Some 2006 tax law reforms become law

Director's bonuses

A number of the proposed 2006 reforms to Japan's laws governing individual and corporate taxpayers became law on March 27th, 2006 and the reform set to impact the most on domestic and foreign corporations doing business in Japan concerns the treatment of directors' bonuses. This issue was discussed in our last newsletter, however the recently announced cabinet orders give clearer guidance.

Prior to the reform, directors' monthly fixed salaries were basically allowed as an expense for the purposes of calculating corporate taxpayers' assessable income. However, directors' bonuses were not allowed as a deduction for the same taxpayers. Under the 2006 reforms, if certain conditions are met, directors' bonuses will be a claimable deduction for the purposes of calculating a corporate taxpayers' assessable income.

1) Regular and fixed amount salaries
Salaries paid regularly on a monthly basis or more frequently with the amounts being the same are allowed as an expense (director's compensations) for the purposes of calculating corporate taxpayers' assessable income. This was the case pre-reform.

2) Fixed amount salaries with defined payment timing
If the timing and amount of directors' salaries and bonuses is predetermined, the salaries and bonuses will be allowed as a deductible expense for corporate taxpayers. In order to benefit from this treatment, the application form is required be submitted to the tax office in advance.

For example, if a director receives two bonuses a year in addition to a regular and fixed amount salary, an application is required to be submitted in advance for the two bonuses to be allowed as deductible expenses for the company. If a director receives a monthly salary which differs from month to month, the application is required to be submitted in advance in order for the salary to be a tax expense for the company.

"In advance" means the earlier of: (a) the date on which the director's assignment commences, or (b) three months after the commencement of the corporate taxpayer's fiscal year.

2) Salaries linked to profitability indicators
Under the tax reform, salaries linked to profitability indicators are allowed as a deductible expense for corporate taxpayers, providing the following conditions are met.

1. The corporate taxpayer is a non-family, domestic corporation.
2. The subject person is managing director.
3. The salary is calculated in an objective way.
4. A limit is decided.
5. The calculation is the same as those for the corporate taxpayer's other managing directors' salaries.
6. The payment amount is decided in an appropriate way by a compensation committee, shareholders' meeting resolution, the board of directors' resolution based on a proposal by a compensation advisory committee or the board of directors' resolution (for a company which the board of directors is set up) by
the day decided under the cabinet order (three months from the last day of the corporation's fiscal year).

7. After the above procedures have been performed, the salaries are disclosed in the annual report etc. without delay.

8. One of the following conditions to be met as prescribed by the cabinet order. Specifically,
   1. The payment is made within one month from the time a profitability indicator is calculated.
   2. The payment is expended on the accounting ledger.

Deductibility of stock options

New accounting and tax rules with respect to stock options came into force on 1 May 2006 and 27 March 2006 respectively. These new rules give clear guidance on the required treatment of stock options, in stark comparison to the uncertainty of how stock options were to be treated pre-reform.

Under the reform, for accounting purposes, a corporation issuing a stock option is required to expense the appropriately assessed value of the stock option; the same amount being recorded in the equity section of the balance sheet. However, such an expense is not a tax deduction, resulting in the amount of the expense being added to the taxpayer's profits on its tax return.

If the stock option is exercised, for accounting purposes, the amount recorded in the equity section of the balance sheet will be transferred to paid-in capital. Under the tax reform, for individuals who receive stock options that are subject to salary income tax etc. at the time the options are exercised, the taxable amount on the individual side will be allowed as an expense for the purposes of calculating the corporate taxpayer's assessable income. Therefore, if the corporation issues a non-qualified stock option, the cost of the stock option can be claimed as a deductible expense. For qualified stock option plans where taxation on grantee is deferred until the disposition of stock, stock option costs are not deductible.

If the stock option has expired, for accounting purposes, the amount recorded in the equity section of the balance sheet will be transferred to income. However, the income amount as recorded in the books will be a claimable tax deduction.

Summary of tax treatment of stock options (for both individual and corporate taxpayers)

### Taxation on individual side

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### Accounting and taxation on corporation side

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Japan DTA Update

**Japan's new DTA with the United Kingdom**

Japan and the United Kingdom signed a new Double Tax Agreement (DTA) on February 2nd 2006 and it is expected to enter into force sometime in 2006. However, the changes impacting on investors to which the new DTA applies, will not come into effect until 2007.

Readers familiar with the Japan-US DTA ratified in November 2003 will immediately see the similarities, particularly the Limitations on Benefits (LOB) provision. Under the LOB article some of the DTA benefits, namely reduced rates of withholding tax (WHT) on certain types of income, are subject to certain conditions.

The major changes to the Japan-UK DTA include:

**Dividend WHT**

- A dividend paid to a shareholder having at least 50% of the voting power in the company paying the dividend will be exempt from WHT in the country in which the dividend paying company is located. This also applies to pension funds and pension plans, provided that the dividends paid do not relate to a business carried on by the fund or plan.
• A dividend paid to a shareholder who has between 10% and 50% of the voting of the company paying the dividend will be subject to 5% WHT.
• A dividend paid in all other cases will be subject to a reduced WHT of 10%.

These reductions do not apply in cases where the company paying the dividend can claim the dividend payment as a deduction on its overall income (e.g. Japan's Tokutei Mokuteki Kaisha or TMK). They also do not apply if the main purpose of the shareholder's arrangements is to obtain the benefit of the reduced WHT.

Under the current DTA a shareholder with at least 25% of the voting power in the company paying the dividend can claim a WHT reduction to 10%. A rate of 15% WHT applies in all other cases.

**Royalties**

There will be no WHT levied on royalty payments made between the countries, provided the payments are not attributed to a permanent establishment that exists in the source country. The exemption is subject to the LOB provision as well two specific inclusions in the royalties provision: (i) back-to-back royalty arrangements entered into with third-country residents are not entitled to DTA benefits, and (ii) the main purpose for an arrangement entered into is to take advantage of the royalty WHT exemption. Under the current DTA, royalties are subject to 10% WHT.

**Capital Gains**

Capital gains realised by a resident of a country from the alienation of shares in a company whose shares derive at least 50% of their value from immovable property located in the other country may be taxed in the other country. However gains will be not be subject to tax should they result from the sale of shares traded on a recognised stock exchange and the resident and related persons hold 5% or less of the total number of shares issues by the company.

Under the current DTA, if a UK shareholder makes a gain on the sale of its shares in a Japanese company, such a gain is taxable in Japan if the shareholder:
• holds at least 25% of the shares in the Japan company, and
• disposes of at least 5% of its share capital in the Japan company.

However, under the new DTA there will be an exemption from tax in Japan if the capital gains are subject to tax in the UK.

**Interest**

Certain types of interest received, namely by government, local authorities, central bank, financial institution etc. are no longer subject to interest WHT in the source country. In other cases, the rate of WHT will remain at 10%.

**Tokumei Kumiai**

Profits or gains derived from a Japanese silent partnership (or TK) are excluded from DTA protection and will be fully taxable according to Japanese domestic law. Under Japanese domestic law, such income is subject to 20% WHT.

**Stock Options**

Income or gains derived by employees under share or stock option plans between when they are granted to when they are exercised will be regarded as remuneration for the purposes of double tax relief under the employment income article.

Should an employee be granted an option and on exercise of the option be subject to tax under both Japan's and the UK's domestic laws, the country in which the employee is not resident at the time the option is exercised will be entitled to tax only a portion of the gain which reflects the period of time, between the grant and the exercise of the option, the individual was employed in that country.

"183 Day Rule"

Under the current DTA, a resident individual of one of the countries who is present in the other country for less than 183 days in any particular tax year and is paid salary by a non-resident and not charged as an expense to an entity in the other country, will not be required to pay tax in the other country on such income. The current treaty states that the 183 days can take place in any particularly tax year, allowing the individual to stay 183 days in the second half of a tax year and 183 days in the next tax year; the individual effectively residing in the other country for one year and escaping tax in that country.

Under the new DTA, the individual must reside in the other country for no more than 183 days in any 12 month period, preventing the taxpayer from using the loophole available under the current DTA.

**India, Japan Exchange Diplomatic Notes on Tax Treaty Protocol**

Aso Taro, Japan's Minister for Foreign Affairs, and Mani Tripathi, representing the Indian government, exchanged diplomatic notes on May 29 regarding the pending India-Japan
income tax treaty protocol. The protocol was signed on February 24 and will now enter into force on June 28.

Japan's Ministry of Finance on May 30 released the protocol, which will amend the India-Japan income tax treaty signed in New Delhi on March 7, 1989.

The protocol will reduce withholding tax rates to 10 percent on dividends, interest, and royalties and fees for technical services. The protocol will also delete the tax sparing provision. Under article 5 of the protocol, the new rates of withholding tax will enter into effect on July 1, 2006, in Japan and April 1, 2007, in India.

Revisions to some of Japan's other DTAs

Japan has agreed in the coming months to revise its Double Tax Agreements with the following countries: France, the Philippines and the Netherlands. Japan and the Philippines held talks in Manila on May 10 to revise their current income tax treaty, which was signed in 1980. Negotiations with the Philippines focused on revising tax rates on cross-border investments.

Japan-Canada Social Security Agreement

In a move designed to reduce the burden of Japanese and Canadian companies doing business in the other country, the Japan-Canada Social Security Agreement was signed earlier this year.

Prior to the agreement, employees from one country temporarily sent to the other were obliged to join the pension plans of both countries, resulting in extra payments for both employee and employer. Furthermore in most cases employees were unable to receive benefits from joining the other pension scheme as they had not been enrolled in the plan for the minimum required period.

The agreement alters the application of the social security systems of both countries as well as establishing entitlement to benefits of those temporarily sent to the other country by being able to calculate an aggregate enrolment period applicable to the time spent working in both countries. Under the agreement, employees sent who work in the other country for no more than five years shall in principle be subject only to the pension systems of the country from which they were sent.

NTA Issues Circular on how TK losses are to be treated by individual TK Investors (This article was first published in Tax Notes International, 17 April 2006)

A circular issued on 26 December 2005 by the chief of Japan's tax authorities (the NTA) to its tax auditors will have potentially serious ramifications for Japan tax residents investing through a Japan Commercial Code's Anonymous Association (commonly referred to as Tokumei Kumiai or TK).

The circular was released with the intention of removing a grey area with reference to how TK distributions, in particular losses, are recognised by individual taxpayers. The distinction hinges on whether the TK investor is deemed to be an "active" or "passive" investor. The circular provides that an active TK investor is one who is regarded as participating in the TK business, such as making important business decisions with respect to the TK business. A passive TK investor is any TK investor who is not an active TK investor.

The NTA chief's circular instructs the tax auditors to treat distributions received by individual passive investors in a TK arrangement as "miscellaneous income" and not "business income", the result being that such investors will be unable to offset any losses it may receive from the TK operator against its assessable income.

Active TK investors will be able to continue to recognise TK distributions they receive from the TK operator as business income or another income basket, such as lease income, if appropriate to the facts and circumstances.

While the circular is silent as to its effective date, sources close to the NTA believe that as it is an order from the chief to tax auditors, it is possible the change in categorisation may be enforced to not only tax returns filed for 2005 but also for earlier years, even as far back as the statute of limitations will allow.

It is believed a vast majority of passive TK investors recognise their TK distributions as business or lease income, hence the circular's release.
Individual TK investor’s treatment of losses

A TK is an arrangement in which silent investors contribute funds to a Japan operator (typically a company) conducting some form of business. In return for the investment, the operator then distributes profits / losses from its operation to the investor(s). The fundamental feature of TK arrangements is the prohibition of the TK investor having any control or management of the TK operator. However, as mentioned above, TK investors are able to make important commercial decisions concerning the TK operator's business and those who do will be classified as active TK investors. Those who don't make such decisions will be passive investors. Income received by individual passive TK investors, prior to the circular's release, could be classified as business income, which in turn enabled the passive investor to offset any losses distributed by the TK operator against its assessable income.

Overview of Individual Income Tax Treatment

In calculating a taxpayer's income tax liability, the individual's income is separated into "income baskets" and dealt with according to that particular income classification's rules. The income basket amounts are then aggregated and the total is taxed at the applicable marginal rate.

Article 22 of Japan's Income Tax Law identifies ten categories of income. A brief outline of these categories and tax treatments follows. All income, other than forestry income, retirement income and certain capital gains are aggregated as total assessable income and taxed at progressive rates.

Employment income

Salaries and bonuses received by the employee are included in this category, along with any other fringe benefits such as reduced rent or low interest loans received for services rendered to the employer. Business expenses related to the derivation of this income are not deductible however a standard employment deduction is available on a sliding scale relative to the amount of income earned.

Business income

Income received by an individual in the course of running a business is included in this category. Examples include income from agriculture, construction, manufacture, real estate, finance, wholesale and retail. Expenses incurred in the derivation of the income are deductible, including cost of goods sold, salaries, rents, utilities etc. As mentioned above, distributions from a TK arrangement to an active TK investor may be treated as business income. Losses distributed to an active TK investor in a TK arrangement will continue to be included with the taxpayer's assessable income, resulting in these losses being able to be offset against the TK investor's total assessable income, reducing their overall amount of income subject to income tax.

Rental (or lease) income

Income from leasing real estate, ships and aircraft are included in this category. Deductible expenses include property taxes, insurance, depreciation and repairs to the property. An active TK investor will be able to recognize distributions from a TK operator as lease income if the TK business is that of real estate investment.

Occasional income

Income non-recurring in nature such as life insurance payouts, prizes and gifts received from corporations, not derived from a transfer of assets or services rendered and not included in any of the other categories will be classified as occasional income. Half of the income amount less any expenses associated with the derivation of such income is included with the taxpayer's other assessable income.

Miscellaneous income

Income such as received pension payments, lecture fees, broadcasting payments and royalty payments received by taxpayers other than professional authors and not included in any other category of aggregate income is deemed to be miscellaneous income. The entire amount of miscellaneous income is included with other income. As a result of the NTA chief's circular, losses from a TK arrangement distributed to a passive taxpayer will be deemed to be miscellaneous income, "insulating" the losses, resulting in them being unable to be offset against the taxpayer's other assessable income.

Dividend income

Dividend income is included with other ordinary income with credits on any withholding tax paid allowed to minimize double taxation (at the corporate and shareholder levels).

Interest income

Interest is generally taxed at 20%, separate to other income.

Capital gain / loss income

Gains on the sale of stocks and real property are generally taxed separately from other income.

Retirement and Forestry income

Retirement and forestry income are taxed separately from the other categories of income.
Consequences for foreign TK investors
As TK arrangements are a popular investment structure with foreign investors, concerns have been raised about what impact the circular will have on their tax position. The circular does not address whether the TK operator would constitute a permanent establishment for a foreign active TK investor. However, as the benefit of being deemed an active or passive TK investor is predominantly only for resident taxpayers this cross-border issue is unlikely to arise.

Tokyo High Court agrees with taxpayer in deductibility of royalties case
On 15 March 2006 the Tokyo High Court agreed with rulings decided by lower courts in Nagoya and held in favour of the taxpayer in a case which examined the deductibility of royalties paid by a Japanese corporate taxpayer to an affiliate in Singapore. The court overturned the corrective measures ordered by the tax authorities.

The NTA challenged a number of agreements entered into between Ichijyo Koumuten (an earthquake-proof housing company) and its affiliates, and subsequently ordered the company pay additional tax. The NTA also revoked the company's status as a blue tax return filer. The NTA was of the belief that the purpose of transferring know-how to the Singapore subsidiary was to reduce the corporate income tax on royalty income and to reduce inheritance tax liability payable on the death of A's death or A's father's death. As a result, the company commenced legal proceedings against the NTA.

The franchise agreements
IJK was set up for the purpose of acting as an R&D company in the IK group. Before IJL was set up, franchise agreements on the operation of the house builders were entered into between IK and franchisees. After IKJ was set up, franchise agreements were into between IK, IJK and franchisees (IKG). The taxpayer and IK supplied trademarks and business systems (e.g. special knowledge, technique, data, manual) related with house construction to franchisees and the franchisees paid a royalty fee to IK and IKK as consideration.

Know-how agreement
A know-how agreement was entered into between the taxpayer and IK. The taxpayer continued to develop existing know-how in addition to creating know-how and supplied this to IK. IK paid the taxpayer a royalty as consideration.

Know-how and database transfer agreement
A know-how and database transfer agreement was entered into between the taxpayer and the Singapore company (S). The taxpayer transferred manuals, know-how and databases, which it had developed from the time it commenced operations, to S. S paid the taxpayer 2 billion consideration.

Points of dispute
The issue before the court was whether the know-how and database transfer agreement was part of a disguised act to reduce its income tax liability. In addition it was argued whether the consideration paid under this agreement was a donation or not. More specifically,

1. Whether the know-how etc. under the concluded agreement between the taxpayer and IK was attributed to IK or the taxpayer.
2. Whether there was any economic substance to the know-how and database transfer agreement.
3. Whether transactions and accounting treatments can be denied or not when the intention of reducing corporate tax is identified.

Nagoya district court (judgment handed down 2005/9/29)
The Nagoya district court discussed the existence of economic substance. It held that S was the research and development (R&D) department responsible for the development of technology related with houses located overseas. This role was part of its business strategy - to focus on the increased growth of the IK group. The court added it was clear S had invested a huge amount of money in R&D with substantial personnel and physical infrastructure and as such the IK group's
entire R&D ability was concentrated in S. This was found (i) consistent with the taxpayer's previous arrangements and (ii) S had expected to establish an efficient R&D system through this arrangement. The court, therefore, held that there was economic substance to the agreement. It concluded that the money transfer based on this agreement should not be treated as a donation.

**Nagoya high court (judgment handed down 2006/2/23)**

The Nagoya high court discussed to which entity most of the know-how etc. should be attributed. It held that a major reason for establishing the taxpayer was to separate its R&D department, allowing it to specialize in further developing construction techniques and house equipment. The court held that under these circumstances, it was possible to argue that know-how etc. previously held by IK was transferred to the taxpayer. Additionally, from this reasoning it was also possible that royalties IK paid the taxpayer was consideration for the usage of the know-how etc.

The court dismissed the argument put forward by the tax authorities that IK should bear the costs associated with the know-how research and development simply because of the payments IK made IK to the taxpayer. Further, the court also held that it did not necessarily follow that the know-how should be attributable to IK for the only reason that some patents were attributable to IK.

The court also held that the existence of the purpose to reduce inheritance tax was only a presumption by the appellant, and the conclusion that the transfer was a fictional transaction cannot be drawn, even if the purpose of reducing corporate tax exists, as long as S is a corporate organization with substance and there is an economic basis to the transfer of know-how.