-tax-qualified reorganization, built-in gains/losses in assets held by the Subsidiary will be crystallized although assets and liabilities are not transferred and remain in the Subsidiary unless the Parent Company and the Subsidiary had a 100 Percent Control Relationship before the reorganization.

(4) Squeeze-Out

Certain squeeze-out (SQO) transactions in which a target company will become a wholly owned subsidiary of its largest shareholder using Shares Subject to Class-Wide Call, Consolidation of Shares and Demand for Sales of Shares are treated as reorganization transactions for tax purposes.

The conditions for the More than 50% Control Relationship of Share-for-Share Exchange are also applied when determining if the SQO transactions are tax-qualified. Note that boot received by minority shareholders does not jeopardize the no-boot requirement.

When a SQO transaction is carried out as a non-tax-qualified reorganization, built-in gains/losses in assets held by the target company will be crystallized although assets and liabilities are not transferred and remain in the target company.

(5) Spin-Off

The following two types of spin-off are treated as tax-qualified reorganizations.

(i) Horizontal-type corporate division

A horizontal-type corporate division in which a company transfers one of its businesses to a newly established company will be treated as a tax-qualified corporate division if all of the following conditions are met:

| Conditions |
| --- |
| (a) Shareholders of the transferor company receive only shares issued by the newly established company proportionate to their shareholding ratio in the transferor company (No-boot requirement).<br>(b) No party owns more than 50% of the transferor company before the corporate division and it is expected that no party will own more than 50% of the newly established company after the corporate division.<br>(c) At least one of directors or important employees of the transferor company is expected to become a senior director of the newly established company.<br>(d) The main assets/liabilities of the transferred business are transferred.<br>(e) Approximately 80% or more of directors/employees engaged in the transferred business are expected to be engaged in businesses of the newly established company.<br>(f) The newly established company is expected to continue to operate the transferred business. |

If a corporate division is tax-qualified, assets and liabilities are transferred at tax book value (i.e. recognition of gains/losses is deferred) for tax purposes, while if it is not tax-qualified, assets and liabilities are transferred at fair market value (i.e. capital gains/losses are realized).

(ii) Share-Dividend

Where a company distributes all of the shares in its wholly owned subsidiary to its shareholders (i.e. a Share-Dividend/Kabushiki-Bunpai), such Share-Dividend will be treated as tax-qualified provided that all of the following conditions are met:

| Conditions |
| --- |
| (a) Shareholders of the dividend paying company receive only shares issued by the subsidiary proportionate to their shareholding ratio in the dividend paying company (No-boot requirement).<br>(b) No party owns more than 50% of the dividend paying company before the Share-Dividend and it is expected that no party will own more than 50% of the subsidiary after the Share-Dividend.<br>(c) At least one of the senior directors of the subsidiary does not resign upon the Share-Dividend.<br>(d) Approximately 80% or more of directors/employees of the subsidiary are expected to continue working for the subsidiary after the Share-Dividend.<br>(e) The subsidiary is expected to continue to operate its own main business. |

As shares are treated as being transferred at tax book value as a result of a tax-qualified Share-Dividend, there is no recognition of capital gains/losses in the hands of the dividend paying company.

(6) Dividend-In-Kind

When a Japanese company pays a dividend-in-kind to its shareholders, if all of the shareholders are Japanese companies which have a 100 Percent Control Relationship with the dividend paying company at the time of the payment, the dividend-in-kind are treated as a tax-qualified dividend-in-kind.

When an asset is transferred under a tax-qualified dividend-in-kind, as the asset is treated as being transferred at tax book value for the dividend paying company, there is no recognition of capital gains/losses in the hands of the dividend paying company.

### 1.16.2 Pre-Reorganization Losses

(1) Pre-Reorganization Losses Incurred by a Merged Company, etc.

While under a non-tax-qualified merger, pre-merger losses are not transferred from the merged company to the surviving company, under a tax-qualified merger, pre-merger losses are transferred from the merged company to the surviving company in principle. However, if the following conditions are not met, the amount of such losses transferred may be restricted.

| Relationship | Conditions |
|---|---|
| 100% Control Relationship | (i) 5-year control relationship requirements<br>or<br>(ii) Joint business operations requirements |
| More than 50% Control Relationship | |
| 50% or less relationship | No conditions (therefore, no restriction) |

(i) 5-year control relationship requirements

If there has been a More than 50 Percent Control Relationship between the surviving company and the merged company continuously since the latest day among the following, this requirement should be passed:

- 5 years before the first day of the fiscal year including the merger date
- establishment day of the surviving company
- establishment day of the merged company

(ii) Joint business operations requirements

If the following conditions ((a) to (d) or (a) and (e)) are satisfied, this requirement should be passed:

(a) The business of the merged company has a relationship with one of the surviving company's businesses.

(b) The relative business size (i.e. sales, number of employees, etc.) of the related businesses does not exceed around 1 to 5.

(c) The relative business size of the merged company at the time when the More than 50 Percent Control Relationship was formed and the size at the time of the merger does not exceed around 1 to 2.

(d) The relative business size of the surviving company at the time when the More than 50 Percent Control Relationship was formed and the size at the time of the merger does not exceed around 1 to 2.

(e) One or more senior directors of both the merged company and the surviving company become senior directors of the surviving company after the merger.

When a Japanese company under liquidation procedures determines the amount of its residual assets, if the shareholders of the company are Japanese companies having a 100 Percent Control Relationship, tax losses incurred by the liquidating company are transferred to the shareholders provided that the 5-year control relationship requirement is satisfied.

(2) Pre-Reorganization Losses Incurred by a Surviving Company, etc.

As for pre-merger losses incurred in the surviving company, if the merger is tax-qualified and requirements discussed in (1) are not met, there may be restrictions on utilization of such losses against future profits after the merger.

This rule is also applied to the following reorganizations:
- non tax-qualified merger between companies having a 100 Percent Control Relationship
- tax-qualified corporate divisions
- tax-qualified contributions-in-kind
- tax-qualified dividends-in-kind (The joint business operations requirements are not applicable.)

Furthermore, there is a rule to restrict utilization of built-in losses after the above reorganizations unless the requirements discussed in (1) are met.

### 1.16.3 Taxation of Shareholders

Where the no-boot requirement (without applying the 2/3 exceptional rule) is satisfied for a merger, a horizontal corporate division, a Share-for-Share Exchange, a Share-Transfer or a Share-Dividend, capital gains/losses from the transfer of the shares are deferred in the hands of the shareholders of the merged company, the transferor company, the Subsidiary or the dividend paying company.

However, if the shareholder is a foreign shareholder and receives shares in a foreign company, the deferral of capital gains/losses is not applicable unless the shares surrendered due to the reorganization were attributable to a PE of the foreign shareholder in Japan. Note that even if the deferral is not available, if the capital gains are not Japanese source income or if tax treaty protection is available, the capital gains will not be taxed in Japan.

Moreover, in the case of a merger, a horizontal type corporate division or a Share-Dividend, if the reorganization is non tax-qualified, the shareholders of the merged company or the transferor company recognize a receipt of deemed dividends.

### 1.16.4 M&A Using Own Shares

Separately from the tax qualified reorganization regime (discussed in 1.16.1 to 1.16.3), by virtue of the 2021 tax reform, a new tax measure for deferral of recognition of capital gains or losses of shareholders of a target company was introduced with regard to M&A to acquire shares in the target company by using own shares on or after 1 April 2021.

This measure is applied to cases where shareholders (both companies[1] and individuals) transfer shares in the target company and acquire shares[2] in the acquiring company under a 'Share Delivery System' (Kabushiki-Kofu Seido) under the Companies Act.

[1] For foreign companies, the measure is applied only to the portion of capital gains or losses on shares in the target company which are managed at their permanent establishments located in Japan.

[2] Where any assets other than shares in the acquiring company are delivered to the shareholders, the measure is applied only in cases where the value of the shares in the acquiring company is 80 percent or more of the total value of assets delivered as consideration for the acquisition. In this case, deferral of capital gains or losses is limited to the portion attributable to the shares in the acquiring company.

# 2 Taxation of Partnerships

In Japan, a partnership (Kumiai) is not recognized as a separate taxable entity and the partners (Kumiai-In) are liable for Japanese tax on the basis of their share of profits under a partnership agreement and in accordance with their own Japanese tax status.

## 2.1 NK-Type Partnerships

### 2.1.1 Definition of NK-Type Partnerships

There are the following three types of NK-type partnership in Japan. These NK-type partnerships are formed by an agreement in which partners agree to jointly carry on business. Generally, assets of an NK-type partnership are deemed to belong to all partners jointly. A foreign partnership similar to these Japanese NK-type partnerships also falls under the definition of an NK-type partnership.

(1) Nini Kumiai (NK)

An NK is formed under the Civil Law. All partners of an NK are liable for the obligations of the NK. One or more managers may be appointed to manage the business operation of the NK. There is no limitation on the kinds of business which an NK can carry on and no registration is required.

(2) Investment Limited Partnership (Toshi Jigyo Yugen Sekinin Kumiai or Investment LPS)

An investment LPS is formed by general partners and limited partners for conducting investment business under the Investment LPS Act. A general partner has unlimited liability for the obligations of the LPS and manages the operation of the LPS business. A limited partner has limited liability for the obligations of the LPS to the extent of its capital investment. An Investment LPS must be registered at a local legal affairs

bureau.

(3) Limited Liability Partnership (Yugen Sekinin Jigyo Kumiai or LLP)

An LLP is formed under the LLP Act. All partners of an LLP have limited liability for the obligations of the LLP to the extent of their capital investment in the LLP and must participate in the management of the LLP business in principle. Either an individual or a company can be a partner of an LLP but another partnership cannot be a partner of an LLP. Furthermore, at least one of the partners must be an individual resident in Japan or a Japanese company. There is a restriction on businesses to be carried on by an LLP. For example, neither accounting firms nor law firms are able to use LLPs, unlike in some foreign countries. An LLP must be registered at a local legal affairs bureau.

### 2.1.2 Taxation of Partners

(1) Japanese Resident Partners

Income/loss of an NK-type partnership allocated to its partners generally retains its nature for tax purposes. Japanese resident partners (both Japanese resident individuals (individuals who have their domicile in Japan or who have resided in Japan for a continuous period of 1 year or more) and Japanese companies) are required to declare their income/loss generated from the partnership by filing tax returns during each of their taxable periods regardless of whether any actual distribution is made.

If the income calculation of a partnership is made once a year or more and the income/loss is allocated to each partner within 1 year after the income/loss is generated, the partners can declare such income/loss for the taxable period in which the calculation period end date of the partnership falls.

In certain cases, utilization of losses generated from partnerships is restricted (please see 2.3 below).

(2) Foreign Partners Having a PE in Japan

In the same way as Japanese resident partners, foreign partners (both foreign individuals and foreign companies) having a permanent establishment (PE) in Japan are required to declare their taxable income/loss generated from an NK-type partnership. Also, in certain cases, utilization of losses generated from partnerships is restricted (please see 2.3 below).

Profit allocations to foreign partners having a PE in Japan derived from businesses carried on in Japan using an NK-type partnership are subject to withholding tax at 20 percent (20.42 percent from 2013 to 2037, including a special reconstruction income tax). The withholding tax is creditable when declaring such income in the partner's Japanese tax return.

In general, where a person makes a payment subject to withholding tax, the person is required to pay the withholding tax to the competent tax office by the 10$^{th}$ day of the following month. As for the profit allocation from an NK-type partnership, the income is deemed to be paid on the day when the cash or any other assets are distributed (or the day when 2 months have passed from the end of the calculation period of the NK-type partnership if no distribution is made within 2 months after the end of the calculation period). Also, a person who allocates partnership income is deemed to be the person responsible for the withholding obligations.

It is sometimes difficult to judge whether the business carried on through an NK-type partnership arrangement is a business carried on in Japan and whether it causes a foreign partner to be treated as having a permanent establishment in connection with the business carried on by the partnership.

If a foreign partner of Investment LPSs or foreign partnerships similar to an Investment LPS (collectively, hereinafter referred to as 'Investment Funds') falls under the scope of a 'Specified Foreign Partner', the foreign partner is taxed in the same way as a foreign partner not having a PE in Japan.

A Specified Foreign Partner of an Investment Fund is a partner who satisfies the following conditions:

(i) being a limited partner of the Investment Fund

(ii) not being involved in the operation of the Investment Fund

(iii) holding an interest of less than 25 percent in the assets of the Investment Fund

(iv) not having a special (affiliate) relationship with the general partners of the Investment Fund

(v) not having a PE in Japan with respect to business other than the business carried on by the Investment Fund

A foreign partner must file an application form to the relevant tax office through a general partner along with a copy of the partnership agreement (including Japanese translation of the agreement) in order to apply the above rule. Also, the foreign partner is required to show the general partner of the Investment Fund a certificate to verify its foreign resident status.

(3) Foreign Partners Not Having a PE in Japan

Income of an NK-type partnership allocated to its partners generally retains its nature for tax purposes. Thus, it is generally taxed depending on its nature as if it were directly derived by each partner.

## 2.2 Tokumei Kumiai

### 2.2.1 Tokumei Kumiai (TK)

A Tokumei Kumiai, or TK, is a silent partnership arrangement provided for under the Commercial Code of Japan. The silent partner(s) in the TK (Tokumei Kumiai-In) contributes funds under a TK agreement for the operation of a specific business carried on by an operator (Eigyosha) and in return is able to participate in the profits or losses from that operation. In entering into a TK arrangement, the TK silent partner(s) does not obtain any interest in the underlying assets of the TK operator's business, nor generally can the TK silent partner(s) participate in the management or operation of the business. The mechanics of a TK can be used in any kind of business.

### 2.2.2 Taxation of the Operator

A TK operator carrying on business in Japan is subject to normal Japanese corporate income tax/individual income taxes in relation to the operation of its business. However, when calculating taxable income, the TK operator is entitled to take a deduction for any element of profits allocated to the TK silent partner(s). Conversely, where losses are allocated to the TK silent partner(s), the TK operator is required to recognize corresponding taxable income.

### 2.2.3 Taxation of Silent Partners

The Japanese tax consequences for a TK silent partner relating to income under a TK arrangement depends upon whether or not the TK silent partner is Japanese resident.

(1) Japanese Resident Partners

The TK profit/loss allocation is treated as normal taxable income/loss of the TK silent partner for the taxable period in which the calculation period end date of the TK arrangement

falls.

As for corporate silent partners, utilization of losses generated from a TK is restricted (please see 2.3 below). As for individual silent partners, the TK profit/loss allocation is basically classified as 'miscellaneous income', which means that a loss allocation from a TK cannot be offset against any other types of income. However, if the individual silent partner is involved with managing the business operation together with the operator, the TK profit/loss allocation may be classified as other types of income that may be offset against other income if the result is a loss.

Withholding tax is levied on actual distributions of TK profit to silent partners at the rate of 20 percent (20.42 percent from 2013 to 2037, including a special reconstruction income tax), which is creditable for the silent partners when declaring such income in their tax returns.

(2) Foreign Partners Having a PE in Japan

The TK profit/loss allocation to foreign TK silent partners (both foreign individuals and foreign companies) having a permanent establishment (PE) in Japan is treated in the same way as Japanese resident partners.

(3) Foreign Partners Not Having a PE in Japan

20 percent withholding tax (from 2013 to 2037, 20.42 percent withholding tax, including a special reconstruction income tax) is applied on actual distributions of TK profit allocations. There is no requirement to file a tax return in Japan.

It should be noted that foreign TK silent partners located in certain jurisdictions with which Japan has concluded a tax treaty containing an appropriate 'Other Income' article, which provides that 'Other Income' is taxable only in the country of the recipient, can apply to the tax authorities to have the

withholding tax on their distributions of TK profit allocations exempted. Note that tax treaties with some countries such as the US, the UK, France, Hong Kong and the Netherlands include a special article for TK income whereby the Japanese tax authorities are given the taxing right with respect to TK distributions.

## 2.3 Limitation on Utilization of Losses Derived from Partnerships

There are rules to limit the utilization of losses derived from a partnership at the level of each partner as discussed below. For a foreign investor, these rules affect the investor's taxable income in Japan only when the investor has a permanent establishment in Japan.

### 2.3.1 Corporate Partners of Partnerships Other than Japanese LLPs: At-Risk Rule (AR rule)

Where a corporate partner of a certain partnership suffers losses from the partnership in its fiscal year, the following amount (excess partnership losses) is not deductible in calculating taxable income for the fiscal year:

(i) Where a corporate partner is not at risk with respect to liabilities of the partnership due to an arrangement such as non-recourse financing:
the partnership losses exceeding the amount calculated based on the capital contribution of the corporate partner

(ii) Where it is obvious that the business of the partnership results in profits due to an arrangement such as a profit guarantee contract or a residual value insurance/guarantee:
the partnership losses

If the corporate partner derives profits from the partnership business in subsequent fiscal years, the excess partnership losses incurred from the same partnership in prior fiscal years

can be offset against the profits.

This rule does not apply to a corporate partner who is continuously involved in decision-making of important transactions of the partnership activity and continuously performs important parts of the transactions (such as negotiating the contracts).

Partnerships covered by this rule are as follows:

(i) NK
(ii) Investment LPS
(iii) Tokumei-Kumiai (TK) and any other arrangement similar to a TK
(iv) foreign arrangements similar to (i), (ii) and (iii)
(v) foreign arrangements similar to a Japanese LLP

### 2.3.2 Individual Partners of Partnerships Other than Japanese LLPs

Where an individual partner of a certain partnership that is involved in rental real property activity incurs losses from the rental activity, such losses are disregarded for individual income tax purposes and cannot be carried over to the following years. This rule does not apply to an individual partner who is continuously involved in decision-making of important transactions of the partnership activity and continuously performs important parts of the transactions (such as negotiating contracts).

Partnerships covered by this rule are as follows:

(i) NK
(ii) Investment LPS
(iii) foreign arrangements similar to (i) and (ii)
(iv) foreign arrangements similar to Japanese LLP

'Rental real property activity' includes not only the rental of land and buildings but also leasing ships and aircraft.

### 2.3.3 Corporate Partners of Japanese LLPs

When a corporate partner of an LLP incurs losses from the LLP business in its fiscal year, the losses exceeding the amount calculated based on the capital contribution of the corporate partner (excess LLP losses) are not deductible in calculating taxable income for the fiscal year.

If the corporate partner derives profits from the LLP business in subsequent fiscal years, the excess LLP losses incurred from the same LLP in prior fiscal years can be offset against the profits.

### 2.3.4 Individual Partners of Japanese LLPs

When an individual partner of an LLP derives rental real property income, business income or forestry income from the LLP business, if the losses incurred from the LLP business in a year exceed the amount calculated based on the capital contribution of the individual partner, such excess portion is not treated as deductible expenses in calculating taxable income for the year.

While a corporate partner of an LLP can offset excess losses against profits generated from the same LLP in subsequent years, the treatment is not available if the partner is an individual.

# 3 Taxation of Individuals

## 3.1 Introduction

Individual income taxes in Japan consist of national income tax and local inhabitant tax. The taxable year for national income tax is the calendar year. Inhabitant tax is assessed by the municipal governments on individuals who reside or have domicile therein as of 1 January of each year, based on income for the preceding year. Moreover, those individuals who are operating certain specified businesses of their own at fixed places in Japan are liable for business tax assessable by prefectural governments.

## 3.2 Taxpayers

### 3.2.1 Classification of Individual Taxpayers

Under the Income Tax Law of Japan, there are two categories of individual taxpayers; resident and non-resident.

(1) Resident

A resident is an individual who has their domicile in Japan or who has resided in Japan for a continuous period of 1 year or more. Residents are further divided into either non-permanent or permanent residents with consequential tax implications as described below.

(i) Non-permanent resident

A non-permanent resident is a resident who does not have Japanese nationality and has lived in Japan for 5 years or less in the last 10 years.

A non-permanent resident is subject to normal Japanese income and inhabitant taxes on (a) income other than foreign

source income plus (b) foreign source income paid in or remitted to Japan.

(ii) Permanent resident

A permanent resident is a resident other than a non-permanent resident; therefore, an individual who has Japanese nationality, or has been domiciled or resident in Japan for a period of more than 5 years in the last 10 years falls under this category.

A permanent resident is subject to Japanese income and inhabitant taxes on their worldwide income.

(2) Non-Resident

A non-resident is an individual other than a resident; therefore an individual who has no domicile in Japan, or has not been resident for a continuous period of 1 year or more in Japan, falls under this category.

Note that in this chapter, the tax treatment of a non-resident is discussed on the assumption that the non-resident has no permanent establishment in Japan.

### 3.2.2 Domicile

'Domicile', as provided for in the Income Tax Law of Japan, means the principal place of living. Whether or not an individual has their domicile in Japan is determined on the basis of objective facts, such as the fact that the person has an occupation in Japan, that the person's spouse or other relatives make up the person's household in Japan, or that the place of business is located in Japan. In view of the nature of a domicile, an individual can never be regarded as having more than one domicile at the same moment.

Generally speaking, if a person, regardless of whether the person is a Japanese national or a foreign national, has come to

reside in Japan to engage in business or an occupation, the person is presumed to have a domicile in Japan, unless it is made clear from the employment contract, etc. based on which the person has come to Japan, that the period of the person's stay in Japan is not 1 year or more. It should be noted in this connection that the visa status under which a foreign national has been permitted to enter Japan is not directly relevant.

### 3.2.3 Short-Term Visitors

Generally, Japan's double tax treaties are in line with the OECD Model Tax Convention with respect to the tax-exempt treatment of foreign employees temporarily working in Japan. Such employees are generally tax exempt if they fulfill the following three criteria:

- They are present in Japan for not more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

- Their salary is paid by a non-resident employer.

- None of the salary is borne by a permanent establishment of the non-resident employer in Japan.

## 3.3 Tax Rates

### 3.3.1 Tax Rates on Ordinary Income

The following progressive tax rates are applied to the net of assessable ordinary income minus allowable deductions and personal reliefs.

(1) National Income Tax Rates

(JPY)

| Taxable income | | Tax rates applicable to taxable income band | Deduction |
|---|---|---|---|
| From | But not over | | |
| - | 1,950,000 | 5% | - |
| 1,950,000 | 3,300,000 | 10% | 97,500 |
| 3,300,000 | 6,950,000 | 20% | 427,500 |
| 6,950,000 | 9,000,000 | 23% | 636,000 |
| 9,000,000 | 18,000,000 | 33% | 1,536,000 |
| 18,000,000 | 40,000,000 | 40% | 2,796,000 |
| 40,000,000 | - | 45% | 4,796,000 |

(2) Inhabitant Tax Rates

Inhabitant tax consists of two elements; a small levy imposed regardless of the amount of income (per capita levy) and a more significant tax based upon the taxable income of the individual taxpayer (Income based levy).

- Per capita levy

(JPY)

| Municipal inhabitant tax | Prefectural inhabitant tax |
|---|---|
| 3,000 | 1,000 |

- Income based levy

The inhabitant tax rate is 10 percent regardless of the amount of taxable income.

### 3.3.2 Tax Rates on Capital Gains from Sales of Real Estate

Capital gains from sales of real estate are taxed separately from ordinary income as follows:

- short-term capital gains (the period of possession is 5 years or less as of 1 January of the sale year) — 30 percent national income tax and 9 percent inhabitant tax

- long-term capital gains (the period of possession is more than 5 years as of 1 January of the sale year) — 15 percent national income tax and 5 percent inhabitant tax

Where the asset sold is a residence, further concessions such as special deductions, tax loss carry-forwards and preferential tax rates are available provided that certain conditions are satisfied.

Note that if land in Japan was acquired in 2009 and 2010, a special deduction for long-term capital gains may be available, which is discussed in 1.6.2.

### 3.3.3 Tax Rates on Investment Income

(1) Investment Income Derived from Listed Shares/Specified Bonds

Dividend income from listed shares, in principle, is required to be added to ordinary income; however, a taxpayer has the following options to settle their tax liability on the dividends from listed shares unless the taxpayer holds 3 percent or more of the outstanding shares of a Japanese dividend paying company at the record date of the dividends (by virtue of the

2022 tax reform, the taxpayer will also be included where the taxpayer and companies, 50 percent of whose outstanding shares are held by the taxpayer, hold more than 3 percent or more of the outstanding shares of a Japanese dividend paying company in the aggregate at the record date of the dividends paid on or after 1 October 2023 ):

- No-declaration in an income tax return:
  This is applied to dividends from a Japanese company. Tax liabilities on dividends are settled by withholding tax.

- Declaration separately from ordinary income:
  Dividend income is taxed at a flat rate of 20 percent (15 percent national income tax and 5 percent inhabitant tax).

Interest from specified bonds is also subject to the above separate declaration.

'Specified bonds' include the following:

- Japanese government bonds, local government bonds, foreign national government bonds, foreign local government bonds

- publicly-offered bonds, listed bonds

- bonds issued on or before 31 December 2015 (except for discount bonds where tax is withheld at the time of issuance)

Capital gains from sales of listed shares and specified bonds are basically taxed at 20 percent (15 percent national income tax and 5 percent inhabitant tax) separately from ordinary income. When calculating the capital gains, any gains/losses from sales of listed shares and specified bonds are aggregated.

Note that when a taxpayer suffers capital losses from certain sales of listed shares and specified bonds in a given year, such

losses can be offset against dividend income from listed shares declared separately from ordinary income and interest income from specified bonds.

Moreover, it is possible to carry over capital losses incurred from certain sales of listed shares and specified bonds for 3 years to set off against the following income:

- dividend income from listed shares declared separately from ordinary income
- interest income from specified bonds
- capital gains from listed shares and specified bonds

Note that dividends and capital gains from publicly-offered stock investment trusts are basically treated in the same way as those from listed shares. Also, interest and capital gains from publicly-offered bond investment trusts are treated in the same way as those from specified bonds.

(2) Investment Income Derived from Non-Listed Shares/Ordinary Bonds

Dividend income from non-listed shares is generally taxed as ordinary income; however, a taxpayer can settle their tax liability by withholding tax without declaration in their income tax return if the amount of the dividend from a Japanese company does not exceed JPY100,000 per annum (where the calculation period of the dividend is less than 1 year, instead of JPY100,000, the amount calculated by multiplying JPY100,000 by the number of the months of the calculation period of the dividend and divided by 12.). Note that such dividends are still required to be declared for inhabitant tax purposes.

Interest from ordinary bonds (i.e. bonds other than specified bonds) is generally taxed only through withholding tax and declaration in an income tax return is not required provided

that the interest is paid in Japan.

Capital gains from sales of non-listed shares and ordinary bonds are basically taxed at 20 percent (15 percent national income tax and 5 percent inhabitant tax) separately from ordinary income. When calculating the capital gains, any gains/losses from sales of non-listed shares and ordinary bonds are aggregated.

Note that dividends and capital gains from privately-offered stock investment trusts are basically treated in the same way as those from non-listed shares. Also, interest and capital gains from privately-offered bond investment trusts are treated in the same way as those from ordinary bonds.

(3) Investment Income Derived from Bank Deposits

Interest from bank deposits is generally taxed only through withholding tax and declaration in an income tax return is not required provided that the interest is paid in Japan.

### 3.3.4 Withholding Tax Rates on Investment Income

Withholding tax rates on interest/dividends paid to individuals in Japan are as follows:

| Investment income | National income tax | Inhabitant tax |
|---|---|---|
| Dividends from listed shares(*) /publicly-offered stock investment trusts | 15% | 5% |
| Dividends from non-listed shares/ privately-offered stock investment trusts | 20% | - |
| Interest on bonds/bond investment trusts/bank deposits | 15% | 5% |

(*) Where a taxpayer holds 3 percent or more of the outstanding shares of a Japanese dividend paying company at the record date of the dividends (by virtue of the 2022 tax reform, the taxpayer will also be included where the taxpayer and companies, 50 percent of whose outstanding shares are held by the taxpayer, hold 3 percent or more of the outstanding shares of a Japanese dividend paying company in the aggregate at the record date of the dividends paid on or after 1 October 2023), the tax rate for dividends from non-listed shares is applied.

Please see 4.8.2 for details of withholding tax imposed on investment income earned by non-residents.

### 3.3.5 Tax Rates Imposed on Non-Residents

In general, a non-resident is liable for Japanese individual income tax at the flat rate of 20 percent of the gross amount of their Japanese source income except for certain income such as Japanese source real estate income which is taxed at progressive tax rates on a net basis. A non-resident is generally not liable for inhabitant tax. Where a non-resident is registered in the relevant municipal government under the Basic Resident Registration system, the individual may be liable for inhabitant tax.

### 3.3.6 Special Reconstruction Income Tax

In addition to the above, special reconstruction income tax will be imposed at 2.1 percent on the national income tax liability from 2013 to 2037 in order to increase tax revenue to finance post-earthquake reconstruction. If a taxpayer takes foreign tax credits (discussed in 3.7.3), special reconstruction income tax will be calculated based on the national income tax liability before the foreign tax credits.

Note that special reconstruction income tax will be imposed not only on national income tax declared in an income tax return

but also on withholding tax.
Also, inhabitant tax (per capita levy) is increased by JPY1,000 (JPY500 for municipal inhabitant tax and JPY500 for prefectural inhabitant tax) from 2014 to 2023 for reconstruction funding.

## 3.4 Assessable Income

An individual's taxable income is defined as assessable income less allowable deductions. Assessable income for these purposes consists of the following:

- interest income
- dividend income
- real estate income
- business income
- employment income
- retirement income
- timber income
- capital gains
- occasional income
- miscellaneous income

### 3.4.1 Remuneration

When considering the tax position of expatriates assigned to work in Japan, the most significant item of assessable income is likely to be employment income.

Employment income may commonly include the following items:

- basic salary
- bonus
- cost of living allowance
- overseas premium
- housing allowance or company housing
- maid allowance
- utility allowance
- children's tuition allowance

- foreign exchange allowance
- tax equalization
- medical allowance
- stock options
- other economic benefits, such as company car or home leave transportation

In addition to the foregoing, the expatriates may continue to be covered by pension and/or profit sharing plans maintained by their head offices while they are in Japan.

As can be noted from the above, whilst employment income will principally consist of cash payments, it is not limited to cash amounts and payments in kind or economic benefits are also included within assessable income, unless specifically exempted from taxes under the tax laws, regulations or administrative rulings.

### 3.4.2 Treatment of Benefits

(1) Company Housing

Rent paid by an employer is not entirely included in assessable income if the 'assessed rent (legal rent)' (i.e. minimum rent measured by administrative guidance of the income tax law) is paid by the employee.

(2) Children's Tuition Allowance

Tuition fees for children paid by an employer are included in assessable income to the employee. However, an exception to such taxable treatment has been established by private tax rulings with respect to the contribution plan of certain international schools in Japan. Under such plans, an employer company can effectively make a donation to the school and in recognition of this, children of employees are exempted from tuition fees for attending the school. The employees are not required to report any benefits arising from this arrangement as

taxable income. However, employer companies are required to treat the contribution payments as donations for corporation tax purposes. As discussed in 1.8.11, donations have only limited deductibility for corporation tax purposes.

Certain international schools have now been granted status as Specified Public Interest Facilitating Corporations. As a result, it may be possible for companies to enjoy a tax deduction for a greater portion of donations to such qualifying schools.

(3) Company Car

A company car used for the employer's business is not treated as a taxable economic benefit.

(4) Home Leave Transportation

Cash or an in-kind benefit provided by an employer to an expatriate in Japan to facilitate a home leave trip to that expatriate's country of origin will generally not be treated as assessable income of the expatriate. The home leave expense can also cover the costs of the expatriate's co-habiting family members. Such home leave should, generally speaking, be limited to a single trip per year and should be in accordance with the employer's working rules, terms of the expatriate's contract, etc. Further, the expense should be reasonable based upon the relevant facts, such as available routes, distance, fare, etc.

(5) Moving Expenses

Moving expenses are generally treated as non-taxable income.

(6) Tax Reimbursements

Any tax reimbursement or settlement made by an employer for an expatriate should be included in assessable income on a cash basis.

(7) Stock Options

(i) Qualified stock options

The income earned from qualified stock options is subject to tax when the stock is sold. Therefore, the tax on income generated by exercise of the stock option is deferred until the stock is sold as a capital gain.

The conditions for qualified stock options are as follows:

- The holder of the stock options is a director (including not only a member of the board of directors but also officers) or an employee of the issuing company, or is a director or an employee of a company whose voting stock is 50 percent or more owned directly or indirectly by the issuing company.

- The stock option rights have to be exercised within the period between the second anniversary of the date of the resolution of the shareholders meeting for the option grant and the tenth anniversary.

- The total exercise price of all options exercised in a year must not exceed JPY12 million.

- The exercise price of the option must be equal to or higher than the fair market value of the underlying shares on the date the agreement for the option grant is concluded.

- The option rights cannot be transferred.

- Issuance of new stock pursuant to the stock options was made in compliance with the Japanese Companies Act relating to a shareholders' meeting resolution.

- With respect to the stock that is issued at the time the option is exercised, the share certificates must not be transferred to

or held by an option holder, but must be kept in trust and custody by either a securities company or a trust company (Trust) in accordance with a prearranged agreement made between a company and the Trust. That is, share certificates must be kept under the supervision and control of the Trust until such shares are sold.

(ii) Non-qualified stock options

Any benefits arising from non-qualified stock options for the directors/employees are taxable at the time of exercise of the option. The director/employee is taxed on the difference between the fair market value and exercise price on the date of exercise. The income is generally treated as additional compensation and subject to ordinary income taxes.

(8) Restricted Stock

Where a company grants specified restricted stock to its directors/employees as compensation for services performed by them, such individuals should recognize taxable benefits at the fair market value of the stock when the restrictions on the stock lapse (i.e. the vesting date).

Restricted stock is defined as stock which is subject to restrictions of transferability for a certain period of time and forfeiture upon certain trigger events. Restricted stock is treated as specified restricted stock in certain cases including where an director/employee of a company contributes monetary claims for their compensation to the company in order to obtain restricted stock from the company (i.e. a contribution-in-kind).

### 3.4.3 Exemptions and Concessions

The following items of income and benefits are specifically excluded from treatment as assessable income:

- commutation allowances not exceeding the lesser of JPY150,000 or actual monthly commutation costs

- reasonable costs of presents, etc. for the commendation of officers or employees for their long-service with the employer company

- costs of goods given to directors or employees in connection with the commemoration of anniversaries, etc. (Such goods must be suitable for the commemoration, and the estimated disposal value thereof shall not exceed JPY10,000.)

- discount sale of merchandise (The discounted sales price must be at least 70 percent of the ordinary sales price, and the quantity of merchandise sold at a discount should be such that ordinary consumers normally consume for their own household use.)

- utilities for a dormitory

- interest on loans in the case of emergency, such as calamity, sickness, etc. or where the amount of such interest does not exceed JPY5,000 a year

- cost of recreation, such as outings, etc. up to a reasonable amount

- life insurance or casualty insurance premiums borne by the employer on behalf of directors and employees provided that the insurance proceeds are to be made to the employer upon expiration of the insurance term

- insurance premiums, provided the amount borne by the

employer shall not exceed JPY300 a month

- compensation for damage paid to a third party and legal fees in connection therewith where such damage was caused by an officer or employee while on duty and not due to their fault

- golf club or social club membership fees, etc. provided that they are connected with the business of the employer

- dividends and capital gains from listed shares held in an individual savings account (NISA: Nippon individual savings account), in which an individual can make investments in listed shares up to JPY1.2 million per year from 2016 to 2023 and hold them for a maximum of 5 years (From 2024, the current NISA scheme will shift to the new NISA scheme which was introduced under the 2020 tax reform.)
  (In addition to the above NISA scheme, the Junior NISA scheme, which will end in 2023, for minors less than 20 years old (18 years old in 2023) and the installment-type NISA scheme for investments in listed stock investment trusts, etc. are also available.)

- subsidies provided by the national or local governments to cover the usage fees of childcare facilities or childcare service

### 3.4.4 Special Measures for Aggregation of Profits and Losses of Real Estate Income Derived from Second-Hand Overseas Buildings

Where an individual has real estate income derived from second-hand overseas buildings and there is any amount of losses from overseas real properties in the calculation of the amount of the real estate income for the year, the amount attributable to depreciation of the second-hand overseas buildings among the amount of losses from overseas real

properties will be disregarded for the purpose of the application of the provisions of income tax.

Note that the amount of disregarded depreciation above will not be deducted from acquisition costs of the second-hand overseas buildings in the calculation of capital gains, when the second-hand overseas buildings are transferred.

■ Definitions of Keywords

(1) Second-Hand Overseas Buildings

Among buildings overseas which had been used by individuals or put into use for business by companies and which were acquired by an individual and used in business operations to generate real estate income, buildings for which the calculation method of the useful life applied in the calculation of depreciation included in the necessary expenses in real estate income is one of the following methods:

- Simplified method

  (i) If statutory useful life ≤ number of years elapsed (A)
  Useful life: statutory useful life x 20%

  (ii) If statutory useful life > number of years elapsed (A)
  Useful life: statutory useful life - (A) + 20% x (A)

- Estimating method

  Useful life: estimated remaining useful life

(Except for the cases where certain documents are attached to the income tax return to prove that the useful life complies with the laws of the state of the second-hand overseas buildings or the estimated remaining useful life is appropriate.)

(2) Amount of Losses from Overseas Real Properties

The amount of losses from renting out second-hand overseas buildings in the calculation of real estate income (if there is any amount of real estate income derived from other overseas properties, the amount of the remaining balance after being netted against real estate income from those overseas properties)

## 3.5 Allowable Deductions

### 3.5.1 Employment Income Deduction

(1) Standard Deduction

(i) For a taxpayer other than (ii)

(JPY)

| Amount of compensation (A) | | Standard deduction |
|---|---|---|
| Up to | 1,625,000 | 550,000 |
| Excess over<br>Up to | 1,625,000<br>1,800,000 | (A) x 40% - 100,000 |
| Excess over<br>Up to | 1,800,000<br>3,600,000 | (A) x 30% + 80,000 |
| Excess over<br>Up to | 3,600,000<br>6,600,000 | (A) x 20% + 440,000 |
| Excess over<br>Up to | 6,600,000<br>8,500,000 | (A) x 10% + 1,100,000 |
| Excess over | 8,500,000 | 1,950,000 |

(ii) For a taxpayer meeting any of the following conditions:

- The taxpayer is a special handicapped person.
- The taxpayer has a dependent aged less than 23 in the same household.

- The taxpayer has a special handicapped dependent or special handicapped spouse in the same household.

The additional deduction calculated as follows is applicable:

| (Total amount of compensation - JPY8,500,000) × 10%<br>(maximum: JPY150,000) |
|---|

Thus, the total of the standard deduction and the additional deduction is as follows for such taxpayers:

(JPY)

| Amount of compensation (A) | | Standard deduction<br>+ Additional deduction |
|---|---|---|
| Up to | 8,500,000 | Same as (i) |
| Excess over<br>Up to | 8,500,000<br>10,000,000 | (A) x 10% + 1,100,000 |
| Excess over | 10,000,000 | 2,100,000 |

(2) Deduction of Specified Expenditure

When a resident taxpayer having employment income has borne specified expenditure in a given year, the amount of specified expenditure less 50 percent of the standard deduction can be deducted from gross compensation in addition to the standard deduction.

Specified expenditure includes expenditure for commuting, relocation, training and business trips. Expenses for books, clothing and entertainment directly required to perform duties are also treated as specified expenditure, up to JPY650,000 a year.

### 3.5.2 Retirement Income Deduction

(JPY)

| Circumstances | Standard deduction |
|---|---|
| Up to first 20 years of service | 400,000 per year of service |
| For each year of service over 20 years | 700,000 per year of service |
| Minimum deduction | 800,000 per case |
| Special deduction for those retiring due to physical handicap | Amount of the above deduction + 1,000,000 |

Note that taxable retirement income is calculated as 50 percent of retirement income after the standard deduction, and it is taxed at the ordinary tax rates but separately from ordinary income.

The 50 percent reduction will not apply to retirement allowances that a director whose service period is 5 years or shorter receives for the service period.

By virtue of the 2021 tax reform, where an employee other than a director whose service period is 5 years or shorter receives retirement allowances, the 50 percent reduction will not apply to the portion of retirement allowances after the standard deduction exceeding JPY3 million. This treatment is applied to individual income taxes from 2022.

### 3.5.3 Specific Deductions

The following deductions are applicable to a resident taxpayer. Note that a non-resident taxpayer subject to progressive tax rates may also enjoy special deductions for casualty losses incurred on the assets in Japan and donations.

(1) Casualty Losses

A deduction is available for losses incurred on a taxpayer's assets, or those of family members living in the same household, from a disaster or a robbery. The deductible amount is equivalent to any loss not covered by insurance proceeds, etc. in excess of the smaller of JPY50,000 or 10 percent of assessable income.

(2) Medical Expenses

■ Basic measure

A deduction is available for medical expenses for the taxpayer and family members living in the same household. The deductible amount is equivalent to medical expenses not covered by insurance proceeds, etc. in excess of the smaller of JPY100,000 or 5 percent of assessable income. The maximum deduction is limited to JPY2 million.

■ Special measure

A special measure for the deduction for medical expenses with respect to expenses for so-called switch OTC drugs (drugs that were previously sold as prescription drugs and have been switched to over-the-counter drugs) is applicable from 2017 to 2026.

Under the special measure, where an individual who receives a medical checkup or a vaccination, etc. in order to maintain and improve their health condition and prevent diseases pays designated switch OTC drug expenses for the person or their family members living in the same household, the total amount of switch OTC drug expenses less JPY12,000 will be deductible in calculating taxable income up to JPY88,000.

The special measure will not be applicable where the medical deduction under the basic measure is applied.

(3) Social Insurance Premiums

Only premiums paid under Japanese social insurance schemes for a taxpayer and family members living in the same household are deductible. Foreign social insurance premiums are not deductible. However, in accordance with the protocol of the Japan-France tax treaty signed in January 2007, contributions paid to the French social security system may be deductible under certain circumstances.

(4) Life Insurance Premiums

The maximum deductible amount for each type of qualified life insurance premiums is as follows:

[For insurance policies entered into before 31 December 2011]

(JPY)

| Life insurance premiums | National income tax | Inhabitant tax |
|---|---|---|
| Life insurance premiums | 50,000 | 35,000 |
| Personal pension insurance premiums | 50,000 | 35,000 |

[For insurance policies entered into on or after 1 January 2012]

(JPY)

| Life insurance premiums | National income tax | Inhabitant tax |
|---|---|---|
| Life insurance premiums | 40,000 | 28,000 |
| Personal pension insurance premiums | 40,000 | 28,000 |
| Medical care insurance premiums | 40,000 | 28,000 |

The total annual caps of the deductible amount for the above insurance premiums are JPY120,000 and JPY70,000 for national income tax purposes and for inhabitant tax purposes, respectively.

Note that insurance premiums paid on policies concluded abroad by foreign insurance companies are not qualified for the life insurance deduction.

(5) Fire and Other Household Casualty Insurance Premiums

The income deduction for casualty insurance premiums has basically been abolished. However, the deduction for long-term casualty insurance premiums remains available provided that the policies were entered into before 1 January 2007. The maximum deduction for long-term casualty insurance premiums is JPY15,000 and JPY10,000 for national income tax purposes and for inhabitant tax purposes, respectively.

If an individual applies for both a deduction for earthquake insurance premiums (discussed below) and a deduction for long-term casualty premiums, the maximum deductible amount in total is JPY50,000 for national income tax purposes and JPY25,000 for inhabitant tax purposes.

(6) Earthquake Insurance Premiums

Certain earthquake insurance premiums up to the value of JPY50,000 can be deducted from income for national income tax purposes, and a half of the premiums for inhabitant tax purposes (up to JPY25,000).

(7) Donations

Donations qualifying as a deduction do not mean charitable contributions or donations in general but those to the following:

(i) the national government

(ii) local governments

(iii) institutions for educational, scientific or other public purposes as designated by the Minister of Finance

(iv) public interest incorporated associations/foundations, educational institutions and social welfare institutions, etc.

(v) political parties or organizations (where the donations are qualified under certain conditions and made by 2024)

(vi) authorized Non-Profit Organizations (NPOs) (where donations are qualified under certain conditions)

The deductible amount is equivalent to the amount of the donations paid during the year (subject to a ceiling of 40 percent of the total assessable income) in excess of JPY2,000. Receipts are required as evidence to support the deduction.

Tax credits are also available for certain donations in lieu of deductions. Please see 3.7.4 for details. For inhabitant tax purposes, only tax credits for donations are available. Please see 3.7.4 for details.

## 3.6 Personal Reliefs

The reliefs described below are available to reduce taxable income for national income tax and inhabitant tax purposes. Reliefs are separately applied to each individual taxpayer. Note that a non-resident taxpayer subject to progressive tax rates is only entitled to the basic deduction.

When a resident taxpayer applies personal reliefs for non-resident family members, submission or presentation of documents identifying the family members and documents for money transfers are required.

### 3.6.1 Basic Deduction

The amount of the basic deduction is as follows:

(JPY)

| Amount of total income (goukei-shotoku-kingaku) | | Basic deduction | |
|---|---|---|---|
| | | National income tax | Inhabitant tax |
| Up to | 24,000,000 | 480,000 | 430,000 |
| Excess over<br>Up to | 24,000,000<br>24,500,000 | 320,000 | 290,000 |
| Excess over<br>Up to | 24,500,000<br>25,000,000 | 160,000 | 150,000 |
| Excess over | 25,000,000 | 0 | 0 |

### 3.6.2 Spouse Deduction

A taxpayer whose total income (goukei-shotoku-kingaku) is not over JPY10 million and who has a spouse who resides in the taxpayer's household and whose total income is JPY480,000 or less is eligible for the spouse deduction.

The deductible amounts are as follows:

(JPY)

| Amount of taxpayer's total income (goukei-shotoku-kingaku) | | Spouse deduction | |
|---|---|---|---|
| | | National income tax | Inhabitant tax |
| Up to | 9,000,000 | 380,000<br>(480,000) | 330,000<br>(380,000) |
| Excess over<br>Up to | 9,000,000<br>9,500,000 | 260,000<br>(320,000) | 220,000<br>(260,000) |
| Excess over<br>Up to | 9,500,000<br>10,000,000 | 130,000<br>(160,000) | 110,000<br>(130,000) |
| Excess over | 10,000,000 | 0 | 0 |

The deductible amounts shown in parentheses are applied for a spouse who is 70 years or older.

### 3.6.3 Special Spouse Deduction

Even when the spouse deduction is not applicable since the total income (goukei-shotoku-kingaku) of the spouse who resides in the taxpayer's household is over JPY480,000, the special spouse deduction in the range of JPY10,000 to JPY380,000 for national income tax purposes (JPY10,000 to JPY330,000 for inhabitant tax purposes) may be applied depending on the amount of the spouse's total income, provided that the total income for the taxpayer and the spouse is not over JPY10 million and JPY1.33 million, respectively. Note that the special spouse deduction is not applicable to both of the taxpayer and the spouse simultaneously.

### 3.6.4 Dependent Deductions

A taxpayer who has a dependent who resides in the taxpayer's household and whose total income (goukei-shotoku-kingaku) is JPY480,000 or less is eligible for the dependent deduction.

The deductible amounts are as follows:

(JPY)

| Conditions of dependent | Dependent deduction | |
|---|---|---|
| | National income tax | Inhabitant tax |
| 16-18 years of age | 380,000 | 330,000 |
| 19-22 years of age | 630,000 | 450,000 |
| 23-69 years of age | 380,000 | 330,000 |
| 70 years or older | 480,000 | 380,000 |
| Parent, 70 years old or older, of the taxpayer or his or her spouse living under the same roof | 580,000 | 450,000 |

By virtue of the 2020 tax reform, where a resident taxpayer has a family member aged between 30 and 69, the dependent deductions will be applicable only if the family member falls under any of the following conditions:

- The family member becomes non-resident due to studying abroad. (required to submit or present documents to prove that a person resides in a foreign country with the status of residence as a student issued by the foreign government)

- The family member is a handicapped person.

- The family member receives a payment of JPY380,000 or more to cover living expenses or education costs in the year from the taxpayer. (required to submit or present documents for money transfers to prove that the amount of remittance is JPY380,000 or more)

This amendment will be applied from 2023 for national income tax purposes and from 2024 for inhabitant tax purposes (for income earned in 2023).

### 3.6.5 Additional Reliefs for Specific Cases

(JPY)

| Relief | National income tax | Inhabitant tax |
|---|---|---|
| Physically handicapped person | 270,000 | 260,000 |
| Severely physically handicapped person | 400,000 | 300,000 |
| If severely physically handicapped person is living with the taxpayer | 750,000 | 530,000 |
| Widow, divorcee or working student | 270,000 | 260,000 |
| Single parent | 350,000 | 300,000 |

■ Definitions of Keywords

(1) Widow

A widow is a person other than '(3) single parent' and who does not re-marry after the death of her husband and whose total income (goukei-shotoku-kingaku) is not over JPY5 million.

(2) Divorcee

A divorcee is a person other than '(3) single parent' and who has dependents without re-marrying after divorcing her husband and whose total income is not over JPY5 million.

(3) Single Parent

A single parent is an unmarried person with a child who resides in the person's household and whose income (sou-shotoku-kingaku) is JPY480,000 or less and total income of the person is not over JPY5 million.

(A taxpayer having a partner who has a de facto marriage relationship with the taxpayer will be excluded from (1)(2) and (3) above.)

## 3.7 Tax Credits

The following tax credits can, where applicable, be claimed by a resident filing a final tax return. Note that a non-resident subject to progressive tax rates is also entitled to credits for withholding income tax and donations.

### 3.7.1 Credit for Dividends

This credit is applicable to domestic dividend receipts only. The amount of the credit is calculated at the following rates:

| Total assessable income (including the dividend income) | | Rates | |
|---|---|---|---|
| | | National income tax purposes | Inhabitant tax purposes |
| Up to JPY10,000,000 | Dividends from shares | 10% | 2.8% |
| | Distribution from stock investment trusts | 5% | 1.4% |
| Over JPY10,000,000(*) | Dividends from shares | 5% | 1.4% |
| | Distribution from stock investment trusts | 2.5% | 0.7% |

(*) Where the taxable income exceeds JPY10 million, the amount of the credit is calculated given the assumption that the dividend income from stock investment trusts is the top slice of the taxable income.

Note that alternatively, more complex tax credit arrangements are also applicable to certain other types of distributions.

A taxpayer may declare dividend income from listed shares separately from ordinary income. In this case, the above tax credit is not available.

### 3.7.2 Credit for Withholding National Income Tax

National income tax withheld from employment income, from dividends not subject to separate taxation and from other income reportable in a final income tax return should be credited against national income tax due on the final income tax return. Special reconstruction income tax imposed on such withholding tax is also creditable against special reconstruction income tax due on the final income tax return.

### 3.7.3 Credit for Foreign Taxes

Where a resident taxpayer pays foreign taxes in a year, such foreign taxes are creditable against their Japanese income tax payable to the extent of the limit calculated by the following formula:

$$\text{Creditable limit} = \text{Japanese national income tax} \times \frac{\text{Foreign source income}}{\text{Entire income taxable in Japan}}$$

Any excess foreign tax can be credited against special reconstruction income tax to the extent of the creditable limit for special reconstruction income tax purposes calculated using a similar formula to the above. If there is still excess foreign tax, such amount can be credited against inhabitant tax to the extent of 18 percent of the creditable limit for national income tax purposes (municipal inhabitant tax) and 12 percent of the creditable limit for national income tax purposes (prefectural inhabitant tax).

Any remaining excess of foreign tax suffered can be carried forward for crediting in the 3 succeeding years. Similarly, any residual amount of the creditable limit for national income tax and inhabitant tax purposes can be carried forward for up to 3 years.

### 3.7.4 Credit for Donations

(1) National Income Tax

If a taxpayer pays donations to the following organizations, the taxpayer is able to choose to claim a tax credit instead of taking an income deduction for national income tax purposes.

<table>
<tr><td colspan="2">Creditable amount = (i) + (ii)</td></tr>
<tr><td rowspan="2">(i) Tax credits for donations to political parties<br>(The smaller of either (a) or (b))</td><td>(a) (Donations to political parties[1] - JPY2,000) x 30%</td></tr>
<tr><td>(b) Income tax before tax credits x 25%</td></tr>
<tr><td rowspan="2">(ii) Tax credits for donations to authorized NPOs/public interest entities<br>(The smaller of either (a) or (b))</td><td>(a) Total of the following:<br>・(Donations to designated NPOs[2] - JPY2,000) x 40%<br>・(Donations to certain public interest entities[3] - JPY2,000) x 40%</td></tr>
<tr><td>(b) Income tax before tax credits x 25%</td></tr>
</table>

[1] Donations to political parties or organizations (where the donations are qualified under certain conditions and made by 2024)

[2] Donations to authorized NPOs (where donations are qualified under certain conditions)

[3] Donations to public interest incorporated associations/ foundations, educational institutions and social welfare institutions, etc. (where donations are qualified under certain conditions)

In principle, the total of the creditable donations and deductible donations is subject to a ceiling of 40 percent of the total assessable income.

(2) Inhabitant Tax

For inhabitant tax purposes, the following tax credits are available:

| Creditable amount = (i) + (ii) | |
|---|---|
| (i) Basic tax credit | (Total amount[1] of eligible donations[2] - JPY2,000) x 10% |
| (ii) Additional tax credit<br>(The smaller of either (a) or (b)) | (a) (Total amount of donations to local governments[3] - JPY2,000) x (90% - marginal income tax rate for the individual x 102.1%[4]) |
| | (b) Inhabitant tax before tax credits x 20% |

[1] Subject to a ceiling of 30 percent of the total assessable income

[2] The eligible donations are donations to local governments and donations designated by the Minister of Internal Affairs and Communications and local governments.

[3] Donations to local governments subject to the additional tax credit are limited to the donations to specified local governments designated by the Minister of Internal Affairs and Communications.

[4] 2.1 percent is an equivalent of the special reconstruction income tax.

## 3.8 Remuneration Paid Outside Japan

As discussed in 3.2, expatriates with not more than 5 years residence in Japan are generally treated as non-permanent residents and are liable for Japanese taxes only on (a) income other than foreign source income plus (b) foreign source income paid in or remitted to Japan. As a result of this treatment, it is possible for expatriates (other than corporate officers) to mitigate their Japanese income tax burden for the first 5 years of an assignment in Japan where their salaries are administered and paid outside Japan (offshore payroll).

Where an offshore payroll is used, the element of the expatriate's employment income treated as non-Japan source can be determined based upon the number of days spent outside Japan on business during the year. Such income will not be taxable in Japan provided no part of the relevant amount is remitted to Japan. For these purposes, remittance would include drawings from the offices in Japan of an employer company, foreign currency brought into Japan, borrowings in Japan to be repaid outside Japan, etc. Where an offshore payroll arrangement is utilized, it is necessary for relevant employees to keep a record of remittances made to Japan.

As noted above, this benefit is effective only for expatriate staff having non-permanent resident status in Japan. If an expatriate employee has lived in Japan for more than 5 years in the last 10 years, the expatriate employee will become a permanent resident for tax purposes and will be taxed in Japan on their worldwide income.

An additional benefit from the utilization of an offshore payroll is that payments made outside Japan should not be subject to Japanese withholding tax. In such cases, the tax liabilities would be settled by filing an income tax return and the associated tax payment dates would be as discussed in 3.10.

## 3.9 Exit Tax Regime

The exit tax regime is a special measure to impose individual income tax on unrealized capital gains on financial assets at the time of departure in order to prevent wealthy individuals from avoiding tax on capital gains in Japan by moving out of Japan with appreciated financial assets and subsequently selling those assets.

(1) Eligible Person

A resident individual departing from Japan and satisfying both of the following conditions:

(i) Total value of eligible assets held by the person as of departure from Japan is JPY100 million or more.

(ii) The person has lived in Japan(*) for more than 5 years in the last 10 years before departure.

(*) The period of living in Japan includes the grace period described in (3) below, but excludes the period of staying in Japan with a status of residence under Table 1 of the Immigration Control and Refugee Recognition Act (e.g. engineer/specialist in humanities/international services, intra-company transferee).

(2) Eligible Assets

- securities stipulated in the Income Tax Law (excluding stock options and specified restricted stock)
- contributions under a Tokumei-Kumiai agreement
- unsettled derivatives transactions
- unsettled margin transactions
- unsettled when-issued transactions (e.g. trading transactions in advance of shares being issued)

(3) Grace Period for Tax Payments

An individual subject to exit tax will be allowed to enjoy a tax payment grace period for 5 years (subject to extension upon an application to 10 years) when collateral equivalent to the amount of the exit tax is provided and a notification for appointment of a tax agent is submitted.

(4) Tax Reliefs

(i) Reversal of taxation

Where an individual who was subject to exit tax returns to Japan within 5 years (10 years for an individual who enjoys a 10-year grace period) from the departure, the exit tax on unsold eligible assets will be reversed by filing a request for correction.

(ii) Reduction of income tax

An individual enjoying the grace period may file a request for correction in order to reduce their exit tax under the following circumstances:

(a) In the case where the eligible assets are sold prior to the expiration of the grace period and the sales price of the assets falls below the value of the assets as of departure

(b) In the case where the grace period is terminated and the value of the eligible assets at the date of the termination falls below the value of the assets as of departure

(5) Exit Tax in the case of Gift, Inheritance or Bequest

The exit tax will also be imposed when eligible persons' eligible assets are transferred to non-resident individuals upon a gift, inheritance or bequest.

## 3.10 Filing Tax Returns and Tax Payments

### 3.10.1 National Income Taxes

(1) Final Tax Returns and Tax Payments Therefor

For individuals, the tax year is the calendar year and a final income tax return must be filed by 15 March of the following year in principle. Extensions of the filing deadline are not available. The final tax due needs to be paid by the same day, which may be extended for about 1 month if the automatic bank transfer system is elected. A tax return for special reconstruction income tax should be filed together with the final income tax return.

If the remuneration subject to withholding tax does not exceed JPY20 million and the amount of other income is less than JPY200,000, the person is not required to file a tax return since the tax liabilities are settled through a year-end adjustment of income tax on the salaries made by the employer and the amount of the other income is minor. If such person has claimable deductions such as for casualty losses, medical expenses and donations that are not deductible through the year-end adjustment procedures, a tax return should be filed to declare such deductions.

(2) Estimated Tax Payments

Those who have filed a final income tax return for the previous year will be required to make estimated tax payments for the current year in July and November. The estimated tax payments are generally equal to one-third of the net of the income tax amount for the previous year less withholding tax declared in such tax return. Note that special reconstruction income tax is also imposed on the estimated tax at 2.1 percent from 2013 to 2037. If the total of the net amount and special reconstruction income tax thereon is less than JPY150,000, prepayments are not required.

(3) Reporting Requirement for Assets/Liabilities

If an individual has an obligation to lodge their income tax return and meets the following two criteria, the individual must submit a 'Statement of Assets/Liabilities' together with their income tax return to report necessary information on assets/liabilities such as type, number, location, value of assets and amount of liabilities as of the end of the calendar year by 15 March of the following year:

(i) Total income exceeds JPY20 million for a calendar year

(ii) Total value of assets as of the end of a calendar year is JPY300 million or more

or

Total value of the eligible assets for exit tax (discussed in 3.9) as of the end of a calendar year is JPY100 million or more

By virtue of the 2022 tax reform, in addition to the above, an individual who meets the following criteria will also be obligated to submit a 'Statement of Assets/Liabilities' for 2023 and thereafter.

- A resident whose assets have a total value of JPY1 billion or more as of the end of a calendar year (No criteria based on the size of income)

Furthermore, the due date of the submission of a 'Statement of Assets/Liabilities' will be extended from 15 March to 30 June of the following year for 2023 and thereafter.

Proper reporting of assets/liabilities may bring the individual taxpayer reduction in penalties when understatements of tax are found in a tax audit, whereas improper reporting may bring them additional penalties.

(4) Reporting Requirement for Overseas Assets

Permanent residents who own overseas assets valued at over JPY50 million as of the end of a calendar year must submit 'Statement of Overseas Assets' to report their overseas assets by 15 March of the following year.

By virtue of the 2022 tax reform, the due date of the submission of a 'Statement of Overseas Assets' will be extended from 15 March to 30 June of the following year for 2023 and thereafter.

Proper reporting of overseas assets may bring the individual taxpayer reduction in penalties when understatements of tax are found in a tax audit, whereas improper reporting may bring them additional penalties.

### 3.10.2 Inhabitant Taxes

Generally, an inhabitant tax return is not required to be filed since the information necessary for assessment is either submitted by employers or included in the final income tax return filed with a national tax office.

If remuneration is paid through an employer in Japan, inhabitant tax on such income is paid to a municipal office through the employer as discussed in 3.11.2. Inhabitant taxes on other income including remuneration paid outside Japan for the previous year are generally paid directly by the taxpayer in four installments, whose payment due dates are 30 June, 31 August and 31 October of the current year, and 31 January of the following year.

## 3.11 Employers' Obligations

### 3.11.1 National Income Taxes

(1) Withholding Tax on Remuneration

The employer company is required to withhold tax monthly from salaries, wages, remuneration, bonuses and other employment income, including taxable economic benefits paid and/or provided in Japan to officers and employees, and to pay the withheld tax to the government by the 10th day of the following month.

With respect to non-residents however, the withholding tax rate is 20 percent, which is applied to the gross amount of their employment income. Moreover, if the employer company of a non-resident has a permanent establishment in Japan, employment income paid to such non-resident outside Japan is regarded as having been paid by the permanent establishment and the 20 percent tax thereon is required to be paid to the government by the end of the month following the month of payment of such employment income outside Japan.

It is common practice for foreign companies operating in Japan to pay expatriates' salaries on a net basis through an offshore payroll (please see 3.8). However, in such situations it can often be the case that certain taxable economic benefits continue to be provided in Japan and these would give rise to withholding tax administration obligations. Such economic benefits might include:

- provision of company housing
- payment of utility costs
- payment of school fees for children of expatriates.

Therefore, it is important to review the arrangements with regard to the compensation packages of expatriate members of an organization in Japan, including taxable fringe benefits, in

order to ensure that any withholding requirements are being properly met.

The employer company of residents (except those whose gross employment income exceeds JPY20 million and daily-employed workers) is required to make year-end adjustments of withholding income tax for the calendar year concerned in connection with the last payment of salaries or bonuses for that year so that the total tax withheld from each payment should be the national income tax to be imposed on the annual compensation.

Note that withholding tax is also subject to special reconstruction income tax at 2.1 percent from 2013 to 2037.

(2) Reporting Requirement for Foreign Stock-Based Compensation

If directors/employees of a Japanese subsidiary of a foreign company (only where 50 percent or more of the outstanding shares in the Japanese subsidiary are directly or indirectly held by the foreign company) or a Japan branch of a foreign company earn stock-based compensation, the Japanese subsidiary or the Japan branch is required to prepare and submit a report including names/addresses of the directors/employees and details of the stock-based compensation to the competent tax office by 31 March (30 April for non-resident directors/employees) of the following year.

Directors/employees subject to reporting include those who are non-residents and those who are ex-directors/employees.

### 3.11.2 Inhabitant Tax

Payers of employment income are required to submit a report on the employment income subjected to withholding income tax for the preceding year, in respect of officers and employees of such payers as of 1 January of the current year, to the

appropriate offices of the municipalities in which the officers and employees resided as of such date.

The municipal offices are to assess inhabitant tax to be collected from the officers and employees in 12 equal installments, from June of the current year to May of the following year. The payers of the officers' and employees' salaries are then required to deduct from monthly salaries the amount of each installment and pay it to the municipalities.

# 4 International Tax

## 4.1 Foreign Dividend Exclusion

### 4.1.1 Tax Treatment of Dividends from Foreign Subsidiaries

A Japanese company holding a Foreign Subsidiary is generally entitled to the foreign dividend exclusion (FDE).

■ Dividends other than Deductible Dividends

Under the FDE rules, dividends from Foreign Subsidiaries and foreign withholding tax[1] thereon are treated as follows:

| Dividends from Foreign Subsidiaries | Foreign withholding tax on the dividends |
|---|---|
| 95% tax exempt[2] | Non-deductible and non-creditable |

■ Deductible Dividends

The following tax treatments of deductible dividends from Foreign Subsidiaries and foreign withholding tax thereon under the FDE rules are provided based on the recommendation of 'Action 2 - Neutralising the Effects of Hybrid Mismatch Arrangements' included in the first deliverables released in September 2014 under the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project[1]:

[In principle]

| Deductible dividends from Foreign Subsidiaries | Foreign withholding tax on the dividends |
|---|---|
| Fully taxable | Deductible or creditable |

[Exceptional rule]

When only part of the dividends paid by a Foreign Subsidiary is deducted in the country where the Foreign Subsidiary is located, only such portion is treated fully taxable as indicated below:

| Deductible dividends from Foreign Subsidiaries | | Foreign withholding tax on the dividends |
|---|---|---|
| Deductible portion | Fully taxable | Deductible or creditable |
| Non-deductible portion | 95% tax exempt(2) | Non-deductible and non-creditable |

(1) Please see 4.6.6 for the treatments of foreign withholding tax where a Foreign Subsidiary was subject to the Controlled Foreign Company (CFC) Regime.

(2) 95 percent of dividends (before deduction of withholding taxes thereon) from a Foreign Subsidiary are exempt from corporation tax in the hands of the Japanese parent company.

### 4.1.2 Foreign Subsidiary

A Foreign Subsidiary for the purposes of the FDE is a foreign company which satisfies the following two tests:

(1) 25 Percent Test

25 percent or more of the shares are held directly by a Japanese company. The holding ratio for this purpose is determined based on the number of outstanding shares or the number of shares with voting rights.

Where a tax treaty with Japan and the country of residence of the foreign company has a reduced holding threshold for

indirect foreign tax credits or FDE, such reduced holding ratio will be used instead of 25 percent, for determining whether the foreign company is a Foreign Subsidiary under the FDE (e.g. 10 percent for the US, Australia and the Netherlands, 15 percent for France).

(2) 6 Month Test

The 25 percent test should be continuously satisfied for at least 6 months prior to the point in time when the obligation to pay the dividends is determined.

For foreign companies established within 6 months prior to the date on which the obligation to pay the dividends is determined, continuous shareholding from the date of establishment to the date when the obligation is determined should be treated as fulfilling the 6 month test.

## 4.2 Foreign Tax Credits

### 4.2.1 Basic Rules

Under the foreign tax credit system, a Japanese company and a foreign company having a permanent establishment (PE) in Japan are allowed to take credits for foreign corporation tax or counterpart of Japanese corporation tax, including foreign local tax and withholding tax, suffered directly by the Japanese company and the foreign company.

### 4.2.2 Creditable Limit

The amount of foreign tax for which credit can be taken is limited to the lower of:

(i) the adjusted creditable foreign tax; and
(ii) the creditable limit.

In calculating adjusted creditable foreign tax, certain foreign

taxes such as those imposed at a high rate (generally a rate in excess of 35 percent) must be excluded from the creditable foreign tax.

The creditable limit for corporation tax purposes is calculated as follows:

[Japanese company]

$$\text{Japanese corporation tax} \times \frac{\text{Foreign source income}}{\text{Total taxable income}}$$

[Foreign company having a PE in Japan]

$$\text{Japanese corporation tax on income attributable to the PE in Japan} \times \frac{\text{Foreign source income included in income attributable to the PE in Japan}}{\text{Income attributable to the PE in Japan}}$$

The following points should be noted in relation to the formula above:

- Japan utilizes an overall limitation system rather than a country limitation system or a separate basket limitation system.

- Foreign source income does not include income which is exempted from foreign taxation.

- The ratio of foreign source income to total taxable income (income attributable to the PE in Japan of a foreign company) for the purposes of the calculation is limited to a maximum of 90 percent.

- Any allocation of expenses between domestic source income and foreign source income should be done on a reasonable basis.

- If the amount of the adjusted creditable foreign tax is over the creditable limit for corporation tax purposes, such excess amount is creditable against local corporation tax to the extent of the creditable limit for local corporation tax purposes, which is calculated in a similar way as discussed above.

- Foreign tax credits are also available for prefectural and municipal inhabitant tax purposes with additional creditable limits (i.e. the creditable limit indicated in the above formula multiplied by inhabitant tax rates).

### 4.2.3 Carry-Forward System

If due to the application of the creditable limit restriction there remains eligible foreign tax which has not been credited in the fiscal year, this amount may be carried forward for up to 3 years to enjoy as a credit in future fiscal years.

Conversely, where there have been insufficient eligible foreign taxes in a fiscal year to make full use of the creditable limit for that year, the residual amount of the creditable limit can be carried forward for up to 3 years to increase the creditable limit applicable in subsequent fiscal years.

### 4.2.4 Tax Sparing Credits

A tax sparing credit is allowed under a very limited number of the tax treaties concluded by Japan. In relation to those applicable treaties, if, for example, interest payable on an approved investment incentive loan is exempt from withholding tax in the treaty partner country, the tax which has been 'spared' is nevertheless creditable in Japan in connection with the calculation of the foreign tax credit of a Japanese company. A tax sparing credit provision can accordingly be of considerable benefit. Note that such provision is generally being repealed under Japan's recent tax treaty policy.

## 4.3 Transfer Pricing

The transfer pricing legislation is set out under the Special Taxation Measures Law for the purposes of preventing tax avoidance by companies through transactions with their Related Overseas Companies.

### 4.3.1 Transactions Subject to Transfer Pricing Legislation

The sale of assets, purchase of assets, rendering of services and any other transactions with Related Overseas Companies which do not meet the arm's-length concept are subject to the transfer pricing legislation. Transactions with Related Overseas Companies conducted through unrelated companies could also be subject to this legislation.

Note that where a company pays donations to its Related Overseas Company, the full amount of such donations is not deductible except for cases where the donations are treated as income attributable to a PE of the Related Overseas Company in Japan.

### 4.3.2 Related Overseas Companies

A Related Overseas Company for these purposes is a foreign company which has any of the following specific relationships with a Japanese company:

(i) Shareholding relationship

- a relationship between two companies in which one company owns directly or indirectly 50 percent or more of the total issued shares of the other company

- a relationship between two companies in which the same person owns directly or indirectly 50 percent or more of the total issued shares in both companies

(ii) Substantial control relationship

- a relationship between two companies in which one company can, in substance, engage in decision making regarding the other company's business affairs due to shared directors, substantial business transactions, financing, etc.

- a relationship between two companies in which the same person can, in substance, engage in decision making regarding both companies' business affairs due to shared directors, substantial business transactions, financing, etc.

(iii)Combination of shareholding relationship and substantial control relationship

### 4.3.3 Arm's-Length Price (ALP)

The transfer pricing legislation provides for six methods to reach an ALP: (1) comparable uncontrolled price method, (2) resale price method, (3) cost-plus method, (4) profit split method, (5) transactional net margin method and (6) discounted cash flow method.

(1) Comparable Uncontrolled Price Method

Under this method the price is determined based upon the pricing of a transaction carried out between unrelated parties which is similar in nature to the subject transaction. Where there are differences in the conditions between the comparable transaction and the subject transaction, price adjustments should be taken into account.

With respect to comparable transactions for this purpose, there are two types: (i) transactions made by one of the related companies with an unrelated company, and (ii) transactions made between third parties.

(2) Resale Price Method

Under this method the price is calculated based on the sales price of the buyer to unrelated companies minus a gross profit which is applicable to similar transactions with unrelated companies (subject to adjustment depending upon the circumstances).

(3) Cost-Plus Method

Under this method the price to be applied to the transactions with Related Overseas Companies is calculated at cost for the seller plus an ordinary profit on similar transactions with unrelated companies (subject to adjustment depending upon the circumstances).

(4) Profit Split Method

Under this method the price is calculated based on allocating the total profit arising from the overall transactions using the respective amount of expenses, fixed assets or other reasonable factors.

(5) Transactional Net Margin Method

Under this method the price is determined by reference to net profit on comparable uncontrolled transactions expressed as a percentage of a base factor (e.g. cost, sales).

(6) Discounted Cash Flow Method

Under this method the price is calculated based on the total amount of the present value of the projected income at the time of the transactions with Related Overseas Companies discounted by a reasonable discount rate.

### 4.3.4 Price Adjustment Measure to Hard-to-Value Intangibles (HTVI)

Japan adopts the price adjustment measure to HTVI in line with the 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017', which reflected the recommendations of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project Action 8-10 final report 'Aligning Transfer Pricing Outcomes with Value Creation.'

(1) Outline of the Measure

Where ex-post outcomes give a result different from the assumptions used in calculating the ALP of the HTVI transaction with a Related Overseas Company, the Japanese tax authorities will be able to make a tax assessment based on the ALP measured by the most appropriate method to reach an ALP of the HTVI transaction taking into consideration the details of the transaction, functions performed by the transaction parties and other circumstances.

This measure will not be applied as long as the ratio of the difference between the above ALP and the original transaction price is 20 percent or less.

(2) Definition of HTVI

HTVI means intangibles(*) with all of the following characteristics:

- Unique and being used to create highly added value
- ALP is calculated based on the income projection.
- Assumptions used in valuing the ALP have considerably uncertain factors.

(*) Intangibles subject to transfer pricing rules are defined as follows:

Patent rights, utility model rights and other assets (assets other than physical assets and financial assets), which should be compensated for their commercial usage (sales, loan, etc.) between independent parties under ordinary terms and conditions

(3) Rules for Exemption

Where documents described in (i) or (ii) below are submitted by the taxpayer within a certain period at the request of the Japanese tax authorities, the price adjustment measure to HTVI will not be applied.

(i) Documentation regarding the consideration of probability of unforeseen events

- Documents describing assumptions used in calculating the ALP of the HTVI transaction with a Related Overseas Company, and

- Documents describing the following facts with respect to the above assumptions:

  - The discrepancy between the projections and the ex-post outcomes is due to a disaster or any other similar events that could not be foreseen at the time of the transaction, or
  - The ALP was determined taking into account the probability of events to cause such discrepancy.

(ii) Documentation regarding the differences between actual income and projected income

Documents describing that the ratio of the difference between the actual income and the projected income against the projected income in the Examination Period(*) of the HTVI transaction with a Related Overseas Company is 20 percent or less

(*) For 5 years starting from the beginning of the fiscal year in which the first income from an unrelated party was generated from the use of the HTVI

Note that where the requirement (ii) is satisfied, the price adjustment measure to HTVI will not be applied after the Examination Period.

### 4.3.5 Documentation Rules

Japan adopts a three-tiered approach (i.e. Country-by-Country reports (CbC reports), master files and local files) to the transfer pricing documentation rules in accordance with the recommendations of 'Action 13 - Transfer Pricing Documentation and Country-by-Country Reporting' of the OECD/G20 BEPS Project.

(1) CbC Reports

A reporting entity of a Specified MNE Group must file a CbC Report to the competent tax office by the deadline through an online system (e-Tax).

■ Reporting entity

(i) Primary mechanism

Either of the following Japanese companies which are Constituent Entities of a Specified MNE Group:

- Ultimate Parent Entity
- Surrogate Parent Entity

(ii) Secondary mechanism

(This mechanism will be applied in limited cases where the Japanese tax authorities acknowledge that a CbC report is not provided through the jurisdiction in which the Ultimate Parent Entity or the Surrogate Parent Entity is resident for tax purposes.)

Either of the following Constituent Entities of a Specified MNE Group:

- A Japanese company which is neither the Ultimate Parent Entity nor the Surrogate Parent Entity
- A foreign company having a PE in Japan

■ Items to be reported

(i) Overview of allocation of income, taxes and business activities by tax jurisdiction

Revenues, profit (loss) before income tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees, tangible assets other than cash and cash equivalents by each tax jurisdiction

(ii) List of all the Constituent Entities of Specified MNE group included in each aggregation per tax jurisdiction

Names and main business activities of Constituent Entities by each tax jurisdiction

(iii) Additional information

Other information to explain the above information

■ Language

English

■ Deadline for filing

Within 1 year after the end of the reporting fiscal year of the Ultimate Parent Entity

■ Penalties

If a reporting entity fails to file a CbC report to the competent tax office by the deadline without good reason, a fine up to JPY300,000 will be imposed.

(2) Notification of Ultimate Parent Entity for CbC Reports

A reporting entity of a Specified MNE Group must submit a notification of the Ultimate Parent Entity for CbC Reports to the competent tax office by the deadline through an online system (e-Tax).

■ Reporting entity

Either of the following Constituent Entities of a Specified MNE Group:

- A Japanese company
- A foreign company having a PE in Japan

■ Items to be reported

Name, location, corporate number of the Ultimate Parent Entity or Surrogate Parent Entity and the name of its representative

■ Deadline for submission

The end of the reporting fiscal year of the Ultimate Parent Entity

(3) Master Files

A reporting entity of a Specified MNE Group must file a master file to the competent tax office by the deadline through an online system (e-Tax).

■ Reporting entity

Either of the following Constituent Entities of a Specified MNE Group:

- A Japanese company
- A foreign company having a PE in Japan

■ Items to be reported

Organizational structure, description of businesses, intangibles, intercompany financial activities, financial positions of the Specified MNE Group

■ Language

Japanese or English

■ Deadline for filing

Within 1 year after the end of the reporting fiscal year of the Ultimate Parent Entity

■ Penalties

If a reporting entity fails to file a master file to the competent tax office by the deadline without good reason, a fine up to JPY300,000 will be imposed.

(4) Local Files (Contemporaneous Documentation)

A company conducting transactions with Related Overseas Companies must prepare or obtain documents considered to be necessary for calculating the ALP for the transactions (local files) by the filing due date of a final corporation tax return and preserve them for 7 years (10 years for fiscal years in which tax losses are incurred).

■ Company which must prepare local files

A company that conducts transactions with Related Overseas Companies

■ Transactions not subject to contemporaneous documentation

Transactions with a Related Overseas Company for the current fiscal year are exempt from the contemporaneous documentation requirement provided that both of the following conditions are met:

- Total transaction amount with that Related Overseas Company for the previous fiscal year (the current fiscal year if the previous fiscal year does not exist) is less than JPY5 billion.

- Total transaction amount for intangibles with that Related Overseas Company for the previous fiscal year (the current fiscal year if the previous fiscal year does not exist) is less than JPY300 million.

■ Documents to be prepared/obtained

<Transactions subject to contemporaneous documentation>

| Documents | Contemporaneous documentation | Deadline of presentation or submission[1] |
|---|---|---|
| Documents considered to be necessary for calculating the ALP for the transactions (Local files)[2] | Required | 45 days |
| Documents considered to be important for calculating the ALP for the transactions[3] | Not required | 60 days |

<Transactions not subject to contemporaneous documentation>

| Documents | Contemporaneous documentation | Deadline of presentation or submission[1] |
|---|---|---|
| Documents considered to be important for calculating the ALP for the transactions[4] | Not required | 60 days |

[1] The tax authorities may ask a company to present or submit the above documents in the event of a tax audit. The deadline of presentation or submission is designated by the tax authorities within 45 days or 60 days indicated above. If the company fails to present or submit such documents by the deadline, the tax authorities may make an assessment presumptively and inspect third parties conducting similar trade or business.

(2) - Documents containing details of transactions with Related Overseas Companies
- Documents used to determine the ALP

(3) - Documents consisting of items that provide the basis of the local files
- Documents consisting of items related to the local files
- Other documents

(4) - Documents equivalent to the local files
- Documents consisting of items that provide the basis of the local files
- Documents consisting of items related to the local files
- Other documents

(5) Definitions of Keywords

- Enterprise Group

  (i) a collection of enterprises for which consolidated financial statements are compiled or (ii) a collection of enterprises for which consolidated financial statements would be compiled if shares in the parent company were listed, provided that the parent company of the group is not a subsidiary of other collections of enterprises for which consolidated financial statements are compiled or for which consolidated financial statements would be compiled if shares in the parent company were listed

- MNE Group (multinational enterprise group)

  (i) an Enterprise Group consisting of Constituent Entities who reside in two jurisdictions or more or (ii) an Enterprise Group consisting of Constituent Entities who reside in the same jurisdiction but have PEs in other jurisdictions

- Specified MNE Group

  An MNE Group whose total consolidated revenue for the preceding fiscal year of the Ultimate Parent Entity is JPY100 billion or more

- Constituent Entity

  (i) an entity of an Enterprise Group of which assets and profits/loss are included the consolidated financial statements of the Enterprise Group (including those which would be complied if shares in the parent company were listed) and (ii) an entity of an Enterprise Group of which assets and profits/loss are not included the consolidated financial statements of the Enterprise Group solely for size or materiality grounds

- Ultimate Parent Entity

  One of the Constituent Entities in an Enterprise Group that controls other Constituent Entities of the group through holding a majority of the voting rights, etc. and is not controlled by any other persons in the group

- Surrogate Parent Entity

  One of the Constituent Entities other than the Ultimate Parent Entity in a Specified Enterprise Group, which the Ultimate Parent Entity has appointed as a reporting entity of CbC reports.

### 4.3.6 Reporting of Information through Tax Returns

If a company has any transactions with Related Overseas Companies, the company must attach to its final corporation tax return statement providing information on the Related Overseas Companies and details of the transactions as follows:

Information concerning Related Overseas Companies:

- name
- address of head office or principal office
- main business
- total number of employees
- amount of stated capital
- classification of Related Overseas Companies by nature of relationship, such as capital relationship, management relationship, business relationship and financial relationship
- percentage of shareholding relationship of Related Overseas Companies
- operating revenue, expenses, operating profits and profits before tax for the preceding fiscal year
- amount of earned surplus

Information concerning transactions with Related Overseas Companies:

- total amount of sales or purchases of inventories and the transfer pricing method
- receipt or payment of compensation for services and the

transfer pricing method

- receipt or payment of rental fees for tangible assets and the transfer pricing method

- receipt or payment of consideration for the transfer of intangible assets and the transfer pricing method

- receipt or payment of royalties for intangible assets and the transfer pricing method

- receipt or payment of interest on loans and the transfer pricing method

- Advance Pricing Agreement (APA) status

### 4.3.7 Miscellaneous

- In a case where the transactions subject to this legislation are those with Controlled Foreign Companies (CFCs), the taxable income of the CFC subject to the full-inclusion rules discussed in 4.6.3 should be calculated based on the adjusted ALP in order to eliminate double taxation.

- The statute of limitations in relation to tax investigations of transfer pricing issues is 7 years (6 years for fiscal years beginning on or before 31 March 2020), while the statute of limitations for non-transfer pricing issues is normally 5 years.

- A grace period for the payment of corporation tax and penalties thereon may be granted for those requesting a Mutual Agreement Procedure (MAP) under the relevant tax treaty.

## 4.4 Thin Capitalization Regime

### 4.4.1 Safe Harbor of Debt-Equity Ratio

The thin capitalization regime is applicable if the debt-equity ratios in (i) and (ii) below for a Japanese company are both more than 3:1.

| | Debt | Equity |
|---|---|---|
| (i) | Debts due to Overseas Controlling Shareholders and Specified Third Parties | Net Equity owned by Overseas Controlling Shareholders |
| (ii) | Total Debts | Net Equity of the Japanese company |

Alternatively, a Japanese company has the option to use the debt-equity ratio of a comparable Japanese company operating the same business, and having similar characteristics relating to size, etc. as opposed to the 3:1 safe harbor ratio.

### 4.4.2 Definitions of Keywords

The definitions of the keywords under the thin capitalization regime are as follows:

(1) Overseas Controlling Shareholders

If a non-resident individual or a foreign company has a specified relationship with a Japanese company, that person is treated as an Overseas Controlling Shareholder of the Japanese company. The criteria for determining whether there is a specified relationship for both individuals and companies are very similar. Where the person is a foreign company, a specified relationship is defined as follows:

- a relationship between a Japanese company and a foreign company in which the foreign company owns directly or indirectly 50 percent or more of the total outstanding shares in the Japanese company

- a relationship between a Japanese company and a foreign company in which the same person owns directly or indirectly 50 percent or more of the total outstanding shares in both companies

- a relationship between a Japanese company and a foreign company in which the foreign company can, in substance, engage in decision making regarding the Japanese company's business affairs due to shared directors, substantial business transactions, financing, etc.

(2) Specified Third Parties

If a person falls under either of the following, that person is treated as a Specified Third Party:

- a third party who provides a loan to a Japanese company under a back-to-back loan arrangement with an Overseas Controlling Shareholder of the Japanese company

- a third party who provides a loan to a Japanese company guaranteed by an Overseas Controlling Shareholder of the Japanese company

- a third party who provides a loan to a Japanese company by taking bonds the Japanese company has borrowed from an Overseas Controlling Shareholder of the Japanese company as collateral

- a third party (A) who lends bonds to a Japanese company which are guaranteed by an Overseas Controlling Shareholder of the Japanese company, and a third party (B) who provides a loan to the Japanese company by taking the

above bonds as collateral

(3) Debts

Debts means the average balance (daily, monthly or quarterly average) of interest-bearing debts. Note that Debts also include zero or negative interest rate debts for fiscal years beginning on or after 1 April 2021.

(4) Net Equity

The average balance of the net of total assets minus total liabilities. If the net is less than the total of stated capital and capital surplus (for tax purposes), the latter is treated as net equity for the purposes of this rule.

### 4.4.3 Amount to be Disallowed

The amount to be disallowed under the thin capitalization regime is calculated as follows:

| Cases | Disallowed amount |
|---|---|
| $\{ (A) + (B) \} \leq (D)$ | $(c)' \times \frac{\{ (A) + (B) + (C) - (D) \}}{(C)}$ |
| $\{ (A) + (B) \} > (D)$ | $(c)' + \{ (a) + (b) + (b)' \} \times \frac{\{ (A) + (B) - (D) \}}{\{ (A) + (B) \}}$ |

The letters used in the above formula refer to the following amounts:

| | |
|---|---|
| (A) | Debt due to Overseas Controlling Shareholders (where interest is *not* subject to income tax/corporation tax in Japan) |
| (B) | Debt due to Specified Third Parties (where interest is *not* subject to income tax/corporation tax in Japan) |
| (C) | Debt due to Specified Third Parties (where interest is subject to income tax/corporation tax in Japan) |
| (D) | Net Equity owned by Overseas Controlling Shareholders x 3 (or comparable ratio) |
| (a) | Interest on (A) |
| (b) | Interest on (B) |
| (b)' | Guarantee fees/bond borrowing fees relating to (B) (where they are *not* subject to income tax/corporation tax in Japan) |
| (c)' | Guarantee fees/bond borrowing fees relating to (C) (where they are *not* subject to income tax/corporation tax in Japan) |

- 'Subject to income tax/corporation tax in Japan' broadly means declared as taxable income in a Japanese tax return. Thus, interest paid to a non-resident individual/foreign company not having a PE in Japan should be '*not* subject to income tax/corporation tax in Japan', regardless of whether Japanese withholding tax is imposed on the interest.

- Interest includes discounts on bills/notes, redemption losses on bonds and other payments whose economic characteristics are equivalent to interest.

### 4.4.4 Miscellaneous

- The amount to be disallowed for corporation tax purposes is not treated as a dividend for withholding income tax purposes.

- Where bonds borrowed under a cash-secured bond lending transaction (genkin-tanpotsuki-saiken-taishaku-torihiki) or purchased under a bond gensaki transaction (saiken-gensaki-torihiki) are lent under another cash-secured bond lending transaction or sold under another bond gensaki transaction to Overseas Controlling Shareholders or Specified Third Parties, the 2:1 threshold with exclusion of the debts related to such transactions is applicable instead of the 3:1 threshold.

- If both the thin capitalization regime and the earnings stripping regime described in 4.5 are applicable in a fiscal year, only the larger of the disallowed amounts (after applying the de minimis rule discussed in 4.5.3) under either of the regimes will be applied.

## 4.5 Earnings Stripping Regime

The earnings stripping regime was totally amended under the 2019 tax reform. The new regime which is discussed in this section is applied for fiscal years beginning on or after 1 April 2020 in principle.

### 4.5.1 Limitation on Deductions for Excessive Interest Payments

When a Japanese company's Net Interest Payments (including interest payments to third parties) exceed 20 percent of Adjusted Taxable Income in a fiscal year, the excess portion (i.e. the following amount) is disallowed:

| | | |
|---|---|---|
| Net Interest Payments | - | Adjusted Taxable Income x 20% |

### 4.5.2 Definitions of Keywords

The definitions of the keywords under the Japanese earnings stripping regime are as follows:

(1) Net Interest Payments

Net Interest Payments means Covered Interest Payments less Eligible Interest Income.

(2) Adjusted Taxable Income

Adjusted Taxable Income means taxable income (calculated by not applying the provisions described in (i) below and treating all donations paid as tax deductible expenses) with an add back of items described in (ii) and a deduction of items described in (iii) below. Note that while 'taxable income' can be negative, 'Adjusted Taxable Income' cannot.

(i) Main provisions not applied in calculating Adjusted Taxable Income

- certain valuation losses
- disallowance of deductions for foreign tax credited against corporation tax
- deduction of carried-forward tax losses
- deduction of dividends paid by tax qualified special purpose companies
- thin capitalization regime
- earnings stripping regime

(ii) Items to be added back in calculating Adjusted Taxable Income

- Net Interest Payments
- tax deductible depreciation
- tax deductible bad debt losses
- tax deductible distribution payment to partners under silent partnership agreements (tokumei kumiai agreement)

(iii) Items to be deducted in calculating Adjusted Taxable Income

- Adjustments related to the controlled foreign company (CFC) regime
- Allocated tax losses to partners under silent partnership agreements (tokumei kumiai agreement)

(3) Covered Interest Payments

The Covered Interest Payments means interest payments less Exempted Interest Payments.

Exempted Interest Payments for a company are defined as follows:

(Interest payments to a third party who provides a loan to a company under a back-to-back loan arrangement with a Related Person of the company, etc. are excluded.)

| | |
|---|---|
| (i) Interest payments other than those in (ii) | (a) Interest payments subject to withholding taxation when paid, income tax/corporation tax in the hands of the recipients in Japan<br>(b) Interest payments to certain public benefit companies<br>(c) Certain amount among interest payments under life insurance contracts and casualty insurance contracts |
| (ii) Interest on specified bonds (Interest on bonds issued by the company and paid to third parties, excluding the case where the number of owners of the bonds is not large) | Either of the following:<br>(This rule is applied for each class of specified bonds.)<br>(a) Interest payments subject to withholding taxation when paid, income tax/corporation tax in the hands of the recipients in Japan, or interest paid to certain public benefit companies<br>(b) Either of the following, depending on the place of issuance of the bonds:<br>• Bonds issued in Japan: 95% of interest payments<br>• Bonds issued outside of Japan: 25% of interest payments |

(4) Eligible Interest Income

Eligible Interest Income for a fiscal year is calculated as follows:

$$\text{Total Interest Income} \times \frac{\text{Total Covered Interest Payments}}{\text{Total Interest Payments}}$$

If a Japanese company receives interest from a Domestic Related Person (a Related Person who is a Japanese resident individual/Japanese company or a non-resident individual/foreign company having a PE in Japan), the lower of the following is deemed to be the interest received from that Domestic Related Person and included in the Total Interest Income in the above formula:

- Interest Income of the Japanese company from that Domestic Related Person

- Interest Income of that Domestic Related Person from a person who is neither the Japanese company nor another Domestic Related Person

The purpose of this rule is to close a loophole whereby a Japanese company provides a loan to a Domestic Related Person for the purposes of: (i) reducing its Net Interest Payments amount; and (ii) reducing taxable income for the Domestic Related Person.

(5) Related Person

If a person (both an individual and a company) has a specified relationship with a Japanese company, that person is treated as a Related Person of the Japanese company. The criteria for determining whether there is a specified relationship for both individuals and companies are very similar. Where the person is a company, a specified relationship is defined as follows:

- a relationship between two companies in which one company owns directly or indirectly 50 percent or more of the total outstanding shares in the other company

- a relationship between two companies in which the same person owns directly or indirectly 50 percent or more of the total outstanding shares in both companies

- a relationship between two companies in which one company can, in substance, engage in decision making regarding the other company's business affairs due to shared directors, substantial business transactions, financing, etc.

(6) Interest Payments and Interest Income

The scope of Interest Payments and Interest Income for the purposes of the earnings stripping regime is as follows:

(i) Interest Payments

- interest payments

- discounts on bills/notes

- the interest portion of finance lease payments (where total lease payments under the arrangement are JPY10 million or more)

- redemption losses on bonds

- guarantee fees and bond borrowing fees paid in the following cases:

    - a third party who provides a loan to a Japanese company guaranteed by a Related Person of the Japanese company as described in (4)

- a third party who provides a loan to a Japanese company by taking bonds the Japanese company has borrowed from a Related Person of the Japanese company as described in (4) as collateral

- a third party (A) who lends bonds to a Japanese company which are guaranteed by a Related Person of the Japanese company as described in (4), and a third party (B) who provides a loan to the Japanese company by taking the above bonds as collateral

- amortization of premiums on securities having a maturity date or a fixed redemption price

- other payments whose economic characteristics are equivalent to interest

(ii) Interest Income

- interest income

- discounts on bills/notes

- the interest portion of finance lease income

- accumulation of discounts on securities having a maturity date or a fixed redemption price

- other income whose economic characteristics are equivalent to interest

### 4.5.3 De Minimis Rules

A Japanese company falling under either of the following cases in a given fiscal year will not have disallowed interest pursuant to the earnings stripping regime in such fiscal year provided the relevant schedules are attached to its tax returns and documents relating to the calculation are retained.

| | | | |
|---|---|---|---|
| (i) | Net Interest Payments | ≤ | JPY20 million |
| (ii) | Net Interest Payments of a Japanese company and its Japanese Related Companies[1] | ≤ | Adjusted Taxable Income of a Japanese company and its Japanese Related Companies[2] x 20% |

A Japanese Related Company means a Japanese company having one of the following specified relationships with the Japanese company (A):

- a relationship between two companies in which one company owns directly or indirectly more than 50 percent of the total outstanding shares in the other company

- a relationship between two companies in which the same person owns directly or indirectly more than 50 percent of the total outstanding shares in both companies

Note that the beginning and the end of the fiscal year of a Japanese Related Company must be the same as the beginning and the end of the fiscal year of the Japanese company (A), respectively.

[1] Where Eligible Interest Income exceeds Covered Interest Payments of a Japanese company or its Japanese Related Companies, the total of Net Interest Payments will be calculated by deducting such excess amount.

[2] Where Adjusted Taxable Income of a Japanese company or its Japanese Related Companies results in a negative amount, the total of Adjusted Taxable Income will be calculated by netting such negative amount.

### 4.5.4 Deductions of Disallowed Interest Payments

When a Japanese company's Net Interest Payments are less than 20 percent of Adjusted Taxable Income for a given fiscal

year, disallowed interest payments incurred in the past 7 years are deductible in such fiscal year up to the 20 percent threshold provided certain conditions are satisfied, e.g. filing of the tax returns for all fiscal years from the fiscal year in which the oldest disallowed interest payments were incurred.

### 4.5.5 Miscellaneous

- If both the earnings stripping regime and the thin capitalization regime described in 4.4 are applicable in a fiscal year, only the larger of the disallowed amounts (after applying the de minimis rule discussed in 4.5.3) under either of the regimes will be applied. As there is no carry forward of the disallowed amount under the thin capitalization regime, recognizing disallowed interest under the earnings stripping regime may be preferential for taxpayers, as they may be eligible to take a deduction for the disallowed amounts in the future.

- Where bonds borrowed under a cash-secured bond lending transaction (genkin-tanpotsuki-saiken-taishaku-torihiki) or purchased under a bond gensaki transaction (saiken-gensaki-torihiki) are lent under another cash-secured bond lending transaction or sold under another bond gensaki transaction, interest income and interest payments through these transactions will be excluded in calculating the extent of deductible interest payments.

- This section covers only the tax treatment for Japanese companies. A foreign company generating Japanese source income attributable to a PE in Japan was subject to the earnings stripping regime. By virtue of the 2022 tax reform, a foreign company generating Japanese source income is subject to the earnings stripping regime, regardless of whether it has a PE in Japan or not, for fiscal years beginning on or after 1 April 2022.

## 4.6 Controlled Foreign Company (CFC) Regime

Please note that although the CFC regime is applicable to Japanese individual residents as well, this section mainly covers the tax treatment for Japanese companies.

### 4.6.1 Overall Picture of the CFC Regime

The CFC regime is a mechanism to include income generated by a CFC in its Japanese parent company's income and tax it in Japan under certain conditions in order to deter tax avoidance by utilizing CFCs.

The overall picture of the CFC regime is shown as follows:

<table>
<tr><th>Effective Tax Rate (ETR)<br>Classification of CFC</th><th>Under 20%</th><th>20% or more & under 30%</th><th>30% or more</th></tr>
<tr><td><u>Specified CFC</u><br>(Paper Company, etc.)</td><td rowspan="2">Full-inclusion</td><td rowspan="3">No income inclusion</td><td rowspan="3"></td></tr>
<tr><td><u>Full-Inclusion CFC</u><br>At least one of the 'Economic Activity Tests' is not satisfied</td></tr>
<tr><td><u>Partial-Inclusion CFC</u><br>All of the 'Economic Activity Tests' are satisfied</td><td>Partial-inclusion</td></tr>
</table>

When the full-inclusion rules or the partial-inclusion rules are applied to a CFC, income of the CFC for a fiscal year should be taxable for the fiscal year of its Japanese shareholder company which includes the day 2 months after the end of the fiscal year of the CFC.

### 4.6.2 Definitions of Keywords

(1) Controlled Foreign Company (CFC)

A 'CFC' is defined as follows:

- A foreign company more than 50 percent of which is directly or indirectly (through foreign companies) owned by Japanese companies, Japanese resident individuals, related non-resident individuals(*) and De Facto CFCs

- A foreign company which has a De Facto Control Relationship with a Japanese company or a Japanese resident individual (De Facto CFC)

(*) A 'related non-resident individual' means a non-resident individual who is a director of Japanese companies or who has special relationships with Japanese resident individuals.

(2) De Facto Control Relationship

A 'De Facto Control Relationship' means, in principle, a relationship between a Japanese company (or a Japanese resident individual) and a foreign company where either of the following facts exists:

- The Japanese company (or the Japanese resident individual) has the right to claim almost all of the residual property of the foreign company.

- There is a contract that provides that the Japanese company (or the Japanese resident individual) has the right to determine how to dispose of almost all of the properties of the foreign company.

(3) Specified CFC

A 'Specified CFC' consists of the following three types of CFC:

■ Paper Company

A 'Paper Company' is a CFC that does not fall under any of the following:

| | | | |
|---|---|---|---|
| (i) | The CFC maintains an office, store, factory or other fixed place of business necessary to conduct its primary business.<br>(Substance Test) | | |
| (ii) | The CFC functions with its own administration, control and management in the jurisdiction where its head office is located. (Administration and Control Test) | | |
| (iii) | Shareholding CFC | (a) | CFC holding shares in Foreign Subsidiaries |
| | | (b) | CFC holding shares in Specified Subsidiaries |
| (iv) | Real estate-related CFC | (a) | CFC holding real estate |
| | | (b) | CFC holding real estate used by Management Controlling Company |
| (v) | Resources development project-related CFC | | |

(There are special rules applied to insurance companies.)

(iii) is the case of a CFC whose income is mostly dividends from its subsidiaries, which are excluded from the Full-Inclusion Income discussed in 4.6.3 or the Partial-Inclusion Income discussed in 4.6.4.

(iv) or (v) are the cases of a CFC whose income is mostly generated from a substantial real estate business or resources business in the jurisdiction where its head office is located.

Where tax officials request a Japanese company to show them evidence proving that a CFC falls under any of the above cases, if the Japanese company does not show them the evidence by the deadline, it will be presumed that the CFC is a Paper Company.

■ Cash Box

A 'Cash Box' is a CFC that meets both of the following conditions:

| | | |
|---|---|---|
| Passive Income Test | $\frac{\text{Passive Income (from (i) to (vii) and from (ix) to (xi) discussed in 4.6.4)}}{\text{Total assets (B/S)}}$ | > 30% |
| Asset Test | $\frac{\text{Securities + Loan receivables + Tangible assets for leasing + Intangibles (B/S)}}{\text{Total assets (B/S)}}$ | > 50% |

(There are special rules applied to certain foreign financial institutions, foreign financial holding companies and insurance companies.)

■ Black-List Company

A 'Black-List Company' is a CFC whose head office is located in a jurisdiction designated by the Minister of Finance of Japan as a non-cooperative jurisdiction with respect to the exchange of tax information. At the time of writing, the Minister of Finance of Japan has not designated any jurisdictions.

(4) Effective Tax Rate (ETR)

The ETR for a CFC is calculated by (i)/(ii)

| | |
|---|---|
| (i) = | Foreign corporate taxes imposed on income in the jurisdiction where its head office is located and other jurisdictions |
| (ii) = (a) + (b) ± (c): | |
| (a) | Taxable income calculated in accordance with the tax laws of the jurisdiction where its head office is located |
| (b) | Non-taxable income calculated in accordance with the tax laws of the jurisdiction where its head office is located (it is not necessary to add back received domestic/foreign dividends even if these are not taxed in the jurisdiction where its head office is located.) |
| (c) | Other adjustments |

Note that if the jurisdiction of the head office of a CFC does not impose tax on income, (ii) is calculated based on income for accounting purposes with similar adjustments as discussed above.

Where a CFC is a member of a tax consolidated group or applies pass-through taxation under the tax laws of the jurisdiction where its head office is located, the above (a) and (b) are calculated based on the provisions of the tax laws given the assumption that the following provisions are not applied:

- Provisions for the tax-consolidation system
- Provisions pertaining to pass-through entities

(5) Economic Activity Tests

The 'Economic Activity Tests' consist of four tests to determine whether a CFC has economic substance.

| | | |
|---|---|---|
| (i) | Primary Business Test | The primary business of the CFC is not any of the following businesses:<br>- Holding of shares or bonds<br>- Licensing of intangibles<br>- Leasing of vessels or aircraft |
| (ii) | Substance Test | The CFC maintains an office, store, factory or other fixed place of business necessary to conduct its primary business in the jurisdiction where its head office is located. |
| (iii) | Administration and Control Test | The CFC functions with its own administration, control and management in the jurisdiction where its head office is located. |
| (iv) | A. Unrelated Party Test | The CFC conducts its primary business primarily (more than 50%) with unrelated parties.<br>(Businesses covered under this test: wholesale, banking business, trust business, financial instrument business, insurance business, ocean transport business, air transport business and aircraft leasing business) |
| | B. Country of Location Test | The CFC conducts its primary business primarily in the jurisdiction where its head office is located.<br>(Businesses covered under this test: businesses not covered under the Unrelated Party Test) |

(There are special rules applied to regional holding companies, regional logistics management companies, foreign financial

holding companies, aircraft leasing companies, insurance companies and toll-manufacturing companies.)

Where tax officials request a Japanese company to show them evidence for meeting the Economic Activity Tests, if the Japanese company does not show them the evidence by the deadline, it will be presumed that the Economic Activity Tests are not satisfied.

(6) Taxpayer

Where a Japanese company falls under one of the following cases and the full-inclusion rules or the partial-inclusion rules are applied to the CFC described in each case (the second-mentioned CFC for (iv)), the Japanese company has to include income of the CFC in its taxable income. The amount of income to be included is calculated by multiplying the Full-Inclusion Income (discussed in 4.6.3) or the Partial-Inclusion Income (discussed in 4.6.4) by the holding ratio shown below for each case, respectively.

| Cases | Holding ratio |
|---|---|
| (i) Where a Japanese company holds directly or indirectly (through foreign companies) at least 10% of a CFC | Direct and indirect holding ratio of the CFC by the Japanese company |
| (ii) Where a Japanese company belongs to a family company group holding directly or indirectly (through foreign companies) at least 10% of a CFC | |
| (iii) Where a Japanese company has a De Facto Control Relationship with a CFC | 100% |
| (iv) Where a Japanese company has a De Facto Control Relationship with a CFC (De Facto CFC) which holds directly or indirectly (through foreign companies) at least 10% of another CFC | Direct and indirect holding ratio of the CFC (the second-mentioned CFC) by the De Facto CFC |

### 4.6.3 Full-Inclusion Rules

(1) Full-Inclusion Income

The Full-Inclusion Income subject to the full-inclusion rules for a Specified CFC and a Full-Inclusion CFC is calculated as follows:

Profits for a fiscal year

↓

- Adjustments of income by using provisions of the Japanese tax laws or tax laws of the jurisdiction where its head office is located[(1)]
- Deduction of dividends from its subsidiaries[(2)]
- Deduction of certain dividends from other CFCs
- Deduction of qualified capital gains from shares[(3)]

Base Income

↓

- Deduction of tax loss carry-forwards (7 years)[(4)]
- Deduction of corporate income taxes[(1)]

Full-Inclusion Income

(1) Adjustments of income by using provisions of the tax laws of the jurisdiction where its head office is located and corporate income taxes

Where a CFC is a member of a tax consolidated group or applies pass-through taxation under the tax laws of the jurisdiction where its head office is located, income and corporate income taxes are calculated based on the provisions of the tax laws given the assumption that the following provisions are not applied:

- Provisions for the tax-consolidation system
- Provisions pertaining to pass-through entities

(2) Dividends from subsidiaries

As shown above, in the process of calculating the Full-Inclusion Income for a CFC, dividends received from its subsidiaries meeting the shareholding requirements (i.e. 25 percent and 6 months) are generally deductible. The shareholding threshold is relaxed from 25 percent to 10 percent if the dividend paying company is a fossil fuel investment company meeting certain conditions.

(3) Qualified capital gains from shares

Where a Japanese company acquires a foreign company group, transfers of shares by a Specified CFC or a Full-Inclusion CFC within the group lead by the Japanese company may be required in the post-acquisition restructuring process in order to streamline their business flow. Such capital gains are excludable from the Full-Inclusion Income provided that certain conditions (e.g. the transfers are made based on a relevant business plan for post-acquisition restructuring) are met.

(4) Tax loss carry-forwards (7 years)

Only tax losses incurred in fiscal years in which the full-inclusion rule was applied are deductible in principle.

(2) Exemption Thresholds

The full-inclusion rules will not apply to fiscal years in which the ETR (discussed in 4.6.2 (4)) of a Specified CFC is at least 30 percent or fiscal years in which the ETR of a Full-Inclusion CFC is at least 20 percent.

### 4.6.4 Partial-Inclusion Rules

This section covers a general explanation of the partial-inclusion rules and does not cover special rules applied to certain foreign financial institutions and foreign financial holding companies.

(1) Passive Income

Passive Income subject to the partial-inclusion rules for a Partial-Inclusion CFC consists of the following twelve items:

| Passive Income | | Excludable income (main items) | Deductible costs/expenses |
|---|---|---|---|
| (i) | Dividends | Dividends received from its subsidiaries meeting the shareholding requirements (i.e. 25% (10% for a fossil fuel investment company) and 6 months) | - Direct expenses<br>- Interest expenses |
| (ii) | Interest | • Bank interest earned in the ordinary course of business<br>• Interest on installment sales<br>• Interest received by a CFC having a money-lending license<br>• Interest received by/from a group-financing company<br>• Interest incurred from the sales of inventories to third parties (that means 'interest on usance bills') | - Direct expenses |

| | | | |
|---|---|---|---|
| (iii) | Securities-lending fees | | - Direct expenses |
| (iv) | Capital gains/losses from transfers of securities | Capital gains/losses from transfers of shares in a company 25% or more of which is owned by the CFC | - Acquisition costs<br>- Direct expenses |
| (v) | Profits/losses derived from derivatives transactions | • Profits/losses derived from certain derivatives transactions for hedging purposes<br>• Profits/losses derived from certain commodity futures transactions conducted by certain commodity futures transaction dealers | |
| (vi) | Foreign exchange gains/losses | Foreign exchange gains/losses generated in the ordinary course of business unless the purpose of the business is to earn income from fluctuations in foreign exchange rates | |
| (vii) | Income derived from assets that could generate income from (i) to (vi) | Income derived from certain transactions for hedging purposes | |
| (viii) | Insurance income[1] | | |

| | | | |
|---|---|---|---|
| (ix) | Leasing fees of tangible assets | • Leasing fees of tangible assets primarily used in the jurisdiction where its head office is located<br>• Leasing fees of real estate located in the jurisdiction where its head office is located<br>• Leasing fees of tangible assets where certain conditions are met | - Direct expenses (including depreciation) |
| (x) | Royalties from intangibles | • Royalties from self-developed intangibles<br>• Royalties from intangibles purchased/licensed for adequate consideration that are utilized for certain business | - Direct expenses (including deprecation) |
| (xi) | Capital gains/losses from transfers of intangibles | • Capital gains/losses from self-developed intangibles<br>• Capital gains/losses from intangibles purchased for adequate consideration that are utilized for certain business | - Acquisition costs<br>- Direct expenses |
| (xii) | Abnormal income[(2)] | | |

(1) Insurance income = (a) - (b)

| | |
|---|---|
| (a) | Insurance premium receipts - Reinsurance premium payments |
| (b) | Insurance claims payments - Reinsurance claims receipts |

(2) Abnormal income = (a) - (b) x 50%

| | |
|---|---|
| (a) | Profits for a fiscal year of a CFC calculated on the assumption that income discussed from (i) to (xi) above (to be calculated without excluding the excludable income and without deductions for costs/expenses except for acquisition costs) did not exist |
| (b) | Total assets (B/S) + Labor costs + Accumulated depreciation (B/S) |

(2) Partial-Inclusion Income

Partial-Inclusion Income of a Partial-Inclusion CFC that is included in taxable income of its Japanese parent companies is calculated as (a) + (b).

| | |
|---|---|
| (a) | Total of Passive Income of (i)(ii)(iii)(ix)(x) and (xii) for the CFC |
| (b) | Total of Passive Income of (iv)(v)(vi)(vii)(viii) and (xi) for the CFC<br>(The minimum amount is zero. Where the amount of (b) is negative, such amount will be carried forward for 7 years to offset future income categorized in (b) for the CFC in principle.) |

(3) Exemption Thresholds

Where a Partial-Inclusion CFC meets one of the following thresholds, the partial-inclusion rules are not applied to the Partial-Inclusion CFC for the fiscal year:

| | |
|---|---|
| (i) | ETR (discussed in 4.6.2 (4)) $\geq$ 20% |
| (ii) | Partial-Inclusion Income $\leq$ JPY20 million |
| (iii) | $\frac{\text{Partial-Inclusion Income}}{\text{Profits before tax}} \leq 5\%$ |

### 4.6.5 Tax Credits

Foreign taxes and Japanese taxes levied on a CFC's income that is also taxed in the hands of its Japanese shareholder company under the full-inclusion rules or the partial-inclusion rules are subject to tax credits in Japan.

Where a CFC is a member of a tax consolidated group or applies pass-through taxation under the tax laws of the jurisdiction where its head office is located, foreign corporate taxes subject to tax credits are calculated based on the provisions of the tax laws given the assumption that the following provisions are not applied:

- Provisions for the tax-consolidation system
- Provisions pertaining to pass-through entities

### 4.6.6 Tax Treatment of Dividends Received by a Japanese Company

There are rules to prevent double taxation where a CFC's income taxed under the full-inclusion rules or the partial-inclusion rules is taxed again when the CFC distributes the income to its Japanese shareholder company.

(1) Dividends from a First Tier Foreign Company

When a Japanese company receives dividends from a foreign company, such dividends are fully exempt from tax for the Japanese company to the extent of the amount of the income of the foreign company having been included in the taxable income of the Japanese company under the full-inclusion rules or the partial-inclusion rules in the fiscal year when the Japanese company received the dividends (the dividend receiving year) and fiscal years beginning within 10 years before the commencement of the dividend receiving year.

The foreign withholding tax on the dividends from a First Tier Foreign Company is treated as follows:

- Where a First Tier Foreign Company is a Foreign Subsidiary defined in 4.1.2

| Dividends from Foreign Subsidiary | | Foreign withholding tax on the dividends |
|---|---|---|
| To the extent of the amount of the income of the foreign company having been included in the taxable income of the Japanese company under the full-inclusion rules or the partial-inclusion rules | 100% tax exempt | Deductible but non-creditable |
| The amount exceeding above amount or<br>Whole amount where there is no above amount | 95% tax exempt | Non-deductible and non-creditable |

■ Where a First Tier Foreign Company is not a Foreign Subsidiary defined in 4.1.2

| Dividends from subsidiary | | Foreign withholding tax on the dividends |
|---|---|---|
| To the extent of the amount of the income of the foreign company having been included in the taxable income of the Japanese company under the full-inclusion rules or the partial-inclusion rules | 100% tax exempt | Deductible but non-creditable |
| The amount exceeding above amount or Whole amount where there is no above amount | Taxable | Deductible and creditable(*) |

(*) Where a Japanese company applies a foreign tax credit discussed in 4.2, the foreign withholding tax is not deductible.

(2) Dividends from a Second Tier Foreign Company

When a Japanese company receives dividends from a foreign company (the first tier foreign company) which has received dividends from another foreign company (the second tier foreign company), such dividends received from the first tier foreign company are fully exempt from tax for the Japanese company to the extent of the smaller amount of the following:

- The Japanese company's proportionate share of the dividends that the first tier foreign company received from the second tier foreign company within the past 3 years

- The amount of the income of the second tier foreign company having been included in the taxable income of the

Japanese company under the full-inclusion rules or the partial-inclusion rules within the past 3 years

The 'past 3 years' above means the fiscal year in which the Japanese company received the dividends from the first tier foreign company (the dividend receiving year) and fiscal years beginning within 2 years before the commencement of the dividend receiving year.

## 4.7 Corporate Inversion

Triangular mergers may enable a Japanese company to become a subsidiary of a foreign company located in a low-tax jurisdiction and to reduce the global ETR (discussed in 4.6.2 (4)) of the group. This is a so called corporate inversion.

If certain conditions are met, such reorganization is treated as a non-qualified reorganization and the deferral of the recognition of capital gains from the transfer of shares is not applicable.

Moreover, under certain circumstances, a Japanese shareholder of the foreign parent company may be required to include in its taxable income an appropriate portion of the taxable income of the foreign parent company, even if the ownership of the foreign parent company by the Japanese shareholder is less than 10 percent.

## 4.8 Taxation of Foreign Companies and Individuals /Tax Treaties

This section covers the main items of the tax treatment of foreign companies and non-resident individuals not having a PE in Japan and the effect of relevant tax treaties.

Chapter 2 covers the taxation of income derived through a partnership and Chapter 3 covers the short-term visitor rule for non-resident individuals. Also, with regard to the taxation of a foreign company having a PE in Japan, please see Chapter 1.

### 4.8.1 Tax Treaties

Japan has concluded tax treaties with the following countries/regions as at the time of writing:

| | | | |
|---|---|---|---|
| Argentina[*] | Finland | Mexico | South Korea |
| Australia | France | Morocco[*] | Spain |
| Austria | Georgia | Netherlands | Sri Lanka |
| Bangladesh | Germany | New Zealand | Sweden |
| Belgium | Hong Kong | Norway | Switzerland |
| Brazil | Hungary | Oman | Thailand |
| Brunei Darussalam | Iceland | Pakistan | Taiwan[3] |
| Bulgaria | India | Peru | Turkey |
| Canada | Indonesia | Philippines | UAE |
| Chile | Ireland | Poland | UK |
| China (PRC) | Israel | Portugal | Uruguay |
| Colombia[*] | Italy | Qatar | US |
| Croatia | Jamaica | Romania | USSR[4] |
| Czechoslovakia[1] | Kazakhstan | Russia[2] | Uzbekistan |
| Denmark | Kuwait | Saudi Arabia | Vietnam |
| Ecuador | Latvia | Serbia | Zambia |
| Egypt | Lithuania | Singapore | |
| Estonia | Luxembourg | Slovenia | |
| Fiji | Malaysia | South Africa | |

Agreements centered on the exchange of information are not included in the above.

[1] This treaty covers Czech Republic and Slovak Republic.

[2] The tax treaty with Russia is not applied to the 8 jurisdictions discussed in note (4) to which the tax treaty with the ex-USSR is applied.

(3) This is not a tax treaty concluded by the Japanese government but the 'Agreement between the Interchange Association and the Association of East Asian Relations for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income' concluded between the Japan-Taiwan Exchange Association (Japanese side) and the Taiwan-Japan Relations Association (Taiwanese side). Japan has maintained its relationship with Taiwan on the basis of non-governmental, working-level relations through these associations. Under the 2016 tax reform, a special domestic tax law was introduced in order to implement the provisions provided for in the agreement.

(4) This treaty covers 8 jurisdictions that constituted the ex-USSR (Armenia, Azerbaijan, Belarus, Kyrgyz, Moldova, Tajikistan, Turkmenistan and Ukraine).

(*) Concluded but not yet applicable as at the time of writing.

The current status of the tax treaties recently amended or newly concluded is as follows:

| Country | Status | General effective dates of the amendments for Japanese taxes |
|---|---|---|
| Spain | Revised tax treaty — signed in October 2018 | - Taxes levied on the basis of a taxable year: Taxes for any taxable years beginning on or after 1 January 2022<br>- Taxes not levied on the basis of a taxable year: Taxes levied on or after 1 January 2022 |

| | | |
|---|---|---|
| Colombia | Tax treaty — signed in December 2018 | - Taxes levied on the basis of a taxable year: Taxes for any taxable years beginning on or after 1 January 2023<br>- Taxes not levied on the basis of a taxable year:<br>Taxes levied on or after 1 January 2023 |
| Argentina | Tax treaty — signed in June 2019 | |
| Peru | Tax treaty — signed in November 2019 | - Taxes levied on the basis of a taxable year: Taxes for any taxable years beginning on or after 1 January 2022<br>- Taxes not levied on the basis of a taxable year:<br>Taxes levied on or after 1 January 2022 |
| Morocco | Tax treaty — signed in January 2020 | - Taxes levied on the basis of a taxable year: Taxes for any taxable years beginning on or after 1 January 2023<br>- Taxes not levied on the basis of a taxable year:<br>Taxes levied on or after 1 January 2023 |

| | | |
|---|---|---|
| Tunisia | Negotiation to conclude a tax treaty — started in March 2019 | |
| Uruguay | Tax treaty — signed in September 2019 | - Taxes levied on the basis of a taxable year: Taxes for any taxable years beginning on or after 1 January 2022<br>- Taxes not levied on the basis of a taxable year:<br>Taxes levied on or after 1 January 2022 |
| Greece | Negotiation to conclude a tax treaty — started in May 2019 | |
| Finland | Negotiation to revise the tax treaty — started in May 2019 | |
| Nigeria | Negotiation to conclude a tax treaty — started in June 2019 | |
| Serbia | Tax treaty — signed in July 2020 | - Taxes levied on the basis of a taxable year: Taxes for any taxable years beginning on or after 1 January 2022<br>- Taxes not levied on the basis of a taxable year:<br>Taxes levied on or after 1 January 2022 |

| | | |
|---|---|---|
| Georgia | Tax treaty — signed in January 2021 | - Taxes levied on the basis of a taxable year: Taxes for any taxable years beginning on or after 1 January 2022<br>- Taxes not levied on the basis of a taxable year:<br>Taxes levied on or after 1 January 2022 |
| Switzerland | Revised tax treaty — signed in July 2021 | |
| Ukraine | Negotiation to conclude a tax treaty — started in March 2021 | |
| Azerbaijan | Agreement in principle on a tax treaty — reached in May 2022 | |
| Algeria | Agreement in principle on a tax treaty — reached in July 2022 | |

The tax treaties entered into by Japan generally accord with the principles of the OECD Model Tax Convention and tax treaties recently signed tend to include provisions dealing with hybrid/transparent entities and anti-treaty shopping provisions (e.g. the Limitation on Benefits provision and the Principal Purpose Test provisions).

Japan deposited its instrument of acceptance for the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI: Multilateral Instrument) with the OECD on 26 September 2018.

As a result, the MLI entered into force on 1 January 2019 for Japan. The MLI is a mechanism to amend simultaneously and efficiently existing tax treaties to be in line with the recommendations made under the BEPS project.

Japan has chosen 42 tax treaties concluded with the following jurisdictions to be covered by the MLI:

| |
|---|
| Australia, Bulgaria, Canada, China, Czech Republic, Egypt, Fiji, Finland, France, Germany, Hong Kong, Hungary, India, Indonesia, Ireland, Israel, Italy, Kazakhstan, Korea, Kuwait, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Oman, Pakistan, Poland, Portugal, Qatar, Romania, Saudi Arabia, Singapore, Slovak Republic, South Africa, Sweden, Thailand, Turkey, Ukraine, UAE, UK |

In addition, Japan has concluded the Convention on Mutual Administrative Assistance in Tax Matters (effective on 1 October 2013) and agreements centered on the exchange of information which generally include provisions on the allocation of taking rights with respect to certain income of individuals with the following countries/regions:

- The Bahamas
- Bermuda
- The British Virgin Islands
- The Cayman Islands
- Guernsey
- The Isle of Man
- Jersey
- Macao
- Panama
- Principality of Liechtenstein
- Samoa

### 4.8.2 Dividends, Interest and Royalties

Japanese withholding income tax is ordinarily imposed on dividend, interest and royalty payments to non-resident individuals and foreign companies. The normal withholding tax rate is 20.42 percent (income tax of 20 percent and special reconstruction income tax that is imposed on income tax at 2.1 percent from 2013 to 2037) and 15.315 percent (income tax of 15 percent and special reconstruction income tax thereon) is applied to dividends from listed shares and certain types of interest. However reduced tax rates may be available under Japan's tax treaties for foreign investors not having a PE in Japan. In order to obtain the reduction (or exemption) of Japanese withholding tax under a tax treaty, the foreign investor or the investor's agent should, before the date of payment, submit an application form for relief from Japanese income tax to the chief of the relevant district tax office through the payer of the income.

The rates of withholding tax under the respective tax treaties (including non-governmental agreement with Taiwan) are as set out below. Note that these are general rates applied in Japan and different rates or exemptions may apply to specific cases. The percentages in parentheses under the dividends heading represent the minimum ownership ratio of the parent company in, broadly, the capital stock of the subsidiary to qualify for the reduced parent/subsidiary tax rate.

Where a reduced withholding tax rate or exemption is applied under a tax treaty, the special reconstruction income tax will not be imposed.

| Name of country | Dividends | | | Interest | Royalties |
|---|---|---|---|---|---|
| | Between Parent and Subsidiary | | Other | | |
| Argentina | 10% | (25%) | 15% | 12% | 3-10% |
| Australia | 0%<br>5% | (80%)<br>(10%) | 10% | 0-10% | 5% |
| Austria | 0% | (10%) | 10% | 0% | 0% |
| Bangladesh | 10% | (25%) | 15% | 10% | 10% |
| Belgium | 0% | (10%) | 10% | 0-10% | 0% |
| Brazil | 12.5% | | 12.5% | 12.5% | 12.5-25% |
| Brunei Darussalam | 5% | (10%) | 10% | 10% | 10% |
| Bulgaria | 10% | (25%) | 15% | 10% | 10% |
| Canada | 5% | (25%) | 15% | 10% | 10% |
| Chile | 5% | (25%) | 15% | 4-10% | 2-10% |
| China (PRC) | 10% | | 10% | 10% | 10% |
| Colombia | 5% | (20%) | 10% | 0-10% | 2-10% |
| Croatia | 0% | (25%) | 5% | 5% | 5% |
| Czechoslovakia[1] | 10% | (25%) | 15% | 10% | 0-10%[5] |
| Denmark | 0% | (10%) | 15% | 0% | 0% |
| Ecuador | 5% | | 5% | 0-10% | 10% |
| Egypt | 15% | | 15% | - | 15% |
| Estonia | 0% | (10%) | 10% | 10% | 5% |
| Fiji[2] | - | - | - | - | 10% |
| Finland | 10% | (25%) | 15% | 10% | 10% |
| France | 0%<br><br><br><br>5% | (15% directly or-25% directly or indirectly)<br>(10%) | 10% | 0-10% | 0% |
| Georgia | 5% | | 5% | 5% | 0% |
| Germany | 0%<br>5% | (25%)<br>(10%) | 15% | 0% | 0% |
| Hong Kong | 5% | (10%) | 10% | 10% | 5% |
| Hungary | 10% | | 10% | 10% | 0-10%[5] |
| Iceland | 0%<br>5% | (25%)<br>(10%) | 15% | 0% | 0% |
| India | 10% | | 10% | 10% | 10% |
| Indonesia | 10% | (25%) | 15% | 10% | 10% |
| Ireland | 10% | (25%) | 15% | 10% | 10% |

| | | | | | |
|---|---|---|---|---|---|
| Israel | 5% | (25%) | 15% | 10% | 10% |
| Italy | 10% | (25%) | 15% | 10% | 10% |
| Jamaica | 5% | (20%) | 10% | 10% | 2-10% |
| Kazakhstan | 5% | (10%) | 15% | 10% | 5% |
| Kuwait | 5% | (10%) | 10% | 10% | 10% |
| Latvia | 0% | | 0-10% | 0-10% | 0% |
| Lithuania | 0% | | 0-10% | 0-10% | 0% |
| Luxembourg | 5% | (25%) | 15% | 10% | 10% |
| Malaysia | 5% | (25%) | 15% | 10% | 10% |
| Mexico | 0-5% | (25%) | 15% | 10-15% | 10% |
| Morocco | 5% | (10%) | 10% | 10% | 5-10% |
| Netherlands | 0%<br>5% | (50%)<br>(10%) | 10% | 0-10% | 0% |
| New Zealand | 0% | (10%) | 15% | 0-10% | 5% |
| Norway | 5% | (25%) | 15% | 10% | 10% |
| Oman | 5% | (10%) | 10% | 10% | 10% |
| Pakistan | 5%<br>7.5% | (50%)<br>(25%) | 10% | 10% | 10% |
| Peru | 10% | | 10% | 10% | 15% |
| Philippines | 10% | (10%) | 15% | 10% | 10-15% |
| Poland | 10% | | 10% | 10% | 0-10%[5] |
| Portugal | 5% | (10%) | 10% | 5-10% | 5% |
| Qatar | 5% | (10%) | 10% | 0-10% | 5% |
| Romania | 10% | | 10% | 10% | 10-15% |
| Russia[3] | 5% | (15%) | 10% | 0% | 0% |
| Saudi Arabia | 5% | (10%) | 10% | 10% | 5-10% |
| Serbia | 5% | (25%) | 10% | 10% | 5-10% |
| Singapore | 5% | (25%) | 15% | 10% | 10% |
| Slovenia | 5% | | 5% | 5% | 5% |
| South Africa | 5% | (25%) | 15% | 10% | 10% |
| South Korea | 5% | (25%) | 15% | 10% | 10% |
| Spain | 0% | (10%) | 5% | 0% | 0% |
| Sri Lanka | 20% | | 20% | - | 0-10%[6] |
| Sweden | 0% | (10%) | 10% | 0% | 0% |
| Switzerland (current) | 0%<br>5% | (50%)<br>(10%) | 10% | 0-10% | 0% |
| Switzerland (revised) | 0& | (10%) | 10% | 0% | 0% |
| Taiwan | 10% | | 10% | 10% | 10% |
| Thailand | 15-20% | (25%) | - | 10-25% | 15% |

| | | | | | |
|---|---|---|---|---|---|
| Turkey | 10% | (25%) | 15% | 10-15% | 10% |
| UAE | 5% | (10%) | 10% | 10% | 10% |
| UK | 0% | (10%) | 10% | 0% | 0% |
| Uruguay | 5% | (10%) | 10% | 0-10% | 10% |
| US | 0%<br>5% | (50%)<br>(10%) | 10% | 0% | 0% |
| USSR[4] | 15% | | 15% | 10% | 0-10%[5] |
| Uzbekistan | 5% | (25%) | 10% | 5% | 0-5%[5] |
| Vietnam | 10% | | 10% | 10% | 10% |
| Zambia | 0% | | 0% | 10% | 10% |

[1] This treaty covers Czech Republic and Slovak Republic.

[2] The original tax treaty with the UK is eligible for Fiji, with exceptions for dividends and interest, to which domestic tax rates are applied.

[3] The tax treaty with Russia is not applied to the 8 jurisdictions discussed in note (4) to which the tax treaty with the ex-USSR is applied.

[4] This treaty covers 8 jurisdictions that constituted the ex-USSR (Armenia, Azerbaijan, Belarus, Kyrgyz, Moldova, Tajikistan, Turkmenistan and Ukraine).

[5] Cultural royalties are exempt.

[6] 50 percent of certain royalties are exempt and royalties for copyright or cinema films are fully exempt.

### 4.8.3 Real Estate

Capital gains from the transfer of real estate located in Japan by a non-resident individual or a foreign company are subject to individual income tax or national corporation tax and local corporation tax, respectively. The law also provides for a surtax on such gains from land for companies at a rate in the range 5-10 percent. However, this surtax is currently suspended until 31 March 2023.

Withholding tax at 10.21 percent (income tax of 10 percent and special reconstruction income tax that is imposed on income tax at 2.1 percent from 2013 to 2037) is generally assessed on the proceeds from a transfer of real estate by a non-resident individual or a foreign company and final settlement of the tax liability on any capital gain arising from transfers of real estate is computed on an individual or corporation tax return. The income tax withheld from the sale proceeds is creditable on this return in calculating the final tax liability, or is refundable to the extent that the withholding tax amount is greater than the tax on the capital gain.

Japan's tax treaties have no provisions to reduce the tax burden under the domestic tax law as detailed above.

### 4.8.4 Shares

(1) Shares in a Real Estate Holding Company - Taxation under Japanese Tax Law

Capital gains from a disposition of shares in real estate holding companies by a non-resident individual or a foreign company are subject to individual income tax or national corporation tax and local corporation tax, respectively.

- Real estate holding company

  A real estate holding company is defined as a company where the fair market value of its real property interests prescribed below equals or exceeds 50 percent of the fair market value of its total assets at any time during 365 days preceding the sale of the shares. Either Japanese companies or foreign companies can be real estate holding companies.

  (i) land, buildings, attachments to buildings and structures situated in Japan

  (ii) shares in other real estate holding companies

- Safe harbor rule

  There is a safe harbor rule which excludes minority shareholders from this taxation system. Where the aggregate shareholding in the real estate holding company of a foreign investor and its related persons as of the day prior to the beginning of the fiscal year including the disposal day was 5 percent or less (2 percent or less for unlisted companies) of the total issued shares of the company, the foreign investor is not taxed on capital gains on a disposal of shares in real estate holding companies.

- Related persons

  'Related persons' of a foreign investor in the above are as follows:

  (i) family relatives of the foreign investor (if the investor is an individual)

  (ii) a company directly or indirectly controlled[1] by the foreign investor

  (iii) a company directly or indirectly controlled by a person which controls the foreign investor

Where a foreign investor holds shares in a real estate holding company through an NK-type partnership[2], any other partners of the partnership are treated as related persons of the foreign investor.

[1] If a company holds more than 50 percent of the total outstanding shares or more than 50 percent of the voting rights in another company, the latter company is treated as being 'controlled' by the former company.

[2] The definition of NK-type partnerships for the purposes of this rule is the same as that described in 2.1.1.

If the foreign investor owns shares in a real estate holding company through two or more partnerships, all partners of those partnerships are treated as 'related persons' for the foreign investor. Note that the aggregate shareholding in a real estate holding company does not include shares that these other partners hold not through those partnerships.

(2) Shares in a Japanese Company - Taxation under Japanese Tax Law

Capital gains from the sale of shares in a Japanese company by a non-resident individual or a foreign company are subject to individual income tax or national corporation tax and local corporation tax, respectively in the circumstances described below:

(i) gains arising from the sale of forestalled shares (shares acquired for the purposes of a takeover of a company or a demand sale of such shares) in a Japanese company

(ii) gains arising from the sale of a substantial interest in a Japanese company, being a sale made by a foreign shareholder of 5 percent or more of the outstanding shares of a Japanese company within 1 fiscal year, where the foreign shareholder has held 25 percent or more of such outstanding shares at any time during the fiscal year of sale or during the 2 preceding fiscal years (25%/5% test)

When judging the threshold of 25 percent and 5 percent in (ii) above, the judgment should be made by looking at the aggregate shareholding in the Japanese company of the foreign shareholder and related persons of the foreign shareholder.

'Related persons' of the foreign shareholder in the above are as follows:

(i) family relatives of a foreign shareholder (if the shareholder is an individual)

(ii) a company directly or indirectly controlled[1] by the foreign shareholder

(iii) a company directly or indirectly controlled by a person which controls the foreign shareholder

Where a foreign shareholder holds shares in a Japanese company through an NK-type partnership[2], any other partners of the partnership are treated as related persons of the foreign shareholder.

[1] If a company holds more than 50 percent of the total outstanding shares or more than 50 percent of the voting rights in another company, the latter company is treated as being 'controlled' by the former company.

[2] The definition of NK-type partnerships for the purposes of this rule is the same as that described in 2.1.1.

If the foreign shareholder owns shares in a Japanese company through two or more partnerships, all partners of those partnerships are treated as 'related persons' for the foreign shareholder. Note that the aggregate shareholding in a Japanese company does not include shares that these other partners hold not through those partnerships.

However, in either of the following cases, 'related persons' of a foreign shareholder do not include other partners of the partnership in determining the shareholding ratio, except for cases where the holding period of the shares is less than 1 year, or where shares in a bankrupt financial institution are transferred:

(a) disposals of shares by a Specified Foreign Partner[*] through an Investment Fund[*]

(b) disposals of shares by a foreign partner of an Investment Fund[*] through the Investment Fund, provided that the

foreign partner has been a limited partner of the Investment Fund and has not been involved in the operation of the Investment Fund for the year of disposal and the past 3 years

(*) Please see 2.1.2 for the definition of the 'Specified Foreign Partner' and 'Investment Fund.'

(3) Taxation under Tax Treaties

The tax treatment of capital gains from the sale of shares in a real estate holding company/a Japanese company in tax treaties concluded by Japan depends on the treaty.
Some tax treaties give Japan the taxing rights in the same way as the Japanese tax laws, while some tax treaties give taxpayers full protection from Japanese tax on capital gains from the sale of shares.

Also, there are capital gain provisions in tax treaties including one or more of the following clauses:

- Clause to give Japan the taxing rights on the sale of shares in a real estate holding company

- Clause to give Japan the taxing rights on the sale of shares in a real estate holding company which is a Japanese company

- Clause to give Japan the taxing rights on the sale of shares in a Japanese company meeting a test that is similar to the 25%/5% test discussed in (2)

- Clause to give Japan the taxing rights on capital gains from shares of distressed financial institutions

# 5 Indirect Tax

## 5.1 Consumption Tax

Japanese consumption tax is a sales based tax applied on supplies of certain goods and services within Japan. It is similar in nature to European VAT and Australian GST.

### 5.1.1 Taxable Transactions

Taxable transactions for consumption tax purposes are the following transactions when carried out for consideration as part of a business carried on by an individual or a company:

(i) the sale or lease of an asset located in Japan

(ii) the supply of services (excluding digital services) provided in Japan

(iii) the supply of digital services provided to individual residents of Japan or Japanese companies (please see 5.1.3 (1) for exceptional rules.)

However, there are a number of transactions which are specifically excluded from being taxable transactions as non-taxable transactions. The main non-taxable transactions are as follows:

- sales or leases of land

- sales of securities and similar instruments (not including golf-club membership rights and other similar items, but including foreign securities)

- monetary transactions including loans, guarantees, distributions from joint operation trusts or other investment trusts and insurance premiums

- transfers of postage stamps, revenue stamps, etc. by the central and local governments (including foreign postage stamps, etc.)

- specified activities carried out by the central and local governments, such as registration and certification activities, as well as handling charges for foreign-exchange transactions

- medical treatment under public medical insurance law

- social welfare activities

- school tuition and examination services

- rental of housing

- services related to childbirth, burial, home help and welfare centers for aged and handicapped persons

From the perspective of the vendor/service supplier in a domestic taxable transaction, the transaction is a 'domestic taxable sales transaction' whilst from the perspective of the purchaser/service recipient, the transaction is a 'domestic taxable purchase transaction.' Consumption tax imposed on a taxable transaction is called 'output tax' for the vender/service supplier and 'input tax' for the purchaser/service recipient.

In addition to the taxable transactions identified above (domestic taxable transactions), the removal of foreign goods from a bonded area (i.e. import of goods) also represents a taxable transaction for consumption tax purposes (import taxable transactions).

Consumption tax imposed on importation is called 'import input tax' for the importer.

### 5.1.2 Export Transactions

Export transactions, including the transfer or lease of goods representing an export from Japan as well as other export-related activities such as international transportation are treated as export exempt transactions, to which an effective zero percent consumption tax rate is applied. It is not necessary to collect or account to the government for consumption tax on such transactions.

Services provided to a non-resident will also be treated as export transactions, except in the case of transport or storage of assets in Japan, provision of accommodation and food in Japan, or provision of services of a similar nature in Japan.

### 5.1.3 Digital Services

(1) Digital Services and Place of Taxation Therefor

Digital services are defined as 'services supplied through telecommunications lines such as supplies of copyrighted works through telecommunications lines' and include neither 'services that merely enable customers to use communication lines (e.g. telephone)' nor 'supplemental services incidental to non-digital services.'

Examples of digital services indicated by the Japanese tax authorities are as follows:

- provision of e-books, digital newspapers, music, videos, and software (including various applications such as games) via the internet

- services that allow customers to use software and databases in the cloud

- services that provide customers with storage space to save their electronic data in the cloud

- distribution of advertisements via the internet

- services that allow customers to access shopping and auction sites on the internet (e.g. charges for posting goods for sale, etc.)

- services that allow customers to access places to sell game software and other products on the internet

- provision via the internet of reservation website for accommodation and restaurants (those who charge for posting on the website from the businesses that provide accommodation and operate restaurants)

- English lessons provided via the internet

- consulting services provided continuously via telephone and e-mail

As the place of taxation for digital services is to be determined by the place of the service recipient, digital services provided to individual residents of Japan or Japanese companies are treated as domestic transactions, which are generally taxable for consumption tax purposes.

There are the following exceptional rules:

- B2B digital services received by a foreign permanent establishment (PE) of a domestic business customer, which are exclusively required for their supplies conducted outside Japan, are treated as foreign transactions (i.e. out-of-scope from Japanese consumption tax)

- B2B digital services received by a PE in Japan of a foreign business customer, which are required for their supplies conducted in Japan, are treated as domestic transactions.

Please see (2) below for the definition of 'B2B digital services.'

(2) Classification of Digital Services Provided by Foreign Suppliers

As Japan has not adopted a VAT identification number system, unlike EU countries, digital services provided by foreign suppliers (non-resident individuals or foreign companies) are classified into B2B (business to business) digital services and B2C (business to consumers) digital services based on the characteristics of the services or the terms and conditions of the transactions as indicated below:

| | |
|---|---|
| B2B digital services | Digital services supplied by foreign suppliers where the recipients of the services are normally limited to business customers based on the characteristics of the services or the terms and conditions of the transactions |
| B2C digital services | Digital services supplied by foreign suppliers not falling under the above B2B digital services |

(3) Tax Treatment of B2B Digital Services (Reverse Charge Mechanism)

Where a foreign supplier provides B2B digital services to a domestic business customer or a PE in Japan of a foreign business customer(*), the obligation to declare/pay consumption tax on the services is imposed on the business customer under the reverse charge mechanism. Thus, consideration of such supplies paid by the business customer does not include consumption tax.

(*) Limited to B2B digital services to a PE in Japan of a foreign business customer which are required for their supplies conducted in Japan

If the taxable sales ratio (discussed in 5.1.8) for a taxable period of a business customer is greater than or equal to 95 percent or if the simplified tax credit system (discussed in 5.1.9) is elected

for a taxable period of a business customer, reverse charge purchases(*) will be ignored for the taxable period for the time being. This is a transitional measure to take into account the administrative burden for business customers.

(*) Reverse charge sales/purchases means sales/purchases subject to the reverse charge mechanism. In addition to B2B digital services, specific entertainment services are also subject to the reverse charge mechanism. When a foreign supplier provides business customers with services performed by entertainers or professional athletes in Japan, such services are treated as specific entertainment services.

(4) Tax Treatment of B2C Digital Services

A foreign supplier has an obligation to file a consumption tax return and pay consumption tax to the Japanese government with respect to B2C digital services in the same way as that for ordinary domestic taxable transactions.

As discussed in (2), digital services provided by foreign suppliers are classified into B2B or B2C based on the characteristics of the services or the terms and conditions of the transactions. Thus, there could be cases where a domestic business customer receives B2C digital services from foreign suppliers. A special rule whereby a domestic business customer receiving B2C digital services is able to take a credit for the consumption tax on the B2C digital services only when it is provided from a registered foreign supplier (please see details in (5) below) was introduced. This is because it is uncertain that the Japanese government is able to collect consumption tax on B2C digital services from non-registered foreign suppliers.

(5) Registration of Foreign Suppliers

A foreign supplier having consumption taxable person status is able to become a registered foreign supplier by submitting an application form together with certain documents to the National Tax Agency (NTA) through the competent tax office. The NTA makes public basic information (e.g. name, address, registration number and date of registration) of registered foreign suppliers on its website once registered so that domestic business customers of B2C digital services can confirm if their counterparties are registered or not.

A registered foreign supplier is required to issue invoices including relevant information (e.g. the registration number) upon customers' requests and preserve such invoices for 7 years.

Moreover, a registered foreign supplier will not be able to have tax exempt status after obtaining approval for the registration unless its registration is canceled.

### 5.1.4 Taxable Persons

Whilst broadly anyone, whether a consumer or a business operator, acquiring goods and services in Japan will suffer a consumption tax charge on those transactions, the concept of a 'taxable person' for consumption tax purposes specifically relates only to those companies or individuals which are required to file a consumption tax return to the Japanese government.

(1) Principle Rules for Taxable Persons

In principle, whether a business operator is a taxable person is determined depending on the amount of taxable sales (domestic taxable sales (excluding reverse charge sales) and export exempt sales) in the past as follows:

| Taxable sales in the base period[1] | Taxable sales in the specified period[2] | Taxable person |
|---|---|---|
| over JPY10 million | - | Yes |
| JPY10 million or less | over JPY10 million | Yes |
| | JPY10 million or less | No |

[1] The base period generally means the fiscal year 2 years prior to the current fiscal year for a company. Where the base period is not 1 year, the annualized value of the taxable sales in the base period is used. For an individual, the base period means the calendar year 2 years prior to the current year.

[2] The specified period generally means the first 6 months of the previous fiscal year for a company. For an individual, it means the period from January to June of the previous year.

(2) Election to be a Taxable Person

Regardless of the rules described in (1), a business operator is able to become a taxable person by an election.

An application report must ordinarily be submitted prior to the commencement of the first taxable period for which it will apply. However, in the first taxable period of a business operator, the election can apply from the commencement of business where the election is made prior to the end of that taxable period. An election is irrevocable generally for a period of 2 years.

If a taxable person who made an election for such status acquires specified fixed assets[*] within this 2-year period (excluding taxable periods in which the simplified tax credit system (discussed in 5.1.9) has been applied), the person must continue to be a taxable person for 3 years beginning from the taxable period in which the specified fixed assets are acquired. Note that the simplified tax credit system is not applicable for such 3-year period as well.

(*) 'Specified fixed assets' means certain assets other than inventories such as buildings, machinery, and equipment whose purchase cost (excluding consumption tax) is JPY1 million or more per unit. The creditable amount of the input tax thereon is subject to an adjustment depending on the fluctuation of taxable sales ratios for 3 years from the purchase of the assets.

(3) Newly Established Companies

Even if a business operator is not treated as a taxable person under the rules described in (1) or (2), if it is a newly established company falling under either of the following tests, the company will be treated as a taxable person in fiscal years with no base period (generally, for the first 2 fiscal years).

(i) The newly established company's stated capital at the beginning of the fiscal year is JPY10 million or more.

(ii) The newly established company other than the company in (i) meets both of the following:

- The newly established company is controlled (e.g. the majority of the outstanding shares of which are directly or indirectly held) by a person (including individuals and companies) as of the beginning of the fiscal year.

- The amount of the taxable sales for the person who is treated as controlling the newly established company or the amount of the taxable sales for a company related to that person exceeds JPY500 million in the period corresponding to the theoretical base period of the fiscal year of the newly established company.

If a company being treated as a taxable person under the above tests acquires specified fixed assets in fiscal years with no base period (excluding taxable periods in which the simplified tax credit system has been applied), the company must continue to

be taxpayer for 3 years beginning from the taxable period in which the specified fixed assets are acquired. Note that the simplified tax credit system is not applicable for such 3-year period as well.

(4) Special Measures for Purchases of High-Value Assets

Where a taxable person purchases a high-value asset(*) in Japan in a taxable period in which the simplified tax credit system has not been applied, the taxable person will continuously be a taxable person for each taxable period from (i) to (ii):

(i) taxable period in which the high-value asset is purchased

(ii) taxable period with the day 3 years from the commencement date of the taxable period (i)

Note that the simplified tax credit system is not applicable for such 3-year period as well.

(*) 'High-value assets' means inventories and specified fixed assets, whose purchase cost (excluding consumption tax) is JPY10 million or more per unit.

The above rules will also be applicable where a taxable person constructs an asset in Japan under certain conditions. In this case, the above restrictions will be applied for each taxable period from (i) to (ii):

(i) taxable period in which the construction costs (excluding consumption tax) for the asset reach JPY10 million

(ii) taxable period with the day 3 years from the commencement date of the taxable period in which the construction of the asset is completed

### 5.1.5 Taxpayers as an Importer

For the purposes of import taxable transactions, an importer (any individual or company importing goods into Japan) must pay consumption tax to the government (Customs Office) unless the importation is tax-exempt under a threshold rule.

Consumption tax on importation is imposed on any importer regardless of whether the importation is carried out for business purposes. Thus, individuals importing goods as consumers can be an import input taxpayer. Where an individual or company pays consumption tax on its importation, that individual or company does not automatically become a taxable person required to file a consumption tax return.

### 5.1.6 Taxable Base

The taxable base for a domestic taxable transaction is the consideration for the transaction.

In the case of import taxable transactions, the taxable base is the value of the imported goods for customs duty purposes (i.e. normally, the CIF price) plus the amount of any customs duties and other excise taxes.

### 5.1.7 Tax Rate

A multiple tax rate system was introduced on 1 October 2019. Under the multiple tax rate system, the consumption tax rate is 10 percent in principle and a reduced tax rate of 8 percent is applied to sales of food/beverages (excluding alcoholic beverages) and certain newspapers under subscription contracts.

An invoicing system discussed in 5.1.12 will also be introduced on 1 October 2023 so that the creditable tax amount can be calculated properly under the multiple tax rate system. The 4

years between the introduction of the multiple tax rate system and the invoicing system is set out as a preparation period for businesses.

### 5.1.8 Computation of Consumption Tax to be Paid

Unless a taxable person elects for the simplified tax credit system (discussed in 5.1.9), consumption tax to be declared in a consumption tax return and to be paid over to the government by a taxable person should be calculated based on the net of (i) and (ii), but to the extent of the creditable amount.

(i) consumption tax received on domestic taxable sales transactions for the taxable period (output tax)

(ii) consumption tax suffered on domestic taxable purchase transactions and import taxable transactions for the same taxable period (input tax)

When the creditable input tax suffered in a taxable period exceeds the output tax in the same period, a refund of the difference will be made.

Note that input tax on rental residential buildings[(1)] is not creditable

[(1)] 'Rental residential buildings' means buildings that fall under high-value assets (please see 5.1.4 (4)) or high-value self-constructed specified assets[(2)], excluding buildings that are not clearly used for rental of housing.

[(2)] 'High-value self-constructed specified assets' means self-constructed inventories which were constructed pursuant to a contract with a third party or constructed for the business operator's own inventory (where the construction costs for assets reach JPY10 million).

If a taxable person receives services subject to the reverse

charge mechanism in a taxable period, the consumption tax on the reverse charge purchases will be added to both (i) output tax and (ii) input tax, unless the taxable sales ratio for the taxable period is greater than or equal to 95 percent.

The creditable input tax is calculated depending on the taxable sales ratio and the taxable sales as follows:

<table>
<tr><th>Taxable sales ratio</th><th>Taxable sales for the taxable period</th><th>Creditable input tax</th></tr>
<tr><td rowspan="2">95% or more</td><td>JPY500 million or less</td><td>Total input tax (i.e. fully creditable)</td></tr>
<tr><td>over JPY500 million</td><td rowspan="2">Creditable input tax is calculated by<br>[1] Individual method, or<br>[2] Pro-rata method</td></tr>
<tr><td>less than 95%</td><td>-</td></tr>
</table>

- Taxable sales ratio

$$\frac{\text{Domestic taxable sales} + \text{Export exempt sales}}{\text{Domestic taxable sales} + \text{Export exempt sales} + \text{Domestic non-taxable sales}^{(*)}}$$

Domestic taxable sales do not include reverse charge sales and the amounts of sales do not include output tax.

(*) As for sales proceeds of certain securities/monetary claims, only 5 percent of the proceeds should be included.

- Taxable sales for the taxable period

Taxable sales means domestic taxable sales (excluding reverse charge sales) and export exempt sales. Where the taxable period is shorter than 1 year, the annualized value of the amount of the taxable sales will be used.

- Total input tax

| | | | | |
|---|---|---|---|---|
| Total gross value of domestic taxable purchase transactions (including input tax) | x | 10/110(*) | + | Input tax on import transactions |

(*) 8/108 is applied to transactions subject to the reduced tax rate of 8 percent.

When a taxable person receives services subject to the reverse charge mechanism, total input tax should include consumption tax on such reverse charge purchases (i.e. total gross value of reverse charge purchases x 10/100).

- Individual method

| | | | | | | |
|---|---|---|---|---|---|---|
| (i) | + | (iii) | x | Taxable sales ratio(*) | | |

(i) input tax relating to the acquisition of goods/services solely attributable to sales transactions other than domestic non-taxable sales transactions

(ii) input tax relating to the acquisition of goods/services solely attributable to domestic non-taxable sales transactions

(iii) input tax other than above

(*) An appropriate alternative ratio may be utilized where this is approved in advance by the tax authorities.

- Pro-rata method

| | | |
|---|---|---|
| Total input tax | x | Taxable sales ratio |

If this method is chosen, it should be used for at least 2 years.

### 5.1.9 Simplified Tax Credit System

A simplified tax credit system, as described below, is applicable to individual and corporate taxable persons the annualized value of whose taxable sales (domestic taxable sales and export exempt sales) for the base period was JPY50 million or less. The taxable persons must submit an appropriate report to the competent tax office in order to utilize this method and once applied, this method must be put to use for at least 2 years.

Under the simplified tax credit system, the tax payable is calculated by using the following formula:

| Domestic taxable sales | x | Assumed profit margin | x | Consumption tax rate |
|---|---|---|---|---|

The assumed profit margin differs depending on the taxable person's business as follows:

| Taxable person's business | | Assumed profit margin |
|---|---|---|
| Wholesale | | 10% |
| Retail | | 20% |
| Manufacturing, construction, mining, agriculture, fishing, electricity/gas industry, etc. | | 30% |
| Service, etc. | Transportation, communication and services | 50% |
| | Real estate | 60% |
| Other than above | Food services, etc. | 40% |
| | Financial or insurance services | 50% |

### 5.1.10 Taxable Period

The taxable period is the respective fiscal year for a corporate taxable person and the calendar year for an individual taxable person.

However, upon election, the taxable period may be on a quarterly basis rather than on an annual basis (i.e. every 3 months starting from the commencement date of the respective fiscal year for a corporate taxable person and the periods from January to March, April to June, July to September, and October to December for an individual taxable person). A monthly taxable period is also available upon election.

### 5.1.11 Tax Returns and Tax Payments

(1) Final Tax Return and Tax Payments

A taxable person is required to file its final consumption tax return and pay tax due within 2 months after the end of the taxable period.

By virtue of the 2020 tax reform, where a company who applies a filing extension of final corporation tax return (please see 1.12.1 (1)), the filing due date of the final consumption tax return will be extended for 1 month by submitting an application form to the tax office. (The payment due date will not be extended.) The rule will be applicable to taxable periods that are included in the end of fiscal years ending on or after 31 March 2021.

(2) Interim Tax Returns and Tax Payments

A taxable person who has not elected for a quarterly or monthly taxable period may be required to make interim payments depending on the amount of the consumption tax payable for the previous taxable period (the annualized value if the previous taxable period is shorter than 1 year) described as

follows within 2 months after the end of each interim period:

| Amount of the consumption tax payable for the previous taxable period | Interim payments |
|---|---|
| over JPY61,538,400 | Monthly basis |
| over JPY5,128,200 but JPY61,538,400 or less | Quarterly basis |
| over JPY615,300 but JPY5,128,200 or less | Semi-annual basis |

Interim consumption tax payable is calculated on a pro-rata basis (i.e. calculated by dividing the consumption tax payable for the previous taxable period by the number of the months of the previous taxable period and multiplied by the number of the months of the interim period) or on a provisional basis (i.e. calculated based on actual operating results for each interim period).

Interim tax returns should be filed within 2 months after the end of each interim period. However, if interim consumption tax payable is calculated on a pro-rata basis, filing can be skipped.

### 5.1.12 Invoicing System

An invoicing system will be introduced on 1 October 2023. Under this system, preservation of 'tax-qualified invoices' issued by registered suppliers(*) will be one of the requirements for tax credits. For the first 6 years, the transitional measures will allow a partial tax credit of consumption tax equivalent on taxable purchases from non-registered suppliers under certain conditions as follows:

| Applicable periods | Amount of applicable tax credits |
|---|---|
| From 1 October 2023 to 30 September 2026 | 80% of consumption tax equivalent on taxable purchases |
| From 1 October 2026 to 30 September 2029 | 50% of consumption tax equivalent on taxable purchases |

(*) An application form must be submitted to the competent tax office in order to be a registered supplier who is eligible to issue 'tax-qualified invoices'.

## 5.2 Customs and Tariffs

All merchandise being imported from foreign countries must be processed through the applicable government agencies as well as comply with the Japanese Customs laws and regulations related to importation. The Customs and Tariff Bureau (CTB), an internal bureau of Japan's Ministry of Finance, is the primary contact for importers entering merchandise into Japan. Importers in Japan are responsible for using reasonable care to enter, classify and value imported merchandise, as well as provide any other information necessary enabling the CTB to properly assess duties, collect accurate statistics, and determine whether any other applicable legal requirements are met.

### 5.2.1 Customs Clearance and Importers of Record

The importer of record is the party legally responsible for fulfilling import formalities and complying with all Customs laws and regulations relating to the subject imported goods. For most imports, the buyer of the goods in the destination country is also the importer of record on the customs entry. When merchandise arrives in Japan, it must be entered by the importer or its agent (e.g. customs broker, freight forwarder, etc.)

In principle, there are no specific requirements to become an importer of record. Therefore, anyone, including a foreign company (i.e., non-resident importer) may act as an importer of record. When a non-resident person or a foreign company clears goods through Customs, the importer must appoint a Customs representative to carry out the work by proxy. The Customs representative must be a person who has an address or residency in Japan, or a company which has a business presence in Japan. A form must be submitted to the Customs

office in advance of importation to notify the CTB of the appointment of a Customs Representative.

### 5.2.2 Customs Duty Rate

All merchandise imported into Japan is subject to, or free of duty in accordance with the Harmonized Tariff Schedule of Japan. Duty rates vary based on the type of product being imported and the country of origin of the product. Duties may be assessed in a variety of ways such as 'Ad Valorem', 'Specific' or 'Compound'. An Ad Valorem Rate is a percentage of value of the merchandise (e.g. 5 percent Ad Valorem). A Specific Rate is a specified amount per unit of weight or other quantity (e.g. JPY4,800 per pair). A Compound Rate is a combination of both an ad valorem rate and a specific rate (e.g. JPY0.70 per kilo plus 10 percent ad valorem).

### 5.2.3 Tariff Quota

Japan's Tariff Quota system is designed to control the amount or volume of various commodities that can be imported into Japan during a specified period of time. It permits for a specified quantity of imported merchandise to be imported at a reduced rate of duty during the quota time period. Once the tariff-rate quota limit is reached, goods may still be imported but at a higher rate of duty. Products which are subject to tariff quota in Japan include leather, leather shoes, corn, certain cheese and dairy, etc.

### 5.2.4 Customs Valuation

As a World Trade Organization (WTO) signatory country, Japan's Customs valuation related laws and practices are similar to those prescribed in the WTO Customs Valuation Agreement and its appraisement hierarchy. Transaction Value is the valuation method preferred by the CTB and it is also the easiest to determine. The Customs laws define Transaction Value to be the price actually paid or payable for imported

merchandise when it is sold for exportation to Japan. Transaction Value is usually the contract or invoice price paid by the importer to an unrelated foreign seller, plus or minus certain statutory additions and exclusions.

When Transaction Value is inapplicable (e.g., no actual sale between foreign seller and Japanese importer), appraisement of the imported merchandise is made in accordance with the remaining methods of valuation applied in sequential order. The alternative methods of appraisement are in order of precedence: Transaction value of identical or similar merchandise, deductive value, computed value and the 'fallback' method.

■ Additions to Transaction Value

- The value of 'assists'. An assist is any material (e.g. tools, dies, molds, etc.) or service (e.g. research and development, etc.) provided by the buyer of imported merchandise, directly or indirectly, free of charge or at a reduced cost for use in connection with imported merchandise;

- Selling commissions incurred by the buyer (Buying commissions are not considered dutiable);

- Packaging costs incurred by the buyer;

- Royalties and licensing fees that the buyer is required to pay a condition of the sale of the imported merchandise;

- The proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue to the seller; and

- The cost of transport and insurance and other expenses associated with the transport of the imported goods to the port of importation.

- Customs Related Party Pricing

The CTB will accept related party pricing as the Transaction Value only if an examination of the circumstances of the sale of the imported merchandise shows that the relationship between the buyer and the seller did not influence the price or that the transaction value approximates one of the several alternative valuation standards. Acceptable product valuation in transactions involving related parties is crucial, because the CTB generally gives greater scrutiny to pricing of such transactions.

- Transfer Price and Valuation

Transfer price adjustments generally occur in order to bring the inter-company prices within an arm's-length range for income tax purposes. When these transfer price adjustments occur retroactively, post-importation, Japanese customs laws and regulations do not prescribe how they should be treated from a Customs Valuation perspective.

In July 2017 the CTB published a customs valuation opinion in response to a specific importer inquiry to serve as guidance on how retroactive transfer price are to be addressed from a customs valuation perspective. Within the customs valuation opinion, the CTB determined that the specific transfer price adjustments they reviewed were considered part of the value declared to the CTB. The determination was based on provisions contained within the sales contract and related supplier and an advanced pricing agreement (APA) between the importer and the bilateral tax authority (that stipulates, in part, that the sales prices for the products to be imported are subject to review and adjustment after payment is made). The CTB further stated that the adjustments would be considered part of the customs value, whether the adjustments were upward or downward.

However, it has not become clear how the CTB will address these issues in practice. As such, obtaining an advance agreement with the Valuation Division of CTB regarding the treatment of the transfer price adjustment for customs valuation purposes can resolve uncertainty in such a situation.

- Commissionaire Model and Valuation

In a typical commissionaire model, the commissionaire carries out the role of the importer of record for Customs requirement purposes. The CTB generally considers these 'import' transactions as intra-company movements of goods by the principal, rather than a buy-and-sell model and would therefore deny the use of Transaction Value as the method of appraisement. In such cases, the CTB would often require the application of deductive or computed value. In such cases, submitting a blanket value application and obtaining advance agreement with the Valuation Division of CTB would also be recommended for determining the appropriate method of appraisement and method of in which it is calculated.

### 5.2.5 Classification

All merchandise imported into Japan is either subject to, or free of duty in accordance with the Harmonized Tariff Schedule of Japan (HS). HS 'Classification' is the term used to designate the ten digit HS assignment that most specifically describes the products under consideration. Classification of merchandise is typically determined based on the common, commercial, or technical name in an article or product description, along with certain considerations for function and material composition. The classification system is based on the HS operated by the WCO. The HS code consists of a six digit HS code, a three digit domestic code, and a final digit which is the NACCS number. NACCS is the Nippon Automated Cargo and Port Consolidated System which is an automated web-based system utilized by the CTB and importers to facilitate the clearance and declaration of merchandise imported into Japan.

### 5.2.6 Rules of Origin

Rules of origin (ROO) are the rules to determine the country of origin of goods. Since the application of certain Customs and tariff policy (e.g. Economic Partnership Agreements, anti-dumping, etc.) depends on the origin of goods, ROO is necessary so that the origin of goods is determined in an objective manner.

In Japan, non-preferential rules of origin are determined according to where the product was "wholly obtained," or where the "last substantial transformation" of the product occurred.

Under the relevant Customs law, "substantial transformation" in Japan is defined as "such manufacturing process that leads to a change of HS heading (i.e., HS 4 digit) between the tariff classification of the non-originating materials and the tariff classification of the good produced.

For ROO specific to preferential tariff treatment under Economic Partnership Agreements (EPA) and Free Trade Agreements (FTA), each Agreement should be reviewed closely for to understand their respective general requirements and product specific rules.

### 5.2.7 Anti-dumping Duty

In principle, anti-dumping duties are assessed on items that are imported into Japan and are sold at less than a fair market value (i.e., the price the goods are normally sold in the home country) to help prevent harm to the domestic industry. Japan has three laws and ordinances that cover anti-dumping: Article 8 of the Customs Tariff Law, the Cabinet Order on Anti-dumping Duties and the Guidelines on Procedures for Countervailing and Anti-dumping Duties. Up to September 30, 2021, Japan has imposed Anti-dumping Duties on 10 import products its history since 1993.

### 5.2.8 Recordkeeping

Customs laws require importers to maintain the book for records for a period of 7 years and import/export permission for a period of 5 years from the day after the date of import/export for information and documentation required for the entry of merchandise. If legal requirements of Customs laws are met, these information and documents may be stored electronically.

### 5.2.9 Advance Rulings

- Advance rulings and informal inquiries

Advance rulings can be utilized by importers and other interested parties to seek advice from the CTB on tariff classification, country of origin, FTA's and EPA's, and valuation methods for imported goods and transaction respectively, prior to importation. Although determinations under this system can be provided either orally or in writing, it is generally advisable to seek clarification in writing for use as confirmation of CTBs' position. Informal inquiries to CTB may also be made via e-mail.

In principle, all written/issued rulings are made publicly available on the CTB website to serve as a reference to the trade community and other interested parties. Any confidential or sensitive information pertaining to specific parties/individuals is not disclosed within an advance ruling. Although the general timeline for receiving a response may vary dependent on the specific circumstances of each request, determinations are generally not given in less than a month's time.

The CTB will generally provide their responses either orally or via email for any informal inquiries made orally or via e-mail. The benefit of an informal oral inquiry is that importers may expect relatively shorter turnaround times to obtain guidance from the CTB.

- Value declaration/application

There are two categories of value declaration/applications which importers may utilize:

- Individual Value Application: The individual value application is valid for a single duty-payable import declaration.

- Blanket Value Application: The blanket value application covers several duty-payable import declarations for a specific import transaction scenario for a specified period of time. Blanket value applications are valid for a maximum period of two years.

As part of the blanket value application process, it is typical that importers would need to participate in a series of face-to-face meetings with the Valuation Division of CTB to discuss the specific transactional circumstances and to review supporting documentation and information. In practice, once these reviews are concluded and if the CTB approves the blanket value application, it is likely that the CTB would respect the agreed upon determination. However, these determinations should not be regarded as an official position of the CTB for the method of valuation for imported goods.

### 5.2.10 Post Entry Customs Audit and Related Administration

The Post Clearance Audit, Investigation and Intelligence Division (PCAII) of the CTB is responsible for auditing importers and other entities involved in international trade compliance with Customs law, other laws and regulations. Typically, importers are selected by the PCAII Division every 3 to 5 years to undergo an audit and in certain instances are selected based on anomalies or 'red flags' identified within the information declared at the time of import through NACCS.

Generally, the audit process will begin with the PCAII Division making a request for information to obtain an understanding of a Company's organization, trade compliance environment and internal controls. Typical documentation requested includes but is not limited to import/export permissions, invoices, contracts and transportation documents. Following the information request, the PCAII Division will schedule onsite visits to meet with Company personnel and to conduct interviews and to review any additional documentation or information that may be necessary. The time period for completing an audit may range from two to six months and upon concluding an audit the PCAII will issue a final report outlining the results. If any errors are identified that result in a loss of revenue, the CTB will calculate the amount owed and instruct the importer to remit payment.

### 5.2.11 Penalty Process and Statute of Limitations

Under current Customs laws and regulations, the CTB may impose an 'Additional Tax' of 10 percent on any underpaid taxes resulting from an incorrect declaration identified by the CTB. In addition, interest is also imposed on any underpaid taxes. If an amended return is filed by the importer without prior knowledge of the correction by inspection, no additional tax is imposed.

The CTB may also impose a 5 percent penalty even on importers who file voluntary disclosures after the advanced audit notice is issued.

In investigations conducted and penalties assessed under Japanese Customs law, the statute of limitations is five years from the date of import.

### 5.2.12 Authorized Economic Operator Program

The Authorized Economic Operator (AEO) Program was developed by the CTB and designed to strengthen the security of the supply chain process. The AEO Program is voluntary and calls for companies to implement improved security practices throughout the supply chain to help ensure a secure society and to prevent terrorism. AEO is open to importers, exporters, warehouse operators, Customs brokers, logistics operators and manufacturers. Benefits of AEO importers include reduced examinations and inspections by Customs, pre-arrival lodgment of import declaration and permission, release of cargo before duty/tax payment declaration and periodic lodgment of duty/tax payment declaration. Japan has also instituted a formal mutual recognition with other countries that have similar AEO programs such as New Zealand, the United States of America, the European Union, Canada, Korea, Singapore, Malaysia, and Hong Kong, China and Australia.

### 5.2.13 Import Duty Savings Considerations

Companies moving goods across borders have a lot to gain from reducing their tariff costs and streamlining their international trade operations. A strategic approach to trade and customs issues can help importers and exporters to decrease their overhead, optimize their supply chains, increase cash flow and better position themselves for new markets.

(1) Free Trade Agreements and Economic Partnership Agreements

FTAs and EPAs may grant lower or eliminate duties to goods that are classified in an allowable HS and that satisfy the ROO established in an agreement. Japan currently has twenty EPAs / FTAs in force and three that are under negotiations. In addition, under its Generalized System of Preferences ('GSP') scheme, Japan applies reduced tariffs to designated import products originating from developing countries/territories, aiming to help

them increase export income, advance industrialization and promote economic development.

■ EPAs in force or signed

The following FTAs and EPAs are in force:

- Japan-Singapore EPA (2002.11 in force)
- Japan-Mexico EPA (2005.04 in force)
- Japan-Malaysia EPA (2006.07 in force)
- Japan-Chile EPA (2007.09 in force)
- Japan-Thailand EPA (2007.11 in force)
- Japan-Indonesia EPA (2008.07 in force)
- Japan-Brunei EPA (2008.07 in force)
- Japan-ASEAN EPA (2008.12 in force)
- Japan-Philippine EPA (2008.12 in force)
- Japan-Switzerland FTA & EPA (2009.09 in force)
- Japan-Vietnam EPA (2009.10 in force)
- Japan-India EPA (2011.08 in force)
- Japan-Peru EPA (2012.03 in force)
- Japan-Australia EPA (2015.01 in force)
- Japan-Mongol EPA (2016.06 in force)
- Comprehensive Progressive Agreement for the Trans-Pacific Partnership (CPTPP) (2018.12 in force)
- Japan-EU EPA (2019.02 in force)
- Japan-U.S. Trade Agreement (2020.01 in force)
- Japan-UK EPA (2021.01 in force)
- Regional Comprehensive Economic Partnership ('RCEP') (2022.1 in force)

■ EPAs under negotiation and others

- Japan-Columbia EPA
- Japan-China-Korea FTA
- Japan-Turkey EPA

Both EPAs and FTAs will generally require that evidence of eligibility (e.g. Certificate of Origin) be presented at the time of entry. This evidence will typically include documentation obtain from the producer / exporter / government authority attesting due diligence in ensuring all program requirements have been met.

(2) Customs Bonded System

Use of 'Customs Areas' and 'Bonded' facilities may allow for importers to import goods for storage, processing or manufacturing or display without payment of duties or taxes, unless and until the foreign merchandise enters the Customs territory for domestic consumption. Such bonded facilities must be approved by the head of the customs office and must various administrative conditions.

(3) Duty Exemption for Re-export

The re-export duty exemption applies to articles which have been imported into Japan and will later be re-exported. In order to utilize this exemption, importers must satisfy certain procedural requirements at the time of import.

(4) Non-Dutiable Cost Elements

Certain costs elements included in the price could potentially be removed and deducted for customs purposes since they might not be subject to duties or indirect taxes.

To give one example, non-dutiable cost elements may include after-sales or post-implementation services such as training, assembly, maintenance and warranty services. Other cost elements such as finance charges, inspection fees, sales and marketing costs, and certain types of commissions could also potentially be deducted based on a review of the supplier agreements and payment structure.

(5) HS Classification Engineering

It may be possible to change the state in which certain goods are imported to obtain a more favorable tariff classification. For example, breaking down a fully assembled product into components, subassemblies, or individual parts could subject the goods to different HS classification numbers that may be subject to a lower duty rate.

It may also be possible to proactively engineer products at the development stage so that they fall into a HS classification with a potentially lower duty rate. In addition, one country may classify a product differently than another country. In such cases, it may be possible to use one country's more favorable product classification decision to influence another country's product classification decision.

### 5.2.14 Import and Export Data Access

The Japan Customs Brokers Association (JCBA) provides Japanese importers and exporters access to their company specific import and export data through the Customs Clearance Information System (CCIS). Utilizing the CCIS, importers and exporters have on-demand access to download their import and export data.

## 5.3 Excise Duty

Excise duty is imposed on gasoline, tobacco, and liquor, etc. and is calculated based on the quantity of imported goods.

# 6 Other Taxes and Surcharges

## 6.1 Social Security and Payroll Taxes

Contributions to the national social and labor insurance systems are required in respect of employees in Japan.

Premiums are borne by employers and employees at the time of writing, as shown below.

(JPY)

| | Employee share | Employer share | Maximum premium |
|---|---|---|---|
| Health Insurance[1] | | | |
| On salaries[2] | 4.905% | 4.905% | 136,359/month |
| On bonuses | 4.905% | 4.905% | 562,113/year |
| Health Insurance[1] (including nursing care premium)[3] | | | |
| On salaries[2] | 5.725% | 5.725% | 159,155/month |
| On bonuses | 5.725% | 5.725% | 656,085/year |
| Welfare pension insurance | | | |
| On salaries[2] | 9.150% | 9.150% | 118,950/month |
| On bonuses | 9.150% | 9.150% | 274,500/month |
| Labor insurance[4] | | | |
| Employment insurance | 0.5-0.6% | 0.85-1.05% | - |
| Workman's accident compensation: | | | |
| - Non-manufacturing | - | 0.25-0.3% (generally) | - |
| - Manufacturing | - | Variable | - |

[1] A variable premium rate (total employee/employer shares —

in the range of 9.51 percent to 11 percent for people under 40 years old and in the range of 11.15 percent to 12.64 percent for people aged 40 or above) is set in each prefecture depending on the domicile of the employer's office. Rates and maximum monthly/annual premiums above are those for offices located in Tokyo.

(2) Applied to standard monthly remuneration amount

(3) Contributors who are 40 years of age or older are required to join a supplementary health insurance system, the nursing care insurance system (Kaigo Hoken), to support elderly residents.

(4) Applied to total salary, bonus and other compensation paid to employees

## 6.2 Stamp Duty

Stamp duty is imposed on certain taxable documents such as deeds and contracts. The levy is either based on the value involved or a flat rate. The maximum stamp duty liability is generally JPY600,000.

## 6.3 Fixed Assets Tax and City Planning Tax

Fixed assets tax is assessable on both real estate and depreciable assets which are in use in a business at 1.4 percent of the assessed value as at 1 January each year.

In addition, city planning tax is assessable on real estate at 0.3 percent of the assessed value.

## 6.4 Business Occupancy Tax

This tax is assessable by 'designated cities' (determined from among those having a population of 300,000 or more), as follows:

### 6.4.1 Taxpayer

Taxpayers for business occupancy tax purposes are companies or individuals operating a business at a place of business in a designated city.

### 6.4.2 Taxable Basis and Tax Rate

| Taxable basis | Tax rate |
|---|---|
| Size of premises for business use | JPY600 per square meter<br>(not assessable where the total space is not more than 1,000 square meters) |
| Gross payroll | 0.25%<br>(not assessable where the number of staff members, including officers, is not more than 100) |

### 6.4.3 Method of Collection of Business Occupancy Tax

(1) Companies

A return is required to be filed within 2 months after the end of each fiscal year and the tax paid thereon.

(2) Individuals

A return is required to be filed for each calendar year by 15 March of the following year and the tax paid thereon.

## 6.5 Registration and Real Estate Acquisition Tax

When certain information is legally registered, this is subject to a registration tax. Key registration events giving rise to such tax include the registration of a Japanese company or a branch of a foreign company and registration of a change in the legal ownership of real estate.

The following registration taxes apply on the establishment of an ordinary Japanese company or branch:

- Kabushiki Kaisha—0.7 percent of stated capital (minimum JPY150,000)
- Godo Kaisha—0.7 percent of stated capital (minimum JPY60,000)
- Branch of a foreign company—JPY90,000 (or JPY60,000 in certain limited circumstances)

On the transfer of real estate, the rate of registration tax will depend upon the nature of the transfer. The tax rates applied to the assessed value of the real estate at the time of writing are summarized below.

| | |
|---|---|
| Transfer of ownership by sale | 1.5% (Land)[1]<br>2% (Buildings) |
| Transfer of ownership by merger | 0.4% |
| Entrusting of real estate | 0.3% (Land)[2]<br>0.4% (Buildings) |

[1] Applicable for the period through 31 March 2023 (It will be increased to 2 percent from 1 April 2023 onwards.)

[2] Applicable for the period through 31 March 2023 (It will be increased to 0.4 percent from 1 April 2023 onwards.)

On the acquisition of real estate, real estate acquisition tax (local tax), will also be applied. This tax is levied at 4 percent of the assessed value of the real estate, however this tax rate has been reduced to 3 percent until 31 March 2024 for land and residential buildings. Furthermore, when land is acquired by 31 March 2024, the tax base of such land will be reduced by 50 percent.

## 6.6 Inheritance and Gift Taxes

Inheritance tax and gift tax are levied on an heir who acquires assets by inheritance and an individual (donee) who acquires assets from another individual (donor) as a gift, respectively. Rates for both taxes range from 10 percent to 55 percent.

### 6.6.1 Scope of Taxable Assets

The following table represents the scope of taxable assets of inheritance tax/gift tax:

| Heir / Donee — Decedent / Donor | | | Domicile in Japan | | No domicile in Japan | | |
|---|---|---|---|---|---|---|---|
| | | | | | Japanese national | | Non-Japanese national (I) |
| | | | (E) | (F) | Domicile in Japan within past 10 years (G) | No domicile in Japan within past 10 years (H) | |
| Domicile in Japan | | (A) | | | | | |
| | | (B) | | | | | |
| No domicile in Japan | Domicile in Japan within past 10 years | (C) | | | | | |
| | | (D)-1 | | | | | |
| | No domicile in Japan within past 10 years | (D)-2 | | | | | |

[Scope of taxable assets]

Both domestic and overseas assets

Limited to domestic assets

| | |
|---|---|
| (B) | Decedent/donor<br>• who has domicile in Japan and 'resident status' when an event occurs causing the inheritance/gift |
| (D)-1 | Decedent/donor<br>• who does not have domicile in Japan when an event occurs causing the inheritance/gift,<br>• who had been domiciled in Japan at a point in time within 10 years before an event occurs causing the inheritance/gift and<br>• who does not have Japanese nationality at any time of having domicile in Japan |
| (D)-2 | Decedent/donor<br>• who does not have domicile in Japan when an event occurs causing the inheritance/gift and<br>• who had never been domiciled in Japan within 10 years before an event occurs causing the inheritance/gift |
| (F) | Heir/donee<br>• who has domicile in Japan and a 'resident status' when an event occurs causing the inheritance/gift and<br>• whose total period of having domicile in Japan is 10 years or less within the past 15 years before an event occurs causing the inheritance/gift |

[Transitional measure]

Where a non-Japanese national living outside Japan (an heir/donee categorized in 'I') acquires assets located outside Japan from a non-Japanese national who left Japan before 1 April 2017 by inheritance/gift during the period from 1 April 2017 to 31 March 2022, inheritance tax/gift tax will not be imposed on the assets.

['Resident status' under the Immigration Control and Refugee Recognition Act]

'Resident status' in (B) and (F) above are from (i) to (v) of the Table 1 below.

| | | |
|---|---|---|
| Table 1 | (i) | Diplomat, Official, Professor, Artist, Religious Activities, Journalist |
| | (ii) | Highly Skilled Professional, Business Manager, Legal/Accounting Services, Medical Services, Researcher, Instructor, Engineer/Specialist in Humanities/International Services, Intra-company Transferee, Nursing Care, Entertainer, Skilled Labor, Specified Skilled Worker, Technical Intern Training |
| | (iii) | Cultural Activities, Temporary Visitor |
| | (iv) | Student, Trainee, Dependent |
| | (v) | Designated Activities |
| Table 2 | | Permanent Resident, Spouse or Child of Japanese National, Spouse or Child of Permanent Resident, Long-Term Resident |

## KPMG Tax Corporation


Tokyo Office
Izumi Garden Tower
1-6-1 Roppongi, Minato-ku
Tokyo 106-6012
Tel: +81 (3) 6229 8000
Fax: +81 (3) 5575 0766

Osaka Office
Osaka Nakanoshima Building 15F
2-2-2 Nakanoshima, Kita-ku
Osaka 530-0005
Tel: +81 (6) 4708 5150
Fax: +81 (6) 4706 3881

Nagoya Office
Dainagoya Building 26F
3-28-12 Meieki, Nakamura-ku
Nagoya 450-6426
Tel: +81 (52) 569 5420
Fax: +81 (52) 551 0580

Kyoto Office
Nihon Seimei Kyoto Yasaka Building 7F
843-2 Higashi Shiokoji-cho,
Shiokoji-dori Nishinotoin-higashiiru,
Shimogyo-ku
Kyoto 600-8216
Tel: +81 (75) 353 1270
Fax: +81 (75) 353 1271

Hiroshima Office
Hiroshima Kogin Building 7F
2-1-22 Kamiya-cho, Naka-ku
Hiroshima 730-0031
Tel: +81 (82) 241 2810
Fax: +81 (82) 241 2811

Fukuoka Office
Kamiyo Watanabe Building 4F
1-12-14 Tenjin, Chuo-ku
Fukuoka 810-0001
Tel: +81 (92) 712 6300
Fax: +81 (92) 712 6301

home.kpmg/jp/tax-en