Doing Business Guide

Japan

PART I

GENERAL BUSINESS ENVIRONMENT

Chapter 1　Introduction - Japan

1.1　Why Japan

The "3 Windows on Japan" is on the value of setting up new businesses in Japan. Discover the three advantages Japan offers foreign companies when investing in Japan; (1) Innovation Hub, (2) Business Platform and (3) Trendsetter.
Currently, the world's eyes are on Asia. Japan is full of business opportunities due to its strong ties with this rapidly developing region.

In Asia, Japan
(1) is recognized as a leading center for innovation and,
(2) boasts highly attractive business and living environments, in terms of safety, medical services, etc.
(3) is one of the world's largest economies, is also attracting increasing global attention for its "soft power," i.e. a positive view of Japan in the areas of fashion, contents, food and more.

Japan has great potential to become a regional hub and an R&D center in Asia, as exchanges of personnel, goods and money accelerate within Asia.
(Manufactured Imports and Investment Promotion Organization (MIPRO))
Full text(http://www.jetro.go.jp/en/invest/whyjapan/pdf/3_windows20110830_en.pdf)

1.2 Population

- Total Population: 128.057 million (2010)

- Composition by age group (2010)

<table>
<tr><th>Age</th><th colspan="2">Composition</th></tr>
<tr><td>0 - 9</td><td>9%</td><td rowspan="2">19%</td></tr>
<tr><td>10 - 19</td><td>10%</td></tr>
<tr><td>20 - 29</td><td>11%</td><td rowspan="4">51%</td></tr>
<tr><td>30 - 39</td><td>14%</td></tr>
<tr><td>40 - 49</td><td>13%</td></tr>
<tr><td>50 - 59</td><td>13%</td></tr>
<tr><td>60 - 69</td><td>14%</td><td rowspan="4">30%</td></tr>
<tr><td>70 - 79</td><td>10%</td></tr>
<tr><td>80 - 89</td><td>5%</td></tr>
<tr><td>90 -</td><td>1%</td></tr>
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- Life expectancy: male 79.64; female 86.39 (2010)
- Birthrate: 1.37 (2009)
- Ethnic groups: Japanese 98.3%; Chinese 0.5%; Korean 0.4%; Other 0.8% (2010)

1.3 Government

- Type: A parliamentary government with a constitutional monarchy
- Capital: Tokyo
- Administrative divisions: 47 prefectures
- Legal system: civil law system based on the German model; system also reflects Anglo-American influence and Japanese traditions; judicial review of legislative acts in the Supreme Court
- Suffrage: 20 years of age
- Executive branch
  - i) Chief of state: Emperor AKIHITO
  - ii) Head of government: Prime Minister Yoshihiko NODA
  - iii) Cabinet: the cabinet is appointed by the prime minister
  - iv) Elections: the Diet designates the Prime Minister; the constitution requires that the Prime Minister commands a parliamentary majority, following legislative elections. The leader of the majority party or leader of the majority coalition in House of Representatives usually becomes the Prime Minister; the monarchy is hereditary.
- Legislative branches: the bicameral Diet or Kokkai consists of the House of Councillors or Sangi-in and the House of Representatives or Shugi-in; the Prime Minister has the right to dissolve the House of Representatives at any time with the concurrence of the Cabinet.
- Judicial branch: the Supreme Court (the Chief Justice is appointed by the monarch after designation by the Cabinet; all other justices are appointed by the Cabinet)
- Major political parties and the leaders: Democratic Party of Japan or DPJ [Yoshihiko NODA]; Liberal Democratic Party or LDP [Shinzo ABE]
- Political pressure groups and leaders: business groups; trade unions

1.4 Economy

Economy

- GDP (purchasing power parity):
  - i) USD 4.389 trillion (2011 estimate)
  - ii) USD 4.41 trillion (2010 estimate)

iii) USD 4.242 trillion (2009 estimate)

- GDP - real growth rate:
  i) -0.5% (2011 estimate)
  ii) 4% (2010 estimate)
  iii) -6.3 (2009 estimate)
- GDP - per capita
  i) USD 34,300 (2011 estimate)
- GDP - composition by sector: Agriculture: 1.4%; Industry: 26.2%; Services: 74.6% (2011 estimate)
- Labor force: 64.97 million (June 2006 estimate)
- Unemployment rate: 4.8% (2011 estimate)
- Budget: Revenues: USD 1.964 trillion; Expenditures: USD 2.483 trillion (2011 estimate)
- Inflation rate: 0.4% (2011 estimate)
- Central bank discount rate: 0.3% (31 December 2009)
- Commercial bank prime lending rate: 1.4% (31 December 2011 estimate)
- Exports: USD 800.8 billion (2011 estimate)
- Imports: USD 794.7 billion (2011 estimate)
- Exchange rates: Yen (JPY) per USD
  i) 79.67 (2011)
  ii) 87.78 (2010)
  iii) 93.57 (2009)
  iv) 103.58 (2008)
  v) 117.99 (2007)

PART II

BUSINESS ENTITIES

AND

LEGAL REQUIREMENTS

Chapter 2 Types of Business Enterprises in Japan

2.1 Summary of the types

The common types of business enterprises in Japan are:

1. Kabushiki Kaisha (Joint Stock Company, abbreviated K.K.)
2. Branch Office (Shiten)
3. Representative office of a foreign company
4. Partnership
5. Joint Venture
6. Non-Profit organization

Chapter 3 Kabushiki Kaisha

3.1 Formation Procedures

There are two methods for the incorporation of a Kabushiki Kaisha. One is “Promotive incorporation”, where the promoters subscribe all of the shares to be issued at incorporation, and the other is “Incorporation by offering”, where only a portion of the shares are issued to promoters, and the remainder are offered to private or public subscribers.

“Incorporation by offering” is an appropriate method to make the scale of the entity large. However, the procedures are complex compared with a “Promotive incorporation” since it requires advertising for subscribers, an inaugural meeting to be held to elect the directors, etc.

3.2 Articles of Incorporation

The Articles of Incorporation are the basic rules of a company. They are sometimes called the constitution of the company.

The Articles of Incorporation of a Kabushiki Kaisha must include the following information

- Objective(s)
- Trade name
- Location of the head office
- Value of the property to be contributed at the time of incorporation or the lower limit thereof
- Name and address of each promoter
- Total number of Authorized Shares

It used to be prohibited to use of the same name or a name that could be confused with the name of another company that already exists in the same municipality. Now it is possible to set up a company if its address is not the same. However the Company Code prohibits the use of a name that may be mistaken for another company if the purpose of this is dishonest.

The Articles of Incorporation must be signed by the promoters and attested to by a Japanese notary public.

3.3 Execution of a capital injection

1. Execution of a capital injection

In the case of a "Promotive incorporation", the promoter has to pay the full amount of the subscribed shares without delay. In the case of "Incorporation by offering", the subscribers of the shares have to pay the full amount of the subscribed shares by the deadline or during a period that the promoter determines.

3.4 Execution of a capital injection

① Shareholder's meetings and the Directors

Every Kabushiki Kaisha must hold shareholders' meetings since this is the decision-making body of the company. Shareholders' meetings cannot execute decisions on behalf of the K.K. Thus, directors are also necessary for every K.K.

② Board of Directors

An open corporation[1] is a company with a board of company auditors and a company with committees[2] must have a Board of Directors. It is possible to have a Board of Directors, even though it is not necessary to set it up.

If a Board of Directors is set up, it needs to have at least one auditor, audit committee, or accounting advisor. However, if the company is a large company[3] it should have an auditor or audit committee.

The Board of Directors must be composed of at least three directors.

If a Board of Directors is not set up in a company, the shareholders' meetings can decide on all matters concerning the company. However, if a Board of Directors is set up, a shareholders' meeting can only decide on those matters that the Commercial Code of Japan and the Articles of Incorporation define.

Each director has authority to execute business in a company without a Board of Directors. On the other hand, in a company with a Board of Directors, the Board of Directors makes the decisions and a representative director or an executive director

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[1] An open corporation is a company that has no restrictions on stock transfers.

[2] A company with committees is a company that has a nominating committee, audit committee and benefit committee. Each commissioner is appointed from the Board of Directors. Thus, each committee is set up as an organ of the Board of Directors.

[3] A large company means a company whose capital is over 500 million JPY or its liability is over 20 billion JPY.

executes the company business.

③ Auditors

A company with a Board of Directors and a company with an accounting auditor should have an auditor, in principal. However, if this company is a company with committees, it is prohibited from having an auditor. This is because a company with committees has an audit committee that supervises the company business. Its function is the same as that of an auditor.

④ Other organs

An Open Corporation formed out of a large company that is not a company with committees should have a Board of Auditors or an Accounting Auditor. A company with committees and a large company that is not an open company should have an Accounting Auditor.

3.5 Shareholders' meetings

There is a difference in the authority of a shareholders' meeting between a company with a Board of Directors and other companies.

In a company with a Board of Directors, the shareholders' meeting can decide only on matters that the regulations and the Articles of Incorporation determine.

On the other hand, in a company that has no Board of Directors, the shareholders' meeting can decide on all matters concerning the company's business.

A shareholders' meeting is called by a director, unless it is called by a minority stockholder

In a company that has no Board of Directors, the directors determine the date, place, etc. In a company with a Board of Directors, the Board of Directors decides on the details and the representative of director calls the meeting.

There are two kinds of shareholders' meetings. One is an annual meeting and the other is an extraordinary general meeting. An annual meeting should be called within three months after the end of the business year. An extraordinary meeting may be called whenever it is required.

3.6 Directors and the Board of Directors

⑤ Authority of a director

In a company that has no Board of Directors, a director executes the company business unless there is a special provision in the Articles of Incorporation. In cases where there are more than two directors, the company business is decided by a majority of the directors unless there is a special provision in the Articles of Incorporation. Each director has the authority to represent the company and to act on everything related the company's business, regarding both legal and non-legal matters.

In a company with a Board of Directors, each director does not have the authority to be the representative. The Representative Director has rights of representation and can act on anything related to the company business, regarding both legal and non-legal matters. Decisions on the company's business are made by the Board of Directors and their actual execution is performed by the Representative Director or Executive Director. Each director supervises the execution of business by the other directors through the board, as a member of the Board of Directors.

⑥ Appointment and dismissal of a director

- In a Kabushiki Kaisha, it is necessary to appoint at least one director and in a company with a Board of Directors, it necessary to appoint at least three directors. In addition, it is possible to determine the number of directors in the Articles of Incorporation. It is possible to determine a fixed number or a lower limit, but it is normal to set an upper limit.
- Corporate bodies, adult wards, persons under curatorship and persons who have a certain criminal history cannot be appointed as a company director. On the other hand, minors[4] or bankrupts can be appointed. In addition, it is possible to impose conditions that a director should have certain qualifications.

  It is prohibited to act as both a director and as an auditor of the same company or the auditor of its parent company. An auditor supervises the company business and has a right to survey any subsidiary company. It is inappropriate for someone to be both an auditor carrying out an audit and a person who is subject to auditing at the same time.

  It is also prohibited to be at the same time both a director and an accounting adviser of the same company or its parent company. This is to protect the independence of the accounting adviser.

  It is possible to be both a director and an employee except in a company with committees. This is to ensure that a company with committees makes a distinction between the execution of the company business and the supervision of it.
- The directors are appointed by a decision of the shareholders' meeting.
- The term of a director's duties is until its determination at an annual shareholders' meeting for the last accounting year of a period within two years after the appointment, in principle. However, the Articles of Incorporation or a decision of a shareholders' meeting can determine a shorter period. In a company that is not an open company or a company with committees, the period can be extended to a maximum of ten years.
- The relationship between a company and a director is a mandate. Directors can

[4] A person under 20 years old

resign at any time. However, if the termination of the term or resignation causes a shortfall in the number that is determined by the Companies Act or the Articles of Incorporation, the directors still have the duties and rights of a director until a new director is elected.

- A shareholders' meeting can dismiss the directors at any time. A director who is dismissed can claim for losses unless there are justifiable grounds.

3.7 Auditor

⑦ Installation of an Auditor and a Board of Auditors.

The Auditor is an agency to audit the execution of the company business by the directors (if there is an accounting adviser, the auditor also audits the accounting adviser.)

In a Kabushiki Kaisha, it is necessary to have a director, but an auditor or a Board of Auditors is not necessary. This can be determined by the Article of Incorporation.

It is prohibited to appoint an auditor to a company with committees.

In a company with a Board of Directors it is necessary to appoint an auditor in principle, unless it is a company with committees or a company with an accounting adviser that is not an open company. In a company with an accounting auditor it necessary to appoint an auditor unless it is a company with committees.

In a large company, it is necessary to appoint a Board of Auditors unless it is not an open company or is a company with committees.

	Auditor		Board of Auditors
It is necessary, in princip	Company with a Board of Directors	Company with an accounting audi	Large company
It is not necessary	・Company with a Board of Direc that is a company with committe ?Company that is not open and w an accounting adviser.	Company with an accounting auditor that is a company with committees	・Company that is not open ?Company with committees

⑧ Appointment of an Auditor

- Corporate bodies, adult wards, persons under curatorship and persons who have a certain criminal history cannot be appointed as the Auditor. On the other hand, minors[5] or bankrupts can be appointed. In addition, it is possible to establish a condition than the Auditor should have certain qualifications.
- The Auditor is elected by a decision of the shareholders' meeting.

[5] A person under 20 years old

⑨ Right to agree to the agenda for a new appointment

- Directors should obtain the Auditor's consent (if there are more than two auditors, the majority of them. If it is a company with a Board of Auditors, its consent.), before proposing the agenda item related to the appointment of auditors at a shareholders' meeting.
- The Auditor (or the Board of Auditors, if it is a company with such a board) can ask the directors to make the appointment of an auditor the purpose of the shareholders' meeting.
- Auditors can comment on the appointment of auditors at a shareholders' meeting.

⑩ Prohibition on holding concurrent posts

It is prohibited for auditors to at the same time also hold the post of a director in the same company or a subsidiary company, or be an employee of the company or employee of a subsidiary company.

⑪ Number of auditors and outside company auditors

In a company with a Board of Auditors, the number of auditors should be three or more and the majority of the auditors should be outside company auditors.

⑫ Term of the duties

The term of the duties of an auditor is, in principle, until its determination at an annual shareholders' meeting for the last accounting year of a period within four years after the appointment. In contrast to directors, it is not permitted to shorten the term of the duties of auditors in order to protect their status so as to enable them to properly execute their duties.

On the other hand, except for open companies, it is possible to extend the term until its determination at the annual shareholders' meeting of the last accounting year of a period within ten years after the appointment.

⑬ Dismissal of an auditor

The dismissal of an auditor may be caused by the termination of duties, resignation from the duties, the loss of the qualification to perform as an auditor or a change in the Articles of Incorporation.

If the number of auditors is less than the required number after the termination of duties, etc., the auditor still has duties and rights until the new auditors are elected.

A shareholders' meeting can dismiss the auditors at any time. Any auditor who is dismissed can claim for losses unless there are justifiable grounds for the dismissal.

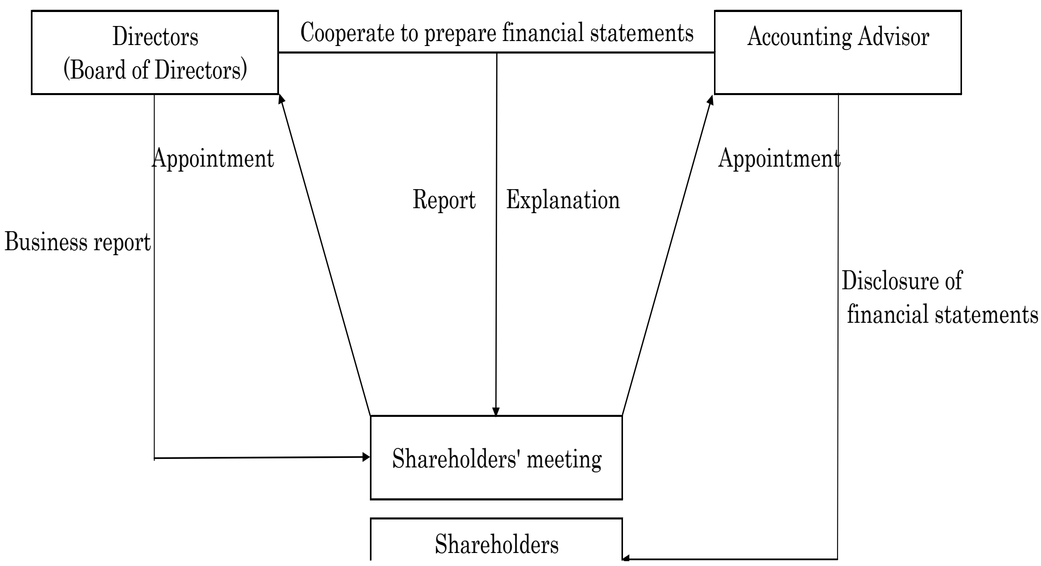
3.8 Accounting Advisors

⑭ Functions of an accounting advisor

Any Kabushiki Kaisha can appoint an accounting advisor based on the Articles of Incorporation. An Accounting Advisor is one of the company entities that the CPA (included audit corporation) or Certified Public Tax accountant (included a Tax Accountant Corporation) can assume. Any accounting advisor makes financial statements in collaboration with the directors.

It is necessary for a company with a Board of Directors that it should not have an Auditor and that if it is not an open company that it should not have an Accounting Advisor.

Functions of the Accounting Advisor



⑮ Relationship between the Company and the Accounting Advisor

The relationship between the Company and the Accounting Advisor is mandatory. The charges for the Accounting Advisor are based on the Articles of Incorporation. If there is no description concerning the fees in these articles, they are determined by a shareholders' meeting.

⑯ Appointment of an Accounting Advisor

Only a CPA (including an Audit Corporation) or a certified public tax accountant (including a Tax Accountant Corporation) can be appointed as an Accounting Advisor.

3.9 Accounting Auditors

・ An Accounting Auditor has a duty to audit the financial statements. Large companies (unless it is not an open company) or companies with committees should have an Accounting Auditor.

The qualifications of an Accounting Auditor are limited to certified public accountants (CPA) or auditing corporations (Kansa Houjin).

To maintain the independence of the Accounting Auditor, the participation of an accounting auditor (the Board of Directors in the case of a company with a Board of Directors) in the appointment, dismissal, fees, etc., is required.

3.10 Companies with committees

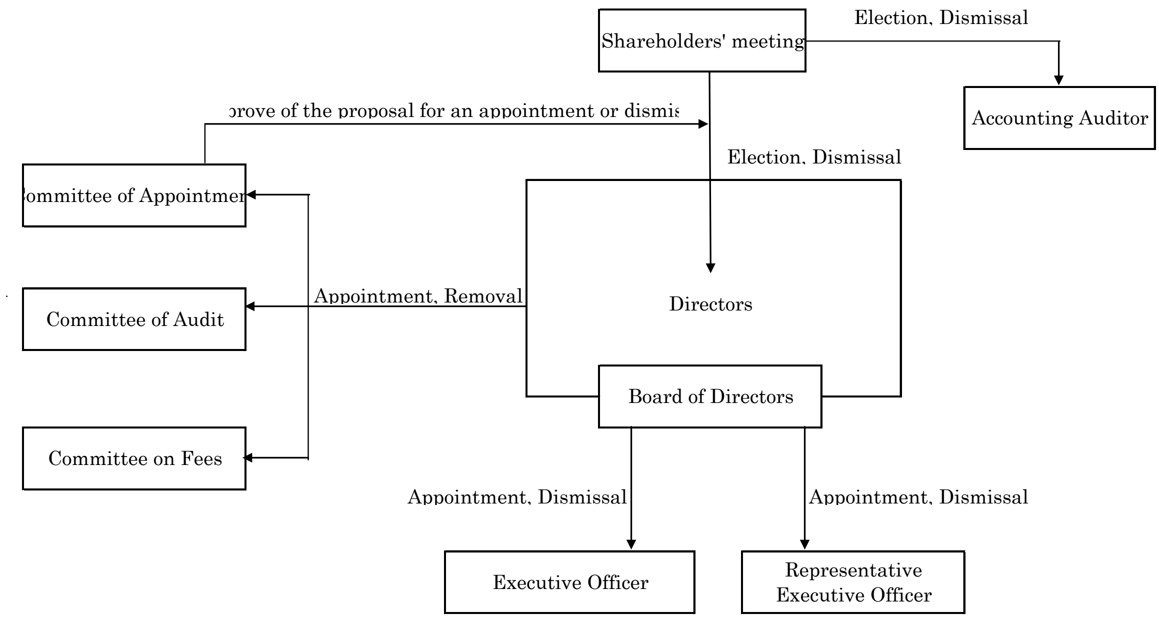
⑰ Purpose

A company with committees is a company that has a nominating committee, an audit committee, and a compensation committee according to the provisions of the Articles of Incorporation.

To be a company with committees, the size of the company is not relevant, or whether or not it is an open company. However, it is necessary to be a company with a Board of Directors. A company with committees has an Audit Committee, so it should not have an Auditor.

Members of the committees are appointed from the Board of Directors by a resolution of a Board of Directors meeting. The number of members of each committee needs to three or more. The majority of the members of each committee should be outside directors.

tionship between the Board of Directors and the commi



⑱ Directors and the Board of Directors

Ⅰ Appointment and term of the duties of a director

In a company with committees, the directors are appointed by a shareholders' meeting. The shareholders' meeting makes decisions concerning proposals that a nominating committee brings to it.

The term of a directors' duties is until the determination of the annual shareholders' meeting for the last accounting year of a period within a year after the appointment.

Ⅱ Authority of a director

In a company with committees, the Board of Directors has the authority to make decisions concerning all of the company's business. In addition, certain affairs can only be decided by the Board of Directors.

The Board of Directors in a company with committees supervises the execution of the business by the executive officers, etc, (the Executive Officer, Directors, Accounting Advisor).

In a company with committees, each committee makes the decisions and executes the company business concerning matters determined by a decision of the Board of Directors.

⑲ Duties and Fees of directors

In a company with committees, the directors are not allowed to execute the company business, in principal.

A director can also be an executive officer, but cannot be an employee.

The fees for directors are determined by a compensation committee.

⑳ Committees

In a company with committees, a Nominating Committee, an Audit Committee and a Compensation Committee should be appointed.

A committee can call on each of the directors to perform as committee members. It is necessary to assure the right to call on outside directors. Therefore, it is not allowed to concentrate on the right to call only on certain directors for membership.

The Executive Director, Directors and Accounting Advisors are required to explain affairs whenever a committee requests them to do so.

A member of a committee that is selected by the committee is required to explain the situation of the performance of the committee to the Board of Directors.

21 Nominating Committee

A Nominating Committee has the authority to determine the agenda of the election and dismissal of the directors.

22 Audit Committee

In a company with committees, an Audit Committee must be appointed. Auditors cannot be appointed in place of such a committee. More than half of the committee members should be outside directors.

The Audit Committee has the authority to supervise the execution of business by the Executive Officer, etc.

23 Compensation Committee

A Compensation Committee shall prescribe the policy regarding the contents of the remuneration for individual executive officers, etc.

24 Executive Officers

In a company with committees, one or more Executive Officers are elected by a resolution of the Board of Directors. An Executive Officer cannot at the same time act as a director, or a member of an audit committee or an accounting advisor.

Chapter 4　Branch Offices (Shiten)

4.1 Branch Offices

A branch office is referred to as a "place of business" (eigyo sho) under the Companies Act. It is the simplest form of vehicle through which a foreign company may fully conduct its business in Japan with a physical presence.

4.2 Formation

If a foreign company intends to establish a branch office in Japan, it must first appoint one or more representatives in Japan (at least one of the representatives must be a Japanese resident).Then, the foreign company must file a registration application with the relevant local legal affairs bureau (Houmu Kyoku) within three weeks of the appointment of the representative. After such commercial registration, the foreign company may engage in business transactions on a continuing basis.

4.3 Representative

At least one representative of a branch office in Japan must be a resident of Japan. However, such a representative does not need to have Japanese citizenship.

The appointed representative in Japan is deemed to have the full statutory powers and authority to represent and bind the foreign company in all transactions and in any court proceedings in connection with the business of the foreign company in Japan. Any restrictions on such powers and authority under a contract or other methods cannot be asserted against bona fide third parties. The foreign company shall be liable for any damage incurred by third parties and caused by the representative in Japan in connection with the performance of his/her duties.

4.4 Registration

Once the local representatives have been appointed, the company must then file a registration application with the relevant local legal affairs bureau.

4.5 Requirements

When a foreign company first appoints its representative in Japan in order to engage in transactions on a continuing basis in Japan, the foreign company must apply for the registration of the foreign company within three weeks of the appointment with the relevant legal affairs bureau.

The application must be submitted to the legal affairs bureau having jurisdiction over the location of the branch office, if a branch office is established, or the residential address of the representative in Japan, if no branch office has been established.

Chapter 5　Representative Office of a foreign

company

The activities of a Representative Office are limited to the collection and dissemination of information on behalf of a foreign company and no business transactions may be undertaken within Japan. A representative office is therefore not taxable in Japan, provided it only operates in its representative capacity. Permission to establish a Representative Office is normally only required with respect to foreign banks, securities and investment management companies.

Chapter 6 Partnerships

The following four types of partnerships exist in Japan
(ⅰ) a partnership (nin-i-kumiai)
(ⅱ) a general partnership company
(ⅲ) a limited partnership company
(ⅳ) a limited liability business partnership

6.1 Partnership (Nin-i-kumiai)

A Nin-i-kumiai("NK") is formed by way of a partnership agreement in which two or more persons agree to jointly conduct business. The NK does not have any corporate veil.

The establishment of an NK requires two or more partners. If the number of partners of the NK decreases to one, the NK will be dissolved.

Unless otherwise provided for in the partnership agreement, each partner of the NK has unlimited liabilities and obligations in relation to the NK in proportion to the ratio of their contributions. Contributions by partners may be made by credit or by the provision of labor.

Each partner may assign their partnership interests in the NK pursuant to an applicable partnership agreement or with the consent of all the partners. Any member of a partnership may withdraw from the NK for unavoidable reasons.

The formation of an NK is accomplished by the execution of a partnership agreement. There is no registration requirement with respect to the formation of an NK.

The properties and assets of an NK are subject to joint ownership among the partners of the NK concerned. However, the partners of an NK may not request a break-up of the property if the NK remains in existence and is restricted from the disposal of the partner's interests in the properties and assets of an NK.

Unless otherwise provided for in the partnership agreement, the business affairs of an NK are operated based on the consent of the majority of the partners.

6.2 General partnership company and limited partnership company

A general partnership company (Gomei gaisha) consists of unlimited liability members only. Any member of a general partnership company is directly liable for the full amount of debts and obligations of the general partnership company to creditors of the company (direct unlimited liability).

A limited liability company (Goshi gaisha) consists of unlimited liability members and may have limited liability members. Each unlimited liability member is directly liable for the debts of the company to creditors.

6.3 Limited liability business partnership (LLP)

① LLP

An LLP is a partnership under the Law concerning Limited Liability Business Partnership Contracts (The LLP Law).

Each partner is responsible for the liabilities of the partnership only to the extent of the amount of the contribution that was provided. However, if one of the partners behaves with malicious intent or is grossly negligent in their duties, then their liability may exceed the amount of such a contribution.

The distribution of profits and the allocation of losses may be made without regard to the ratio of the contribution by any partner, pursuant to the partnership agreement.

Unless otherwise provided for in the applicable partnership agreement, a partner may assign its partnership interests in the LLP to third parties only with the consent of all the other partners. Any partner may withdraw from the LLP without the consent of the other partners if there are any unavoidable reasons, unless otherwise provided for in the applicable partnership agreement.

② Formation of an LLP

An LLP is formed effectively upon the execution of a contract (Partnership agreement) between or among individuals/companies (partners) by which it is possible to jointly carry on a business for commercial purposes, and the making of a contribution (in cash or other types of property only, not credit or labor) by each partner.

③ Residency requirement

At the time of the formation of an LLP and thereafter, the LLP must have at least two partners and at least one partner must either be an individual who has an address in Japan or has had a domicile in Japan for a consecutive period of one year or more, or a company having a head office or principal office in Japan.

④ Operations

Since the LLP does not have any separate corporate existence, it does not have any corporate organization, such as a shareholders' meeting or a board of directors. The operation of the business affairs of the LLP are decided by the unanimous consent of all the partners, unless otherwise provided for in the partnership agreement.

One of the most important characteristics of the LLP is that each partner of the LLP must be involved in the operations of the LLP

⑤ Property of the LLP

Since the LLP does not have a separate corporate existence, any property or assets of the LLP are legally considered to be jointly owned by all the partners. However, since the disposal and break-up of the property of an LLP is restricted, its property is independent of each partner to this extent.

The registration of real estate and industrial property rights of the LLP may be made in the name of all the partners in a description of the LLP. If the business to be conducted by the LLP requires government permits and licenses, each partner may need to obtain them.

The property of the partnership cannot be distributed beyond the net assets after the deduction of three million yen or the total amount of the contributions, whichever is the lesser.

⑥ Financial statements

Financial statements such as a balance sheet and income statement of profits or losses must be prepared and made available to any creditors. However, unlike a joint stock corporation, an LLP is not obliged to publicly disclose these documents.

⑦ Tax treatment

Since the LLP does not have any separate corporate existence, it is eligible as a "pass-through" entity for tax purposes. However, any losses of the LLP beyond the amount calculated based on the capital contribution of any corporate partner may not be deductible from the taxable income of such a corporate partner.

6.4 Limited liability company (LLC)

⑧ LLC

A limited liability company ("LLC") is a new type of company in Japan, modeled on the limited liability company in the US.

An LLC can be established and survive with a sole shareholder. The LLC is constituted by the "limited liability members" only. Each limited liability member of the LLC is liable for the debts and obligations of the LLC to the extent of the amount of their contribution as stated in the Articles of Incorporation.

However, since each member has a duty to operate the business affairs of the LLC, if they fail to perform such duties, they may be liable for the payment of compensation in the event of damage caused to the LLC or third parties.

⑨ Formation

An LLC is legally formed upon the registration of incorporation at the location of its principal office, after going through the preparation of the Articles of Incorporation and a capital contribution by the persons considered to be its initial members.

Any contribution to the LLC must be in property such as cash. No credit or labor services can be contributed for the formation of an LLC.

⑩ Operations

Any fundamental issues must be determined with the consent of all the members.

Unless otherwise provided for in the articles of incorporation, each member has the duty and authority to operate the LLC's business affairs and to represent the LLC. If any member with the duty to operate its business affairs is not a natural person, then that member must appoint a person who will actually perform the relevant duties.

A shareholders' meeting and a board of directors as required in a joint stock corporation are not required for an LLC. No accounting auditor can be appointed by an LLC, even if its size is the same as a "large corporation" of a joint stock corporation. In addition, no LLC is obliged to facilitate an internal control system or to disclose its balance sheet to the public, as is required for a joint stock corporation.

Accounting and the dividend distribution of the surplus of the LLC shall comply with similar rules as are applicable to a joint stock corporation.

⑪ Tax treatment

During the course of preparing the bill on the Companies Act, the LLC was intended to be a pass-through entity in terms of tax treatment, as it is in the US. However, under the current Companies Act, an LLC is not eligible to be a pass-through entity for Japanese tax purposes.

⑫ Assignment of an LLC's interests and withdrawal

The assignment of an LLC's interests by a member requires the consent of all the other members, unless otherwise provided for in the Articles of Incorporation. However, the assignment of an LLC's interests by a limited liability member having no duty to operate the business affairs of the LLC will require only the approval of other members having the duty to operate its business affairs.

Nonetheless, a member may at any time withdraw from the LLC for any "unavoidable reason", even if his or her withdrawal is restricted in the Articles of Incorporation. Withdrawing members are entitled to receive a refund in cash for their contribution.

The name, address and amount of the LLC interests of each member of an LLC must be set out in its Articles of Incorporation, and the name of each member authorized to operate the business affairs or to represent the LLC must be recorded in the commercial registry. Accordingly, any change to these matters as the result of the assignment of LLC interests requires amendment to the articles and application for registration, as applicable.

6.5 Differences between an LLP and an LLC

- An LLC can be incorporated and exist with only one member. However, an LLP always requires two or more partners.
- Every partner of an LLP must be involved in the operations of the LLP. The members of an LLC are not necessarily involved in the operations.
- An LLC may obtain any necessary business permit, license or approval in its own name. On the other hand an LLP may not obtain them in its own name, and thus each partner of the LLP needs to obtain these.
- The members of an LLP may be entitled to the benefit of pass-through tax treatment, but the members of an LLC may not be eligible for this.

Chapter 7　Joint Ventures

Many foreign companies wishing to start a business in Japan form a joint venture operation (usually a joint stock company) with a Japanese company. Such agreements can sometimes facilitate the provision of manufacturing bases and patents, the recruitment of suitable personnel, negotiations with distributors and market penetration. However, great care must be taken over the selection of a Japanese partner, particularly in the areas of business philosophy and long-term corporate objectives, and in the drafting of the joint venture documentation.

Chapter 8　Non-profit making organizations

In addition to ordinary business entities as described above, there are other legal entities for non-profit making or charitable organizations.

PART III

ACCOUNTING AND TAXATION

Chapter 9 Accounting and Reporting Requirements

9.1 Governing laws and bodies

The *Kabushiki Kaisha* (“KK”) or stock company is the most common type of company in Japan. For historical and regulatory reasons, there are two relevant laws related to accounting and reporting requirements: the Companies Act, as promulgated in 2005 by the Ministry of Justice and which went into effect on May 1, 2006, replacing a portion of the Commercial Code, and the Financial Instruments and Exchange Act, promulgated in 2007 by the Ministry of Finance.

The emphasis of accounting and reporting under the Companies Act has been towards the needs of creditors as much as shareholders and, as a consequence, great importance is placed on rules for valuing assets in a conservative manner, rather than for the measurement of earnings. The Financial Instruments and Exchange Act applies to public corporations that offer their own shares or bonds to the public in Japan either through a public offering or through a listing on a stock exchange. Disclosure requirements under the Financial Instruments and Exchange Act are more detailed than those required under the Companies Act in order to protect the interests of both public creditors and shareholders. Any corporation regulated by the Financial Instruments and Exchange Act, therefore, has to prepare two different sets of financial statements, although the net income and shareholders' equity will be identical under both sets of regulations.

Since 1949, the Business Accounting Deliberation Council (“BADC”), an advisory body of the Minister of Finance, has issued Financial Accounting Standards for Business Enterprises and other pronouncements, which are regarded as generally accepted accounting principles in Japan. In addition, the Japanese Institute of Certified Public Accountants (“JICPA”) has published many statements that provide guidelines for the interpretation and application of various accounting principles and requirements under the Companies Act and the Financial Instruments and Exchange Act.

Japanese tax laws and regulations have a strong impact on accounting practices, because certain accounting practices have to be followed in order to obtain tax benefits. The tax laws now allow more flexible treatment, or have been amended to comply more appropriately with commercial accounting principles and practices. However, they still have a significant influence on accounting practices in general.

The JICPA is a key member of the International Accounting Standards Board (“IASB”), the International Federation of Accountants (“IFAC”), and the Confederation of Asia and Pacific Accountants (“CAPA”) and has contributed to establishing international accounting and auditing standards. The current accounting principles and practices generally accepted among Japanese companies are, with certain exceptions, similar to those prescribed in International Accounting Standards. Some larger corporations whose shares are traded on foreign stock exchanges disclose financial information in accordance with accounting principles generally accepted in the United States of America.

9.2 Form and content of financial statements

Under the Companies Act, all stock companies must prepare statutory financial statements consisting of a business report, balance sheet, income statement, statement of changes in net assets, Notes to non-consolidated financial statements, and Supplementary Schedules. Accounting periods may not be in excess of 12 months and the statutory financial statements must be submitted to the annual general meeting of shareholders within three months of the end of its financial year. Many Japanese companies have financial years ending on 31 March, which is also the end of the government fiscal year.

The form and contents of financial statements required under the Companies Act are dictated by the Ordinance for Companies Accounting. Large companies whose financial statements are filed with the FIEA should prepare consolidated financial statements.

Public corporations under the Financial Instruments and Exchange Act are required to prepare an annual financial report (*Yuka Shoken Hokokusho*), which must be submitted to the Minister of Finance within three months of the end of the fiscal year. The annual report includes the audited financial statements consisting of:

- Balance sheet
- Income statement
- Statement of changes in net assets
- Statement of cash flows (non-consolidated basis is not required if a consolidated statement is prepared), and
- Supporting schedules

These are prepared in accordance with the “Ordinance on the Terminology; Forms and Preparation Methods of Financial Statements”. The statements prepared under the Financial Instruments and Exchange Act rules disclose much more financial information than those prepared under the Companies Act rules, including comparative figures of the previous year and notes about accounting policies and other matters,.

In addition, a Quarterly Report (*Shihanki Hokokusho*), which includes the balance sheet, income statement, and statement of cash flows, is required to be submitted to the Minister of Finance within 45 days from the last day of each quarter.

A quarterly report with an independent auditor’s review has been required under the Financial Instruments and Exchange Act.

If a corporation, reporting under the Financial Instruments and Exchange Act, has significant subsidiaries and affiliated companies, consolidated financial statements are required. Consolidation accounting practices prevailing in Japan are similar to international practices in general, but detailed reporting regulations are set by the Minister of Finance. Annual consolidated statements include comparative figures and are published within three months of the end of the year.

9.3 International harmonization of accounting standards

After collapses among larger public companies in the late 1990s, including banks, securities houses and general construction companies, there was strong criticism of Japanese accounting standards. It is true that the BDAC had not been keen on the implementation of new and recent changes in the International Accounting Standards. Under pressure from the financial sector and general investors and at the urgent request of corporate associations, the Japanese Institute of CPAs is now playing a key role in the amendment and implementation of new principles in the generally accepted accounting principles, the Financial Instruments and Exchange Act, the Companies Act and the Corporate Tax Law. It is further expected that the BDAC can be reorganized so that the accounting principles and standards in Japan are updated at least in accordance with the IAS and will proactively respond to recent changes in financial technologies.

9.4 Public filing requirements

Under the Companies Act and its related regulations, a stock corporation falls into one of two categories depending on its size. Auditing and reporting requirements are dependent on these classifications:

- Large corporations - Capital stock of not less than 500 million yen or total liabilities of not less than 20 billion yen.
- Other corporations -

The audited statements are approved by the Board of Directors and are simply reported to the shareholders, although the appropriation of retained earnings has to be approved by the shareholders.

The financial statements together with a statutory auditor's report must be maintained at the corporation's principal office and copies made available for inspection by shareholders and creditors at major branch offices for three years. A condensed balance sheet and income statement for large corporations and a balance sheet only for medium-sized and smaller corporations must be published in newspapers or the official gazette immediately after approval by the shareholders.

The annual financial report, including the consolidated and parent only financial statements with an independent auditor's report, is required to be filed with the Minister of Finance within three months of the fiscal year end. At the same time, copies of the report of listed corporations are also submitted to the stock exchange or to the governing securities association if a corporation's shares are traded on the over-the-counter market. These copies are then available for public inspection. The semi-annual report is filed with the same bodies as the annual report.

9.5 Audit requirements

There are varying audit requirements, which are dependent upon a corporation's size and status. In Japan, the financial statements of the company must be approved by the regular shareholders' meeting.

The companies that must be audited by an independent CPA under the Companies Act are as follows:

Large Companies: Capital stock of ¥500 million or more, or liabilities of ¥20 billion or more, as of the latest fiscal year-end;

Companies that adopt a "company with committees" corporate governance system and other companies that appoint an accounting auditor (*kaikeikansanin*) on a voluntary basis.

The companies that must be audited by independent CPAs under the FIEA are as follows:

Companies that issue shares listed on a financial instruments exchange or are in the process of listing, companies that filed a registration statement, and companies with a specified number of shareholders.

a. General Rules

Under the Companies Act, a statutory auditor ("*Kansayaku*") is a mandatory requirement for a Small and Medium-sized Closed Company. On the other hand, once the statutory auditor is elected, he/she is responsible for not only accounting matters but also operational issues, unless his/her responsibility is restricted to the accounting audit by the Articles of Incorporation.

There is also no external independent audit requirement for Small and Medium-sized Corporations.

b. Large Corporations

For large corporations, a CPA or Audit Corporation is elected as the independent auditor by the shareholders. The independent auditors are required to examine the statutory financial statements and express their opinion on whether they give a true and fair view of the company's financial condition and the results of its operations. The statutory auditors review the audit procedures and the opinion of the independent auditors as far as accounting and financial reporting is concerned. The statutory auditors are required to refer in their report to whether they are in agreement with the independent auditor’s opinion.

c. Listed Corporations

Under the Financial Instruments and Exchange Act, the financial statements, consolidated and parent only, of public corporations are required to be audited by a CPA or Audit Corporation. Their audit report is included in the annual financial report and it describes their opinion as to whether the financial statements fairly present on a consistent basis, the company's financial conditions, the results of operations and its cash flows in accordance with generally accepted accounting principles and the Financial Instruments and Exchange Act reporting regulations. Audited consolidated financial statements are treated as the principal financial information in the annual report.

The financial statements for the first-half year are audited by the independent auditor’s report and such statements are included in the semi annual report as required under the Financial Instruments and Exchange Act. A quarterly financial report with the independent auditor’s review is disclosed under the FIEA. Auditors express their opinion on these statements as to whether such statements represent meaningful financial information on the company for the period.

The FIEA also requires listed companies to prepare an Internal Control Report and to have it audited. This requirement is modeled after the one provided by Section 404 of the Sarbanes-Oxley Act, though with modifications in consideration of the experience in the US.

d. Foreign Corporations

Foreign corporations listed on the Tokyo Stock Exchange are also required to submit their annual financial report, in Japanese, to the Financial Services Agency and the Stock Exchange within three (six) months of the end of the fiscal year. The reporting formats are fully regulated by the Financial Instruments and Exchange Act and the financial statements together with an audit report issued by a Japanese CPA or Audit Corporation are required to be included with the report.

9.6 Fundamental accounting concepts

Accounting principles and practices generally accepted among Japanese companies are based on the following fundamental concepts.

a. True and fair reporting

Financial accounting for business enterprises should provide a true and fair report of the financial position and of the results of operations and cash flows of the business enterprise.

b. Orderly system of bookkeeping

Financial accounting for business enterprises should encompass the maintenance of accurate accounting records of all transactions in accordance with the principle of an orderly system of bookkeeping.

c. Distinction between capital surpluses and earned surpluses

Capital surpluses and earned surpluses should be kept separate.

d. Clear disclosure

Financial accounting for business enterprises should, through the financial statements, present clearly essential accounting facts to interested parties and present them in a manner that will not be misleading in their interpretation of the financial status of the business enterprise.

e. Consistency

Accounting principles and practices should be consistently applied between fiscal periods and should not be changed without justifiable reason.

f. Prudence

Financial accounting for business enterprises should include prudent accounting practices in providing for possible unfavorable effects upon the financial condition of the business enterprise.

g. Accordance with reliable accounting records and facts

When several different forms of financial statements are required for such purposes as shareholders' meetings, credit ratings, tax reporting, etc., the content of the financial statements should be prepared from reliable accounting records and the presentation of the facts should be the same for each presentation.

h. Income Statement Principle & Balance Sheet Principle

- **Income and Expenses -** The accrual principle is applied to the recognition of income and expenses. Conservative methods are accepted for accounting for income from installment sales or long term construction business. Smaller corporations are accustomed to applying cash accounting in practice.
- **Assets -** The historical cost convention is followed in Japan. Revaluation of assets is strictly prohibited under the Companies Act, except for mergers and reorganizations, in order to protect creditors. If the market value of an asset is significantly less than its cost, the Companies Law requires that the asset should be reduced to the market value. Inventories and

marketable securities are normally valued at the lower of the cost and market value.

- **Liabilities -** All liabilities outstanding on the balance sheet date shall be provided for in the accounts. Accruals for employee bonuses, after sales expenses, employee retirement benefits and other similar future expenses are provided for at least in accordance with Japanese income tax law and regulations. Some larger corporations, mainly listed companies, apply their own established methods to calculate such items, which may be more theoretically accurate and conservative. The excess of these provisions over the tax-based amounts are disallowed for income tax purposes.

Banks, insurance companies and other public interest corporations are regulated by specific laws and different accounting principles are applied accordingly.

9.7 Consolidated financial statements

The Financial Instruments and Exchange Act requires large corporations to report consolidated statements as principal information in their annual and semi annual reports. Consolidation Financial Statement Principles were set by the BADC in 1975 (Final revision 2011) and the disclosure of consolidated financial statements under the Financial Instruments and Exchange Act commenced in 1978.

All subsidiaries in which the parent company owns more than 50% of the voting shares should be included in the consolidation, although they may be omitted where they are immaterial. A subsidiary must be excluded from the consolidation, if:

- the control is intended to be temporary,
- its activities are so dissimilar that its inclusion would make the consolidation misleading, or
- severe restrictions over the operations of the subsidiary prevent effective control.

The FIEA regulations set out the reporting formats to be used and additional information required, which includes details of the significant consolidation accounting principles followed. Audits by a CPA or Audit Corporation are also required for consolidated financial statements. Multinational companies may have the audit of their overseas subsidiaries and affiliated companies carried out by other accountants.

9.8 Financial instruments

Under the current accounting standards for marketable securities, each marketable security is individually valued by the cost method. In the notes to financial statements, comparisons of the aggregated cost and market value for each class of financial instruments, including derivatives, are disclosed.

In order to implement IAS related to the valuation of financial instruments, the BDAC issued an opinion in January 1999 to make the new accounting rules effective for the years after April 1, 2001.

a. Definition of financial instruments

Financial instruments represent monetary assets and liabilities and derivative contracts. Bank deposits, trade receivables, loans, bonds and equity securities are included in monetary assets.

In principle, financial instruments shall be valued at the current fair value, which are represented by the market value at recognized exchanges or the fair value determined on a reasonable basis.

The evaluation standards for financial instruments are as follows:

Financial Instrument		Method of Valuation	Presentation of Gain/loss
Securities	Held for sale or trade	Current price	Gain or loss in P/L
	Bonds held until maturity	Cost plus accumulation or less discounts *1	Interest income or expenses in P/L
	Stocks of affiliates	Cost	N/A
	Others held for the long term	Current price	Charged to shareholders' equity *2
Monetary receivables		Cost plus accumulation or less discounts *1	Interest income or expenses in P/L
Investment trusts and funds		Current price	Gain or loss in P/L
Derivatives		Current price	Gain or loss in P/L

*1 *In the case of purchasing financial instruments at a higher or lower cost than the face value, the cost shall be adjusted according to the difference between the purchase cost and face value over the period of the investment.*

*2 *Alternatively, the aggregate loss will be charged to P/L.*

b. Permanent devaluation

Where the devaluation of value is significant and permanent for each of the bonds held until maturity, affiliated companies and securities held for the long term, the resulting loss should be charged to P/L. The original acquisition cost of such instruments is replaced by the new book value.

c. Bad debts

The provision for doubtful accounts had been generally made in accordance with the tax law. A more precise method for estimating losses due to bad debts has been newly enumerated.

Essentially, receivables are classified into three groups according to the financial condition of the debtors:

Normal debts - Based on the past experience of bad debt losses
Doubtful debts - Based on the estimated value of mortgages or collateral and financial conditions including the cash flow of the debtor
Bankruptcy - Based on the estimated value of mortgages or collateral

d. Recognition of derivative gains or losses

Gains and losses on derivative transactions have previously not been recognized prior to closing the books. Under the new standard, gains or losses on derivative transactions should be recognized at each year end.

e. Derivatives used for hedging

On the condition that derivatives used for hedging purposes meet a specific requirement, such as the relevance of a floating exchange rate or the effective measures for a hedge, the recorded gains and losses on the derivatives should correspond to the profits and losses of the underlying asset or liability of the hedge derivative.

Gains or losses on the derivatives can be recorded as deferred assets or liabilities on the balance sheet until the closing of the underlying asset or liability of the hedge. Alternatively, both the derivatives and the underlying assets or liabilities are valued at their respective current price at every year end.

9.9 Inventories

Inventories are normally stated either at cost or at the lower of the cost or market value on a consistent basis. Companies may not use the cost basis where there has been a substantial and permanent reduction in the market value of the inventory.

Although the cost should be the actual cost of the purchase, approximations to the actual cost derived from using FIFO or a weighted average method may be used. The actual cost of production may include variable overheads and fixed overheads based on a normal level of capacity.

Inventories should be separated in the financial statements into the following categories:

- Supplies
- Raw materials
- Work in progress
- Semi-finished goods
- Finished goods

In the notes accompanying the accounts, the company should specify which method has been used for valuation purposes for each of the above categories.

9.10 Tangible assets and depreciation

Tangible assets are required to be capitalized at the acquisition cost of each asset, which may include expenses associated with the acquisition. Minor assets with a cost of 100,000 yen or less may be charged to expenses in the year of acquisition. All assets other than land and leasehold property must be depreciated over their useful lives and shown in the balance sheet at cost less accumulated depreciation.

For assets acquired on or after 1 April 2007, the limits on asset costs subject to depreciation and residual values are no longer required. Depreciation may be taken on assets acquired on or after 1 April 2007 up to remainder value (*bibo kagaku*) of one yen.

The declining balance method is the most popular way of calculating the depreciation charge, although the straight line, sum of digits and unit of production methods are all acceptable.

Disclosure must be made in a supplementary schedule to the financial statements of the aggregate depreciation for each category of fixed assets, including the charge and any other movements in the year. The major categories of fixed assets are land, buildings, leasehold improvements, plant and machinery, furniture and equipment, vehicles and ships.

9.11 Intangible assets and amortization

Patents, trade and service marks, copy rights, software, know-how, goodwill, mining rights and other intangible assets are capitalized and then amortized under the straight line method. The useful lives to be adopted, varying from three to thirty years, are set out in the tax law.

9.12 Research and development expenses

a. Definition

The range of costs included in research and development expenses had previously been unclear, as there was no authorized accounting standard related to this subject. In March 1998, the BADC issued a new standard that clarifies the definition of R&D expenses, the accounting method and the presentation in the financial statements.

Research means activities under a certain program with the intention of conducting an investigation or study of new technologies or materials. Development means the activities of planning or designing new products, services or production methods for the realization of the results of research or other knowledge.

b. Accrual basis

R&D expenses, including all the related costs for personnel, materials, depreciation and indirect costs must be recorded on the accrual basis. In the past, some R&D expenses, which may be recovered in a future period, have been recorded as deferred assets. Effective April 1, 1999, all of these R&D expenses are required to be charged to the current year. The amount of research and development costs charged to income in the accounting period should be disclosed in the financial statements.

c. Software Development

The new accounting standard for software development expenses is summarized as follows:

Client-contracted software development	Production costs are charged to inventory until sales recognition. Sales are recorded based on either the progress or the completion standards.
Development of software products to be sold in the market	Production costs of software up to completion of the master program shall be recorded as an intangible fixed asset and shall be amortized based on the estimated production copies within the useful life.
Development of software to be used internally	Production costs for software developed for internal use may be recorded as an intangible fixed asset.

9.13 Deferred charges

Company formation costs, pre-operating costs, capital stock issue expenses and other deferred charges are also amortized under the straight-line method. Useful lives are three years in general, but immediate write-off is also accepted. Details of additions, amortization charges and balances on these accounts are shown in supplementary schedules.

9.14 Taxation

Japanese corporations pay national corporation tax, local inhabitant tax, which is levied as a percentage of the national corporation tax, and local enterprise tax. All these taxes are based on the corporation's profits. Taxable income is derived from the book income with some additions and deductions. Typical permanent differences are:

- national corporation and inhabitant taxes
- entertainment expenses (an allowance of ¥6 million is available to smaller corporations)
- donations, except for approved charity contributions
- director's bonuses and excessive director's salary

Temporary differences, which may reverse over time, are:

- inventory write-downs that are only allowable when the inventory is sold
- provision for bad debts in excess of tax limits
- accelerated depreciation and amortization in excess of the tax limits
- accrued expenses in excess of the tax limits
- accrued enterprise tax that is only deductible when paid
- tax reserves provided as an appropriation of retained earnings

Tax effect accounting was also to be applied in interim non-consolidated financial statements and interim consolidated financial statements for interim accounting periods commencing on or after 1 April 2000.

9.15 Retirement benefit plans

It is customary in Japan for an employer to have a retirement benefits plan for the employees. Under the plan, an employee is entitled to receive a lump-sum retirement benefits payment at the mandatory retirement age or at the time of the employee's voluntary severance. The amount of these benefits may be determined based on reason for retirement, length of service and basic salary at retirement.

The Japanese GAAP takes a similar approach to recognizing and measuring retirement benefit costs/obligations as IAS 19 (1998) *Employee benefits*. However, some differences in specific treatments are noted. The following are the most significant:

(1) IAS 19 addresses various types of employee benefits, including short-term and long-term post-employment benefits; the Japanese GAAP specifically focuses on post-employment benefits. In addition, IAS 19 deals with defined benefit plans as well as defined contribution plans. The Japanese GAAP deals only with defined benefit corporate pension plans.

(2) As to accounting for actuarial gains and losses, IAS 19 adopts the "corridor approach" by setting a permissible limit for the resulting calculation difference. The Japanese GAAP applies the materiality rule to determine the basis of actuarial assumptions.

(3) Prior service costs for vested active employees and retirees would be recognized immediately under IAS. Under the Japanese GAAP, past service liabilities should be amortized over a certain number of years, within the average remaining service period, and recognized as expenses in each period.

(4) IAS 19 retires the use of a discount rate based on the current rate of return on high-quality fixed-income investments (bonds); the Japanese GAAP requires that the discount rate be determined by taking into consideration fluctuations in the yield of bonds over approximately five years.

9.16 Leasing

There are several types of lease and hire-purchase transactions in Japan. They are classified into three categories in accounting: operating lease, financial lease and purchase. An operating lease is normally for a short period of time and is cancelable without any penalties. A financial lease is for the period of the useful life of the asset and is non-cancelable so that the cost of the asset will be fully paid out by lessee. The definition of financial lease is prescribed in the tax regulations. Transactions other than operating or financial leases could be classified as a purchase.

9.17 Capital and reserves

Capital accounts consist of the stated capital, additional paid in capital and retained earnings. When new stocks are issued, then, as a minimum, their aggregate par values shall be recorded in the stated capital. When new stocks are issued at above the par value, up to half the subscription amount can be classified as additional paid in capital. The additional paid in capital is transferred to the stated capital in the event of stock splits or free share distributions (bonus issues).

A legal reserve must be set up as an appropriation of retained earnings. An amount equal to 10% of cash dividends must be transferred to the legal reserve until the reserve balance reaches 25% of the stated capital. Both the legal reserve and the additional paid in capital may be used in order to eliminate accumulated losses, if an appropriate resolution is passed by the shareholders.

Director's bonuses are accounted for as an appropriation of retained earnings rather than as an operating expense, as this is not allowed for income tax purposes. Various tax reserves, such as reserves for the special depreciation of assets, deferred capital gains and overseas investment losses, are provided as an appropriation of earnings in accordance with the tax law.

Appropriations of retained earnings are subject to approval at the annual shareholders' meeting, although an interim dividend and the related transfer to the legal reserve is determined by the Board of Directors.

9.18 Foreign currency transactions

Foreign currency transactions are recorded in the books using the exchange rate ruling at the time of the transactions. At the year-end, short-term monetary items are translated at rates ruling on the balance sheet date, although long-term assets and liabilities may remain at historical exchange rates. However, where there are significant exchange losses in connection with long-term assets and liabilities, they should be translated at current rates ruling on the balance sheet date. Differences arising from these transactions are recognized as exchange gains or losses in the current period.

When the financial statements of foreign subsidiaries are consolidated, monetary assets and liabilities are translated at current rates although equity capital accounts are translated at historical rates. Companies may choose average rates during a business term or closing rates for the translation of profit and loss accounts. Exchange differences arising in the consolidation are recorded in the Foreign Currency Transaction Adjustment Account, which is shown in the balance sheet.

9.19 Treatment of government grants

Although accounting principles suggest that government grants should be credited to income, the Companies Act requires such grants to be deducted from the acquisition cost of the related assets. The amount of the grants deducted is normally disclosed in the notes to the financial statements.

9.20 Unusual and prior period items

A special gains and losses section is presented under the operating income section. Items to be reported in the section are not necessarily similar to extraordinary items reported under US, and other, accounting standards. Examples are:

- losses on the closure of specific businesses or factories
- extra depreciation charged due to a shortened useful life of the assets

- reversal of accruals in excess of the actual costs

9.21 Related party transactions

The accounting standards address related party disclosures from the viewpoint of ensuring the international convergence of accounting standards, taking into consideration such matters as a comparative analysis between the current rules associated with the Securities and Exchange Law (the Regulation for Financial Statements and the Regulation for Consolidated Financial Statements) and International Financial Reporting Standards and the US generally accepted accounting principles.

Scope of Related parties

Jointly controlling investing entities of the entity preparing the financial statements (any entities that jointly control the entity preparing the financial statements) and jointly-controlled entities (any entities that are controlled jointly by the entity preparing the financial statement (which, for consolidated financial statement purposes, are included in its consolidated subsidiaries) and any other independent entities) are prescribed in the “Accounting Standard for Business Combinations” and are, in accordance with the revised rules associated with the Securities and Exchange Law, clearly specified as falling under “other related entities” and “affiliates,” respectively.

In the disclosure items under the current rules associated with the Securities and Exchange Act, the accounting standards also require information on the provision for the future credit losses and on actual credit losses, etc., as information concerning doubtful receivables and uncollectible receivables in connection with transactions with related parties (refer to paragraph 10(8) of the Accounting Standards).

9.22 Segmental reporting

Since May 1988, segment information has to be disclosed in the Japanese GAAP.

The Standard and Guidance adopt the management approach adopted in IFRS and GAAP in the United States as the segment reporting method.

Disclosures about the segments of an enterprise and related information are required to provide proper information on the nature of various business activities in which it is engaged and the economic environments in which it operates, so that the users of financial statements can understand the enterprise’s performance and properly evaluate future cash flow predictions.

9.23 Commitments and contingencies

Contingencies and commitments are required to be disclosed in the accompanying notes. These include guarantees of indebtedness, letters of credit, notes discounted at banks, purchase commitments and lease installment payments.

9.24 Price level changes

All financial statements must be prepared under the historical convention and there are no inflation accounting requirements.

9.25 Accounting for smaller entities

There are no special accounting principles for smaller entities in Japan.

9.26 Accounting for asset retirement obligations

There was no specific standard to guide the accounting treatment for the retirement (decommissioning) of fixed assets in the Japanese GAAP before 2008, though there were special cases such as the accounting for nuclear power plant decommissioning costs by electric utilities as provisions in practice. To improve the accounting standards for better information provision, the Accounting Standards Board of Japan (ASBJ), taking into consideration the need for convergence with the International Accounting Standards, initially issued accounting standards for asset retirement obligations in March 2008.

The standards were applied to the fiscal years commencing on or after 1 April 2010.

Chapter 10 Company Taxation

10.1 Corporate Taxes

a. Taxable entities

Resident companies

Resident companies (those corporations that have their registered head offices in Japan) are taxable on their worldwide income and capital gains.

Non-resident companies

Non-resident companies are basically taxable on income derived from sources within Japan.

These are subject to corporation tax on the aggregate of income from the above business. From the utilization, sale or disposal of assets located in Japan, rental income arising in Japan, and such parts of any income derived from interest, dividends, royalties, etc., as are attributable to their business in Japan. If they are not so attributable, the gross income arising is subject to a flat 20% withholding tax or such other rate as is laid down in the relevant tax treaty.

Any other non-resident companies are normally taxable only on the aggregate of the income from the utilization, sale or disposal of an asset in Japan, professional fees, occasional income and rent. Income such as interest, dividends, royalties, etc., is subject to a flat 20% withholding tax, unless the rate is reduced by tax treaty provisions.

The taxable income of non-resident companies is, in principle, subject to the same rules and tax rates as those applied to resident companies.

b. Tax year and filing requirements

The financial year of a company may be any fixed twelve-month period provided in the company's Articles of Incorporation. Tax returns shall be filed and taxes shall be paid within two months after the financial year and companies with fiscal periods exceeding six months are generally required to file interim tax returns for the first half year and make provisional tax payments within two months after such a period ends. A one-month extension for tax filing and payment is normally granted.

c. Blue tax returns

A company that maintains a proper standard of accounting records may apply to the tax authorities to use a blue tax return (as opposed to a white tax return). Certain privileges are then available, including the net loss carried forward and other general tax-deductible provisions. Because of the nature of these privileges, the majority of corporations file blue tax returns.

d. Tax imposed

Taxes imposed on a corporation are the national tax and local taxes. Local taxes consist of the prefectural inhabitant tax, municipal inhabitant tax and enterprise tax. Corporation taxes are chargeable according to the tax year in which their accounting period ends.

Because Japan adopts a declaration system, companies should file tax returns and pay taxes in time by themselves. In the case of a failure to file and pay by the due dates, penalties are imposed by the tax authorities. Further, if any under-declaration of income is found by tax examinations, additional tax and penalties are levied.

10.2 Tax rates

a. National tax

The corporation tax rates currently payable are as follows:

Beginning 1 April 2012 to 31 March 2015

Corporations with issued share capital of more than 100 million yen	28.05%
Corporations with issued share capital of 100 million yen or less	
For a taxable income of more than 8 million yen	28.05%
For a taxable income not more than 8 million yen	16.50%

Beginning 1 April 2015

Corporations with issued share capital of more than 100 million yen	25.50%
Corporations with issued share capital of 100 million yen or less	
For a taxable income of more than 8 million yen	25.50%
For a taxable income not more than 8 million yen	15.00%

b. Local taxes

Inhabitant tax

Per corporation tax levy

The tax base for the corporation tax levy is the amount of the national corporation tax.

Per corporation tax levy (Tax rate)

The standard tax rate is as follows:

Prefectural inhabitant tax	Municipal inhabitant tax	Total
5% (6%)	12.3% (14.7%)	17.3% (20.7%)

The maximum tax rate is shown in ( ). Almost all prefectures apply the maximum tax rate in practice.

For example, a Tokyo tax authority applied the following tax rate:

Capital amount is more than ¥100,000,000 or

Corporation tax amount is more than ¥10,000,000………………20.7%

Other corporations……………………………………………….17.3%

Per capita tax levy

Additional local per capita tax is also payable, depending upon the amount of issued share capital and the number of employees.

Enterprise tax

Tax base and tax rate

Standard corporate enterprise tax rates are as follows.

(1) Corporations doing business as electric power supplies, gas suppliers or insurers……………………………..0.7% of their gross proceeds

(2) Other corporations:

(a) Ordinary corporations with capital amounts over 100,000,000 yen

The income up to 4,000,000 yen annually	1.5%
The income over 4,000,000 yen and up to 8,000,000 yen annually	2.2%
The income over 8,000,000 yen annually	2.9%
Per value added	0.48%
Per capital	0.2%

(b) Ordinary corporations with capital amounts of 100,000,000 yen or less

The income up to 4,000,000 yen annually	2.7%
The income over 4,000,000 yen and up to 8,000,000 yen annually	4.0%
The income over 8,000,000 yen annually	5.3%

(c) Special corporations

The income up to 4,000,000 yen annually	2.7%
The income over 4,000,000 yen annually	3.6%

Local special corporate tax

Local special corporate tax is levied on all corporations who are liable to pay corporation enterprise tax. The tax amount is computed on the basis of income or gross proceeds. Local special corporate tax is separated from the specified portion of enterprise tax.

c. Effective corporation tax rate

The normal effective corporation tax rate combining the national and local taxes is approximately 38.01% in Tokyo for a corporation with more than 100 million yen of stated capital.

d. Extra taxes

For a family company, additional income taxes are levied on undistributed income less allowances (the minimum 20 million yen).

Aggregate tax rates are:

For undistributed taxable income of less than 30 million yen 10%
For undistributed taxable income of 30 to 100 million yen 15%
For undistributed taxable income of more than 100 million yen20%

A family corporation is defined as a corporation in which 50% or more of the entire capital stock is owned by not more than three shareholders and persons or corporations connected with them.

10.3 Income subject to tax

a. General rules

Corporation tax is levied on the net income of each accounting period (measured under generally accepted accounting principles), as adjusted in accordance with the requirements of the general tax laws.

Within specified limits, foreign taxation imposed on a domestic Japanese corporation is creditable from the Japanese national and local tax liabilities.

In order to be able to fully take advantage of certain tax concessions, corporations should register under the Blue Tax Return Scheme. Once registration is obtained, subsequent renewal is not required.

b. Taxable income

The tax base for taxable income is the corporation's net income for each business year. Net income is the excess of "gross income" over "total costs" for each business year.
The gross income minus total costs represents the taxable income for tax purposes. Though the tax laws require or allow some adjustment of corporate profits calculated in accordance with generally accepted accounting principles in reaching the taxable income, the calculation of corporate net income generally follows normal accounting principles and practice.

c. Gross income

Transactions giving rise to gross income are follows:
(1) Sales of assets (sales of goods, products, etc).
(2) Transfer of assets (transfer of assets such as securities and fixed assets, etc).
(3) Provision of serviced (contracts and the provision of the services).
(4) Free transfer of assets or the provision of services.

(5) Free reception of assets.
(6) Other transactions (interest on deposits, interest on loans and other sources).

d. Special stipulations

Those items of gross income that accrue from transactions by corporations and which are stipulated to be excluded from the gross revenue by special provisions and regulations are not included in the gross income.

Examples of exclusions from the gross income include dividends received, increases in the book value of assets, tax refunds.

e. Dividends received (exclusion from gross income)

Dividends received by domestic corporations from other domestic corporations, less the interest chargeable to the shares on which those dividends were paid, are fully excluded from gross income in computing the amount of taxable income. However, if a domestic corporation owns less than 25% of the shares of another domestic corporation that pays dividends, 50% of those dividends received, less the interest chargeable to the shares on which those dividends were paid, are excluded.

f. Revaluation profits (exclusion from gross income)

Profits from the revaluation of an asset are excluded from gross income, regardless of whether or not the new book value of the asset is its fair market value.

However, the following types of revaluations are exceptions for tax purposes and the revaluation profits are included in the gross income:

(1) Revaluations of assets in accordance with the Corporation Reorganization Law or the Civil Rehabilitation Law; and
(2) Revaluations of stock by an insurance company, based on the Insurance Business Law.

10.4 Deductions

a. General rules

Costs and expenses incurred by corporations in the conduct of their business are generally deductible for tax purposes. Some less business-related expenses are partly or entirely disallowed as deductions.

b. Total costs (business expenses)

A corporation's "total costs" (or business expenses) for a business year are used to determine the net income. Total costs are categorized as follows:

(1) Costs of acquisitions, costs of completed construction work, and other costs corresponding to the gross income derived in the business year under review.

(2) Besides those mentioned above, sales expenses, general administrative expenses and other expenses accrued in the business year under review.
(3) Losses incurred in the business year under review accruing from transactions other than capital transactions, etc.

c. Costs

"Costs" include the outlays needed to derive gross income, such as the cost of buying commodities sold, the cost of manufacturing products sold, fixed assets acquired, transfer costs of securities, etc., the costs of construction work, contract costs, etc.

d. Expenses

"Expenses" include various expenditures incurred in the business year including selling expenses, etc. Expenses that have not become payable in that accounting period are not recognized as expenses except for depreciation. Usually a corporation sets aside money to cover expenses if the cause of a liability has come into being, even if the liability itself has not been established. Under the tax law, amounts set aside as security for such expenses are not recognized except in the case of *special stipulations, such as bad debt reserves, etc.

*Special stipulations

The above-mentioned costs, sales expenses and other expenses, as well as those that are not normally regarded as expenses such as losses, or which have been specifically stipulated by laws and regulations as deductible expenses, are included in expenses under the Corporation Tax Law.

e. Depreciation and amortization

1. Depreciable assets

The corporation tax law permits the deduction of a reasonable allowance for the exhaustion or wear and tear of depreciable assets, tangible or intangible, within the limits allowed as expenses for the accounting purposes of the corporation.

Depreciable tangible assets include all kinds of tangible fixed assets, excluding land, objects of art, etc. For example, buildings structures, machinery and equipment, vessels, airplanes, vehicles, tools, etc., are depreciable.

Depreciable intangible assets are enumerated in the laws and regulations. These include intangible property such as patents, trademarks, mining rights, fishing rights, goodwill, etc.

Methods of depreciation are showed in 11-5-e-2. However, acquisition costs for minor assets (excluding those on a lease in a foreign country) may be simply deducted as follows.

(1) In the case of an asset whose acquisition cost is less than ¥100,000 per unit;
It may be immediately deducted as expenses in the business year of acquisition
(2) In the case of an asset whose acquisition cost is less than ¥200,000 per unit (excluding one to which (1) above is applicable);

Total cost of the assets acquired in the business year may be deductible each business year in equal amounts over three years.

(3) Certain corporations** can deduct as expenses acquisition costs as a lump sum within a limit of ¥3,000,000 for depreciable assets of less than ¥300,000 at purchase during April 1, 2006 through March 31, 2014.

** Certain corporations; those whose capital is ¥100 million or less, etc.

2. Method of depreciation

The depreciation deduction should be computed using one of the following main methods:

(1) Reducing balance method

The depreciation base is reduced each year by the amount of the depreciation deduction and a certain amount of the rate is applied to the resulting balance.

(2) Straight line method

A certain amount of the rate is applied to the acquisition costs of the depreciable assets. The acquisition costs less the memorandum value are deductible each business year in equal amounts over the useful life applicable to the depreciable assets.

g. Bad debts reserve

When a corporation credits a certain amount to the bad debts reserve account in a particular business year, the credited amount is deductible, within a definite amount, in computing the income of that business year.

h. Losses due to changes in the book value

The computation of taxable net profits usually ignores any change in the book value of the assets held by a corporation, whether or not such a change in the book value reflects a change in the market value.

Loss due to the revaluation of an asset is excluded from the total costs for tax purposes. However, this principle does not prevent a reduction in the book value of assets when they have been severely damaged by floods or earthquakes, etc., or when their value has diminished due to obsolescence, or when a change in the book value is necessary under the Corporation Reorganization Law, etc.

i. Royalties

Royalties payable are allowed as a normal business expense.

10.5 Specifically non-deductible expenses

a. Taxes and fines

The national corporation tax, prefectural inhabitant tax, municipal inhabitant tax, penalties, fines etc., are not deductible.

b. Entertainment expenses

For the business years beginning on or after April 1, 2006, entertainment expenses, except for those spent for eating and drinking up to the amount of ¥5,000 or less per person, are not deductible, even though such expenses are necessary for the conduct of the business (SM 61-4).

However, corporations*** whose capital is ¥100 million or less are allowed to deduct as expenses 90% of their entertainment expenses up to ¥6 million.

*** This is not applicable to a corporation in a 100 percent group if the capital of the parent company is ¥500 million or more.

c. Salaries and bonuses for the directors

Salaries paid to the employees of a corporation are deductible expenses of the corporation, not only for accounting purposes, but also for tax purposes.
However, salaries periodically paid to the director of a corporation are not deductible for tax purposes. An unreasonably high salary paid to a director of the corporation is also not deductible.
When the amounts of such salaries have been determined in advance in a shareholders' general meeting or in the Articles of Association of a corporation, etc., the part of the salaries that exceeds the amount determined is treated as the non-deductible excess.
Bonuses paid to a director are also not deductible.

10.6 Net losses

If the taxable income for a given business year shows a net loss, the net loss may, at the option of the corporation, be carried back to the preceding year or carried forward nine years.

If the corporation selects to carry back the net loss to the business year beginning within one year before the start of the present business year, the tax on the taxable income for the past business year is refunded fully or partially.

If the corporation does not elect to carry back the net loss, the net loss is carried forward and is deductible from the income of each business year beginning within nine years after the start of the present business year.

Deductible amount for the net loss carried forward

Corporations**** whose capital is ¥100 million or less

100% of the amount of taxable income in each business year

Corporations whose capital is ¥100 million or more

80% of the amount of taxable income in each business year

****This is not applicable to a corporation in the 100 percent group if the capital of its parent company is ¥500 million or more.

10.7 Taxation on transactions within a 100% group

1. Taxation on the transfer of assets within a 100 percent group

Capital gains from the transfer of certain assets within a 100 percent group are taxable by the seller when the assets are sold outside the group, etc. .

Note:

A 100 percent group means a group of companies that owns 100% of the shares of the other companies in the group directly or indirectly.

2. Tax treatment of donations within a 100 percent group

Donations within a 100 percent group are not treated as expenses as a donor nor income as a donee

3. Capital transactions within a 100 percent group

(1) When applying the dividend received deduction rule to the dividend paid within a 100 percent group, a deduction of interest corresponding to the dividend is not required.

(2) The transfer of shares to the issuing company of the shares within a 100 percent group is not taxable.

4. Application of special tax treatment to a 100 percent group

Special tax treatment, as mentioned below, as it is applicable to a corporation whose capital is ¥100 million or less shall not be applicable to a corporation in a 100 percent group if the shares of the corporation are owned by two or more corporations whose capital is ¥500 million or more.

(a) Reduced tax rate
(b) Non-application of additional taxation for retained earnings in a family corporation
(c) Fixed amount deduction for entertainment expenses
(d) Refund of the tax by the application of a loss carry-back

10.8 International aspects

a. Tax haven legislation

The anti-tax haven legislation was introduced in 1978 and since then a number of amendments have been made. Under this legislation, the undistributed income of a foreign subsidiary whose tax burden on its income is 20% or less is considered as a domestic corporation. The attribution as a domestic corporation occurs when it owns directly and/or indirectly 10% or more of the total stock of the foreign subsidiary, and more than 50% of the total stock or the voting power of the subsidiary is owned directly and/or indirectly by domestic corporations and residents. These measures are not applicable, however, if the foreign subsidiary satisfies all of the four criterion below:

(1) Substance criterion

The substance criterion is satisfied if the Designated Tax Haven Subsidiary has an office, store, factory, or other fixed facility in the jurisdiction where its head or the main office is located or registered and such a facility is deemed to be necessary for it to conduct its main business there. If a Designated Tax Haven Subsidiary conducts two or more businesses, its main business is determined based on the facts and circumstances, taking into consideration such factors as (1) revenues, (2) income, (3) number of employees and (4) fixed assets.

(2) Local Management and Control Criterion

The local management and control criterion is satisfied if the Designated Tax Haven Subsidiary itself manages and controls its main business in the jurisdiction where its head or main office is located or registered.

(3) Active Business Criterion

The active business criterion is satisfied if the main business of the Designated Tax Haven Subsidiary is other than (1) holding debt or equity securities (such as a holding company), (2) licensing of industrial property rights, other technical rights, or copyrights (such as a patent holding company), or (3) the leasing of ships or aircraft.

(4) Business with unrelated persons criterion and Local Country Business Criteria

Depending on the type of business the Designated Tax Haven Subsidiary is engaged in, it must satisfy either the business with unrelated persons criterion or the local country business criterion.

(a) Business with unrelated persons criterion

If the main business of the Designated Tax Haven Subsidiary is a specified business, more than 50% of the business must be conducted with unrelated persons. Specified Businesses include wholesaler trade, banking, trust company, securities, insurance and marine or air transport businesses.

(a) Local country business criterion

If the main business of the Designated Tax Haven Subsidiary is retail sales, manufacturing, services, real estates, personal property leasing, construction, land transport, agriculture, forestry, fisheries, mining, or any business other than those covered by the criterion of a business with unrelated persons, the Designated Tax Haven Subsidiary may satisfy the local country business criterion by conducting its business mainly in the jurisdiction, including the water zones of such a jurisdiction, where its head or main office is located.

Regional Headquarters Companies

Effective for the tax years of the Designated Tax Haven Subsidiaries beginning on or after 1 April 2010, the local business exception is extended to **the** shares of a tax haven subsidiary that is a regional headquarters company (tokatsu kaisha). For this purpose, a designated tax haven subsidiary is a regional headquarters company if:

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

(2) it owns directly at least 25% of the shares (including the voting shares) of two or more controlled foreign companies that carry on an active or substantial business in the country where their head or main office is located, and

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

b. Transfer pricing taxation

In order to deal with transfer pricing problems, and to realize fair and legitimate taxation in the field of international transactions, transfer pricing taxation provisions were introduced in 1986 in Japan.

In the event that a corporation has conducted the sale or purchase of assets, the provision of services or other transactions with a foreign affiliated company, if the amount of consideration in such transactions is not an arm's length price, and if this results in a reduction of the income of the corporation, the transactions shall be deemed to have been carried out at an arm's length price, for the purpose of determining the corporate income taxation liability of the corporation. A foreign affiliated company refers to a corporation that has one of the following special relationships with the said corporation:

- A relationship in which either of two corporations owns, directly or in directly, 50% or more of the total number of issued shares of the other corporation.
- A relationship in which 50% or more of the total number of issued shares of two corporations is owned, directly or indirectly, by the same company.
- A relationship in which a director represents (or a number of directors together represent) at least 50% of the directors of one corporation and, concurrently, that the director is a director or employee (or those directors are directors or employees) of another corporation.
- A relationship in which a considerable portion of the business that one corporation conducts is reliant upon transactions with another corporation, or a relationship in which one corporation procures a considerable portion of the funds necessary for its business activities by borrowing from another corporation, or by receiving guarantees from that corporation.

The arm's length price shall be deemed to be the amount that is computed in accordance with the following methods depending upon the types of transactions:

Comparable uncontrolled price method: a price that would be determined by an unrelated seller and buyer of the same kind of property under conditions involving similar levels of transactions.

Resale price method: determined by deducting a normal amount of profit from the price at which the inventory is resold to a person who is not a specially-related person.

Cost plus method: determined by adding a normal amount of profit to the amount of the costs incurred by the seller to acquire the inventory in question by purchase, manufacture, or by other acts.

Other methods. Other methods may include combinations of the above methods or the profit split method.

The difference between the actual amount of the consideration in the transaction, which is subject to the transfer pricing provisions, and the arm's length price as prescribed above shall not be deductible for the purpose of computing the taxable income.

In the event that the tax authorities make a request, the corporation shall provide records or books, or copies thereof, and if further necessary, the records and books of the foreign affiliated company. If the corporation does not provide this information, the authorities determine the taxable income by presuming such an amount to be the arm's length price that is computed in accordance with a method listed above. This is done by taking as the basis the gross margin ratio of the business activity of similar corporations.

A corporation shall, in the event it has conducted transactions with a foreign affiliated company, attach to its tax returns a document that contains the name and location of the foreign company, its transaction volume, gross income, etc., as prescribed by a Finance Ministerial Order.

Adjustment with respect to transfer pricing taxation can be made by the tax authorities for six years after the lodgment of the tax returns.

In cases where transfer pricing taxation was applied to one of the related companies, the resultant upward revision of its income may give rise to double taxation on those two related companies, taken as a single economic entity.

A downward adjustment of the income of the counterpart company to eliminate such double taxation is generally called "the correlative adjustment". Japan has a policy of making such correlative adjustments to its enterprises where a mutual agreement with the tax authority in the country of the counter party has been reached under a tax treaty.

c. Thin capitalization

When a foreign-owned Japanese corporation or a Japanese branch of a foreign corporation raises funds from its parent corporation or its head office, the domestic tax burden of the corporate group can be reduced artificially by substituting debt finance for equity finance. This is because the payment of interest can be deducted from the taxable income for corporation tax, while the payment of dividends cannot. This form of international tax avoidance is known as thin capitalization. The purpose of thin capitalization rules is to prevent foreign or foreign-owned corporations from reducing their tax burden through this type of capitalization. The rules were implemented in Japan in 1992.

If a corporation's debt to its foreign parent corporation exceeds 300 percent of the share capital paid-in by such a foreign corporation, an interest payment corresponding to the excess portion of the debt will be disallowed as a deduction for tax purposes, provided that the ratio of the corporation's total debt to its total equity exceeds 300 percent.

Foreign-related corporations are defined as those non-resident individuals or corporations who own directly or indirectly 50 percent or more of the total equity of the corporation in question, who control the corporation in other ways that constitute effective control, or who are controlled by the same persons who control the corporation.

The corporation's debt to its foreign-related corporations is limited to interest bearing debt. In cases where foreign-related corporations have a permanent establishment in Japan, the amount of interest that is subjected to corporation tax as the income of the permanent establishment will not be included in the interest payment in the above formula, provided that the liability for corporation tax is not reduced or exempted under the tax treaty.

If the corporation proves that its debt/equity ratio is reasonable in comparison with the ratios of other corporations of a similar size and conducting a similar business, such an ordinary ratio will be used in applying the thin capitalization rules instead of the 300 percent ratio.

d. Foreign tax credit

Japanese domestic corporations that pay foreign national or local taxes based on income may take a credit against Japanese Corporation Tax subject to the limitations under the foreign tax credit rules.

Deduction or credit

A Japanese domestic corporation may elect to take a credit or deduction for foreign taxes incurred during the taxable year. If the credit is elected, no deduction is allowed for any creditable foreign taxes.

Creditable foreign taxes

A credit is allowed only for foreign taxes on income, including excess profits taxes, taxes on the income or a part of the income but which are assessed based on receipts or similar amounts, and taxes on income that are collected based on receipts for the convenience of tax collection. Taxes on income that are assessed based on receipts are commonly found in oil-producing countries and countries with substantial agricultural exports. Withholding taxes on interest, dividends and royalties are examples of taxes on income that are collected based on receipts for the convenience of tax collection. Value added taxes and penalty taxes do not qualify for the credit.

The foreign tax credit limitation

The Japanese foreign tax credit limitation is designed to prevent foreign taxes in excess of the corresponding Japanese tax amount from being used to reduce the Japanese tax on domestic income. The limitation is based on the taxpayer's overall foreign income and tax; separate country limits are not used. The amount of foreign taxes for the current tax year that a Japanese taxpayer can take as a credit is equal to the lesser of:

- the creditable foreign tax amount incurred during the year, or

- the amount of the foreign tax credit limitation.

Carryovers of foreign tax credit benefits

Taxpayers may carry forward for three years the national and local tax foreign tax credit limitation amounts that are not used in the current taxable year. Taxpayers may also carry forward for three years excess creditable foreign tax amounts.

e. Foreign dividend exemption system

Effective for the tax year beginning on or after 1 April 2009, the indirect foreign tax credit has been replaced by a system of exempting 95% of foreign dividends from the income of the Japanese company shareholder. Only 95% of dividends are eligible for exemption under the assumption that approximately 5% of the dividends represent expenditures associated with the shareholding. To qualify for the exemption, the Japanese company must have owned directly at least 25% (or any lower percentage applicable to the qualification of dividends for indirect foreign tax credit under an income tax treaty between Japan and the country of residence of the company paying the dividend) of the outstanding shares of the foreign corporation for at least six months prior to the date the dividend is declared. No deduction or credit against Japanese tax is allowed for foreign taxes, including withholding taxes, paid on the 5% of the dividends not eligible for exemption.

Chapter 11 Taxation of Individuals

11.1 Taxable individuals

a. Residents

Individuals are deemed to be resident if they have a domicile in Japan or have resided continuously in Japan for one year or more up to the current date. There are two categories of residents:

Permanent residents

A permanent resident is one who is domiciled in Japan either as a citizen of Japan or someone who has domicile or residence in Japan for an aggregate period of more than five years within the last ten years.

Non-permanent residents

A resident of non Japanese nationality who has had domicile or residence in Japan for an aggregate period of five years or less within the last ten years is classified as a non-permanent resident.

A non-permanent resident is assessed on Japanese sources of income and on any other income from outside sources that is paid in or remitted to Japan.

b. Non-residents

An individual who does not fall into either of the above categories is deemed to be a non-resident and is only liable to pay income tax on Japanese sources of income, regardless of where the income is paid. However, many tax treaties exempt from Japanese tax the employment income of a non-resident who works in Japan for an aggregate period of less than 183 days during a calendar year or in any twelve month period commencing or ending in the taxable year concerned.

c. Domicile

A domicile is defined by the Japanese Civil Code as the base for one’s living. An individual’s domicile is to be determined by the objective facts and no one individual is deemed to maintain two domiciles simultaneously. If the domicile cannot be determined, the person’s residence is treated as the domicile. A dual national of Japan and another country will be presumed by the tax office to not reside permanently in Japan .

11.2 Taxes on income

Introduction

Under the Income Tax Law, taxable income is classified into the following thirteen categories in accordance with the nature of the income, taking into consideration the taxable capacity as well as the convenience of computation;

(a) Employment income
(b) Business income
(c) Capital gain
(d) Dividend income
(e) Interest income
(f) Rental income
(g) Pensions and annuities
(h) Temporary income
(i) Forestry income
(j) Exempt income
(k) Foreign source income

The income tax is to be primarily assessed on the basis of the aggregate income, regardless of the nature and type of income. Individual taxpayers are liable to pay income tax on their total income earned during the calendar year concerned.

Retirement income and forestry income, however, are taxed separately from other sources of income under the Income Tax Law. Interest income is taxed separately from other sources of income under the Special Taxation Measures Law. Dividends and capital gains are or may be taxed separately from other sources of income as well.

Local inhabitant tax is assessed in full by both the prefecture and the municipality on an individual who is resident in Japan on January 1st in any year and is based on the individual's income reported for national income tax purposes in the previous year. In view of this, careful consideration should be given by taxpayers as to the timing of their permanent departure from Japan. For practical purposes, both prefectural and municipal taxes can be treated as components of one system of local inhabitant tax.

Enterprise tax is only applied to certain business income as reported for national income tax purposes in the previous year.

a. Employment income

This includes salaries, wages, bonuses and allowances. Allowances are normally treated at full value as taxable benefits in kind and include overseas living allowances, those for the provision of children's education, company cars, free utilities and accommodation. If an employee pays over to his/her employer an amount calculated as the 'economic rent' for the accommodation (which is normally a fraction of the market rent), no taxable benefit will arise. Otherwise, the taxable benefit is the value of the 'economic rent', except for directors in which case it is normally 50% of the market rent. For some other allowances a deduction is available in respect of the attributable business element.

Employer's social security contributions and contributions to approved pension funds are tax exempt. Some other benefits such as a commutation (office - home) allowance (there is an amount limit at a level appropriate for the commuting distance), meal expenses for overtime work, and subsidies to employees' recreational parties or trips for not longer than four nights, including overseas trips, are tax free in general.

For expatriates working in Japan, the salary income in respect of services performed in Japan is treated as being a Japanese source income regardless of where, by whom, or in which currency, the payment is made. A pro-rata deduction from total receipts in Japan is available for any days spent working outside Japan, if the person is not a permanent employee. Moving expenses and home leave transportation once a year are generally tax free.

Taxable employment income is ordinary assessable income as explained above, less an employment deduction. Employment income deductions are calculated as below:

(Unit: thousand yen)

Gross salary income		Employment deduction
Under	1,625	650
1,625 to	1,800	Receipt ×40%
1,800 to	3,600	Receipt ×30% + 180
3,600 to	6,600	Receipt ×20% + 540
6,600 to	10,000	Receipt ×10% + 1,200
Over	10,000	Receipt × 5% + 1,700 *

* maximum 2,450 from 1 January 2013

b. Business income

Income from a self-employed business or professional activities is classified as business income. Necessary expenses directly incurred and expended during a tax year for carrying on a business are allowed in computing the net income arising in that year.

If a taxpayer maintains proper accounting records, he/she may be permitted to submit a Blue Tax Return rather than a normal White Return. The Blue Return confers significant tax advantages in computing net business income and also net rental and forestry income. These include the charging of specified tax allowable general provisions and depreciation allowances, together with greater flexibility in utilizing tax losses. Furthermore the blue return special deduction of ¥650,000 is allowed.

Losses arising can normally be offset against other income in a prescribed order, firstly against recurring income (such as income from interest, dividends, rentals and employment), secondly against income of a temporary nature (such as capital gains and occasional income), thirdly against forestry income and finally against retirement income.

Any net losses remaining may be carried forward for three years or back for one year, provided that a Blue Tax Return is filed in the year the losses are incurred.

c. Capital gains

Capital gains are treated differently depending on whether they arise from the sale of land and buildings, the sale of securities or of other assets. Gifts or donations are also normally regarded as taxable disposals.

Capital gains from the sale of assets other than land and buildings and securities; an allowance of up to Yen 500,000, or the amount of the capital gain, whichever is less is available each year against short-term gains (on assets held for less than 5 years), with any excess being available to reduce long-term gains . The net taxable capital gain (the acquisition, installation or improvement in the past, minus the total of the depreciation cost) that is included in the ordinary income tax computation comprises the net short-term gains and 50% of the net long-term gains.

Capital gains from the sale of equity securities

In calculating the income amount, the taxpayer can deduct any necessary costs and various expenses from the proceeds. The necessary costs are computed as the amount of stock or shares at the end of the year valued by the weight-average method. Capital gains derived from the sale of stock or shares are taxed at the rate of 15% (20% including local inhabitant tax). A taxpayer can select the taxation method of withholding income tax for the sale of listed stock or shares.

In the case of a taxpayer subject to withholding income tax only, the amount of the net capital gain is deemed to be 7% (10% on the transfer of listed stock or shares during April 1, 2003 to March 31, 2013. This special tax treatment will end after April 1, 2014) of the proceeds for listed stock or shares.

Capital gains from the sale of land or buildings

Long-term gains – Where the property sold was held for more than 5 years, as of January 1 of the year in which the transfer was made, the tax rate on capital gains from the sale of such property is 15% (20% including local inhabitant tax). If a property used as a residence that was sold was held for more than 10 years as of January 1 of the year in which the transfer was made, the tax rate on capital gains from the sale of such a property is 10% (14% including local inhabitant tax) on a gain up to 60 million yen and 15% with a deduction of 3 million yen (20% with a deduction of 3.6 million yen including local inhabitant tax) on a gain over 60 million yen.

Short-term gains - Capital gains arising from sale of land and buildings held for less than 5 years, as of January 1 of the year in which the transfer was made, are taxed at 30% (39% including local inhabitant tax) of such gains.

Taxable gains are the computed gross proceeds, less the acquisition costs and expenses incurred in connection with the transfer less other applicable deductions. The special deductions available are:

Case of disposition	Deduction
Compensation upon expropriation	50 million yen
Sale of residential property	30 million yen
Special land development program	20 million yen

Special housing program	15 million yen
Farmland development program	8 million yen

The aggregate deduction is limited to 50 million yen per taxpayer per year.

d. Dividends

Dividend income includes all distributions of profits, including stock dividends, distributions of gains by investment trusts and fixed interest amounts paid to shareholders during the first two years of a company's trading. Dividends are subject to a 20% withholding tax.

Normally, dividend income is added to other sources of income for the purpose of tax calculation, with credit being given for the withholding tax imposed.

e. Interest income

Most interest, like dividends, is subject to a 20% withholding tax but, unlike dividends, is not presently taxed at higher marginal rates.

Interest and dividends on securities issued outside Japan and paid to Japanese residents through a Japanese paying agent are also subject to a 20% withholding tax. Interest receivable on loans made by an individual for business purposes is normally classified as assessable business income.

f. Rental income

Rental income includes income arising from the lease of land, buildings, ships and aircraft. All reasonable and necessary expenses, including depreciation and interest, are deductible in calculating the taxable income.

Rental losses are generally allowed to be offset against other sources of taxable income. The limitation on offset is to be implemented under the land value countermeasures. The limitation is that the amount of financing cost related to the acquisition of land or the net rental loss, whichever is less, is not allowed to be offset.

g. Pensions and annuities

At retirement or severance, employees may be entitled to receive from employers or it’s private pension funds either or both lump-sum payments and pension annuities. Only 50% of retirement income, that is the lump-sum payment less a special deduction that is calculated based on the length of service and/or disability, is separately taxed. However, this special deduction is not applicable to private pension funds paid to administrators who have been working for their companies for less than five years.

The pension annuities received from the employer’s fund are taxed every year with a special deduction together with the national pension annuities.

h. Temporary income

Temporary income includes gifts received from a corporation, prizes, and other income of a temporary nature. Expenses paid in order to acquire the income concerned are deductible and an allowance of up to Yen 500,000, or the amount of temporary income, whichever is less, is available each year. Only 50% of the amount of temporary income after deducting the allowance is taxable as a part of the ordinary income amount..

i. Forestry income

Special deductions are allowed from income derived from the sale or transfer of timber that has been owned for a period exceeding five years.

j. Exempt income

Exempt sources of income include:

- interest from approved employee savings schemes, established for the purpose of a house purchase or retirement purposes;
- interest received, up to specified limits, by elderly or disabled people and widows with dependent children;
- academic prizes;
- insurance payments for damages; and

k. Foreign source income

Foreign source income consisting of dividends, interest, royalties and business income are normally taxed in Japan and the foreign taxes imposed at the source are normally credited against Japanese tax liabilities.

11.3 Personal allowances and deductions

a. Allowances

An annual personal allowance of ¥380,000 is available to each taxpayer. An additional allowance of ¥380,000 is available for each dependent (including a dependent spouse) providing that the dependent's taxable income does not exceed certain limits. A dependent in this case is someone who is 16 years old or older as of the date of December 31. If the dependent is 19 years or older, but under 23 years, the amount of ¥630,000 can be deducted, taking into consideration educational expenses. Further allowances are available for elderly, handicapped and widowed persons.

b. Deductions

Deductions are also allowed for accidental losses, medical expenses, social security contributions, life and non-life insurance premiums, and donations with some limitations.

c. Losses

Any loss from a source of income, except for losses in income from of dividends, miscellaneous income (royalties and social security benefits, etc.), security stock transactions and temporary income, can be offset against any categories of income in the same year under certain conditions. The net loss can be carried forward for three years if the taxpayer files a blue tax return.

d. Special family rules

Tax is imposed on individuals who have earned income and capital gains. A joint tax return system is not used in Japan.

11.4 Tax rates

a. National tax

The following scale of national income tax rates applies to individual taxpayers for 2007 or after.

Yen	Rate %	Cumulative tax for each bracket
Up to 1,950,000	5	-
1,950,000 – 3,300,000	10	97,500
3,300,000 – 6,950,000	20	427,000
6,950,000 - 9,000,000	23	636,000
9,000,000- 18,000,000	33	1,536,000
Over 18,000,000	40	2,796,000

The above rates are applied separately to each of the four categories of taxable income, that is, ordinary income, forestry income, capital gain and retirement income.

In an effort to secure the financial resources needed for the recovery from the Great East Japan Earthquake, a special recovery tax (income tax × 2.1%) also applies to employment income earned during 2015 to 2037.

b. Local inhabitant tax

For all practical purposes, municipal and prefectural local taxes can be considered as a single component. The local inhabitant tax has been fixed at 10% and the inhabitant tax is on a per capita basis.

c. Withholding tax

The rate of any withholding tax depends on the category of the income. Dividends and interest are subject to a tax rate of between 10% and 20%.Withholding tax tables for salary and wages and for bonuses are set showing the marginal rate. Royalties, fees to writers, entertainers, sports players, designers, lawyers, accountants, and other professionals are normally subject to tax at a rate of 10% up to 1 million yen and 20% over 1 million yen.

The withholding tax rate for overseas payments of dividends, interest and royalties is 20%, unless tax treaties between Japan and the country of the recipient provide for lower rates. The salary paid to a non-resident director is subject to tax at 20%.

d. Tax credits

The following annual credits are available to reduce an individual's tax liability. Although no tax refund is permitted if total credits exceed the year's tax liability, the excess credits may normally be carried forward.

- Foreign tax paid or withheld on income from overseas sources.
- Dividends- If there is aggregate taxation of dividend income, in principle, it is possible to deduct 5% or 10% of the amount of the dividend income.
- A tax credit is available for the acquisition of a residential property, subject to restrictions on the size of the property and the taxpayer's income level, when the taxpayer acquires a new house and borrows the necessary funds from a public or private financial institution based on a loan contract in which repayments are made by installments over 10 years or longer. Even if a housing loan is not needed, a tax credit is available when renovations are made that meet certain requirements (barrier-free, earthquake resistant, energy saving, etc.).

11.5 Payment of taxes

a. Taxable period

Taxes are assessed for the calendar year.

b. Payroll deductions

Withholding tax (national) and inhabitant taxes are deducted by the employer from salaries and wages. The withholding tax is adjusted at the year-end to settle the ultimate national tax liability for each employee.

c. Estimated payment

All taxpayers with an estimated national tax liability of more than ¥150,000 (after allowing for tax deducted at the source) will be assessed on one-third of that amount, to be prepaid in two installments, in July and November. The balance of the tax due is payable on the submission of a final return.

d. Returns and assessment

Each resident individual must file a return before the 15th of March of the following year and on or before the individual’s departure from Japan.

Normally, an employee with gross earnings of less than ¥20 million (subject to a tax deduction at source) and with other taxable income below ¥200,000 is not required to submit a return.

e. Local inhabitant taxes

An inhabitant tax return is not necessary if a national tax return has been filed or the individual only has employment income. The taxes are paid either by twelve monthly deductions from the taxpayer's salary or in four equal payments per annum.

Chapter 12 Indirect and Other taxes

12.1 Consumption tax

This is a type of value added tax which is imposed on a very wide range of goods and services consumed in Japan. Almost every domestic transaction and every transaction for the importation of foreign goods is subject to taxation at the rate of 4%. Together with the effective local consumption tax rate of 1%, the total effective tax rate is 5%.

Suppliers of goods and services calculate their tax liability based on the difference in value between the gross taxable sales and gross taxable purchases and normally files a consumption tax final return for each year. The consumption tax interim return is paid twice or three times or eleven times per year depending on the amount of tax for the previous accounting year, together with the required tax payment. If taxable purchases exceed taxable sales, a repayment of consumption tax is made to the supplier. The tax year is the calendar year for self-employed individuals and the accounting year for companies.

A supplier with taxable sales of under ¥10 million per year is not subject to consumption tax, but may nevertheless elect to register in order to get the repayment of consumption tax under the scheme. Some suppliers with annual taxable sales of under Yen 50 million may receive permission to compute their taxable purchases as a given percentage of taxable sales. The agreed percentages are currently 90% in the case of wholesalers, 80% for retailers, 70% for manufacturers, 60% for restaurants, financial or insurance businesses, etc., and 50% for service industries.

A number of goods and services are exempted from consumption tax, including proceeds from the sale of land and securities, residential house rental, interest, education fees and medical expenses.

Export sales are not subject to consumption tax under certain required conditions.

Where the taxable sales ratio during the taxable period is less than 95%, or 95% and over and the taxable sales of this accounting year are over ¥500 million, the amount of consumption tax on taxable purchases and taxable foreign goods that are necessary for transfers of taxable assets, etc., is calculated using the itemized method or proportional methods, respectively.

If all transfers of assets, etc., conducted in a taxable period are transfers of taxable assets, etc., or if the taxable sales ratio of the enterprise is 95% and over and taxable sales of this accounting year are less than ¥500 million , the whole tax amount on taxable purchases, etc., is creditable.

12.2 Stamp tax

The Japanese Stamp tax is a national tax imposed on persons who prepare any of a wide variety of commercial documents. If two or more persons prepare the document, those persons are jointly and severally liable for the tax.

12.3 Fixed assets tax

The fixed assets tax is levied on land, buildings and depreciable property and is levied on the owner who has these assets as of January 1st each year.

It is required to submit a fixed assets report by the end of January. Then the local authority calculates the tax amount based on the report.

The standard rate of fixed assets tax is 1.4% of the tax basis.

In Tokyo, the payments due are during the months of June, September, December and February of the following year.