

# ASG tax news

ASG Tax Corporation  
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**Our news letter provides information on Japanese tax and business which we believe is of interest to international companies doing business in Japan.**

## **Shares acquired under a “poison pill” to be tax exempt in Japan**

Shareholders of a company who purchase rights given by the company as a result of an attempted takeover will be exempt from taxes on those rights given by the target company, as long as the rights are also offered to the bidder, the Japanese government decided in July this year.

A company utilizing a poison pill prepares a share purchasing rights plan in advance and lays dormant until an individual's shareholding reaches a certain percentage, triggering the issue of the rights plan at a price at usually half the current market value of the shares.

If the shareholders exercise their rights and acquire the shares issued under the scheme, the percentage of the bidder's holding of the shares in the company falls dramatically as its share in the company becomes diluted, preventing the bidder, from becoming the company's major shareholder. This acts as a deterrent to the bidder and the takeover bid is abandoned. However, in such cases, shareholders exercising the right to purchase shares are subject to corporate, personal income, and other taxes.

Officials from the National Tax Administration said the current structure is based on the premise that share purchasing rights would be given to existing shareholders alone, and not to a hostile bidder. Under this system the existing shareholders have acquired “profits” at the time they are given the purchasing rights, and are thus subject to taxes, while a hostile bidder, who does not qualify for the rights, is tax exempt.

With the introduction of these changes, a company would first give share purchasing rights to all shareholders, including the hostile bidder. If the bidder exercises its purchasing rights with respect to the shares, it will fail to

function as a poison pill, thus the bidder is barred from exercising its rights, although it can sell the rights to a third party. The sale of such rights by the bidder will create “profits” in line with those of the company's incumbent shareholders and not be required to pay taxes on them.

With the very real possibility that the hostile bidder is selling the rights acquired under the scheme to member's of the bidder's group, the Ministry of Economy, Trade and Industry is urging corporations to include in their articles of incorporation provisions that allow the board to scrutinize such third parties when the conversion from rights to shares is sought.

## **NTA Assessments for Transactions with Related Overseas Manufactures**

Japan's National Tax Administration's threat to focus on examinations of royalty payments for trademarks, patents, manufacturing technologies and other intellectual properties used by Japanese companies' related foreign corporations has been anything but empty with three Japanese electronics firms – Sony, TDK, and Funai Electric corporations announcing recently that they had each received multi-billion yen transfer pricing adjustments for transactions with overseas manufacturing firms.

### **Sony Corp.**

Sony Corp. has been assessed on underreported income of ¥21.4 billion (US\$193.8 million) for transactions with seven of its fully owned subsidiaries, including those in Hong Kong, the United States, and the United Kingdom, as a result of the company not receiving arm's-length royalties from related compact disc and digital video disc

manufacturing operations. The administration determined that Sony used a formula in calculating profit allocation that fell below comparable arm's-length prices.

The company estimated corporate, local, and other tax payments resulting from the assessment at about ¥4.5 billion. The transactions were conducted in the five fiscal years between 1998 and 2002, according to a company release.

According to a press release issued by Sony subsequent to the ruling, the company indicated it would lodge an objection to the assessment on the grounds that its allocation of income was appropriate and that it has paid

the proper amount of taxes to each of the jurisdictions.

Sony also plans to request competent authority relief from Japan and the seven countries to avoid double taxation.



### **TDK Corp.**

TDK Corp. has been assessed on underreported income of ¥ 21.3 billion (US\$192 million) for the five years ending March 2003, for transactions with its Hong Kong and Philippines subsidiaries involving electronic parts used in computer hard disk drives, and that it owes an estimated ¥12 billion in corporate, enterprise, regional and other taxes, the electronic company announced June 30.

A TDK spokesperson stated most of the transactions cited by the Bureau were between the Tokyo parent and its Hong Kong subsidiary. The spokesperson emphasized that TDK has been using arm's-length prices based on transaction stages, transaction volume, market conditions, and other factors of third parties and that the methodology it had used for the transactions assessed had been the comparable uncontrolled price method.

A press release on the company's Web site indicated that TDK is unconvinced by the correction determinations and is going to file a request for reconsideration. It also stated that the company and its overseas subsidiaries have dealt with transfer pricing taxation issues in a consistent manner and have been appropriately reporting and paying taxes.

### **Funiai Electric**

The Osaka Regional Tax Bureau ruled that Funiai Electric had underreported ¥39.3 billion (US\$360 million) in income from a related party in Hong Kong, stemming from the Hong Kong affiliate being found to not have a permanent establishment (PE) as a manufacturer and therefore failing to qualify for exclusion from Japan's tax system, a Funiai spokesperson said. The Bureau held that the income recorded by the affiliate should have been

recorded as Funiai profits in Japan. Had it been found to have a PE, such exemptions afforded it would have included foreign tax credits and other preferential measures to taxpayers in tax havens.

The spokesperson added that the company is preparing to pay ¥16.5 billion in national, local corporate, and other taxes on the assessment, and will ask the Bureau or the NTA tribunal for relief.

According to the spokesperson, Funiai's Hong Kong entity commission manufactures television sets, DVD recorders and other consumer electric equipment with three Chinese governmental manufacturing plants located in Guangzhou province. The "commission-manufacturing system" has been heavily promoted by the Chinese government recently and under such a system, the Hong Kong affiliate procures parts and components primarily in Hong Kong, where it has about 30 administrative employees, and ships the materials to the Chinese plants without invoicing. In addition to this it also receives finished products from the Chinese plants--also without invoicing-- for exports to Japan, the United States, and other export markets.

Funiai's Hong Kong subsidiary has been using China's commission-manufacturing system since 1992 and had been recognized as legitimate by the NTA during that time, according to the spokesperson, who went on to say that numerous other Japanese and foreign companies, probably totaling more than 20,000, are using the commission-manufacturing system and that if Funiai was singled out, the tax authorities should investigate other taxpayers.

The Osaka Bureau determined that the Hong Kong Funiai unit is a controlled foreign corporation of the Osaka's parent as, over a period of time, it has developed into a quasi-headquarters for the three Guangzhou manufacturing plants, handling human resources and other labor issues for the plants.

Under Japanese anti-tax haven legislation, certain Japanese shareholders are subject to Japanese income taxation on the undistributed income of certain foreign subsidiaries. These rules apply where the earnings of such foreign related companies are subject to an effective tax rate in the foreign jurisdiction (in Funiai's case Hong Kong) of 25% or less. Unless a Hong Kong subsidiary meets the four tests that qualify it for an "exclusion of application" to the controlled foreign corporation (CFC) legislation, the Japanese shareholders will be taxed on the subsidiary's undistributed income.



The Funiai case could best be described as a reflection of the authorities' changing policies with respect to tax havens, including quasi-tax havens like Hong Kong and brings the NTA in line with Organization of Economic Cooperation and Development moves to combat harmful tax systems.

Despite Funiai's claims that thousands of other Japanese companies operated under similar arrangements, it remains unclear as to whether such companies running similar subsidiaries in Hong Kong might also be determined to be CFCs of Japanese parents.

### NTA Rules Lease To Be A Loan

Troubled Japanese trading giant, Sojitz has been ordered by the NTA to pay more than \3.2 billion in taxes and penalties.

One of the companies party to the merger that created Sojitz in 2004, the former Nishi Iwai Corporation, was ruled to have failed to declare interest income on loans to its subsidiaries, as well as participating in a lease agreement deal that the NTA ruled was effectively a loan agreement between the company and its UK subsidiary (Nishi Iwai Europe).

Prior to the deal being struck, Nishi Iwai purchased copper futures on the London Metal Exchange from 1996 to 1998 and, as a result of a downturn in the market, was forced to have the futures converted into a form of warrant which are able to be traded as proof of ownership of certain commodities.

It was then Nishi Iwai entered into the disputed lease deal with Nishi Iwai Europe, running from 1998 to 2004, at which point the subsidiary sold the warrants and made a profit of \25 billion on the deal. Despite the lease agreement granting the subsidiary full control over investment decisions made with the profit from the warrant sale, the NTA found sufficient evidence to indicate Nishi Iwai had retained control of the warrants and as such the profit made by the subsidiary from the sale constituted a \25 million loan.

The NTA then calculated the interest income from the "loan" to the subsidiary as being about \2.2 billion. Nishi Iwai had declared its income from the lease agreement as being \400 million, \1.8 billion less than it would have received under a loan agreement.

The remaining \1.4 billion owed includes a \200 million penalty and \1.2 billion in undeclared interest income from other loans to subsidiaries.



### China-Japan APA a coup for both countries

Hot on the heels of the release of its first formal Advanced Pricing Agreement rules late last year, China has signed its first bilateral APA with Japan, with the respective tax authorities confirming the transactions between a Japanese electronics company and its manufacturing subsidiary located in China as being appropriately priced.



With foreign investment in China showing no signs of abating, in addition to China's expected phasing out of foreign tax exemptions, it is anticipated that there will be a surge in double taxation disputes in the coming years.

As an incentive for foreign investment, China implemented what is known as the "two-year exemption, three-year halving" of corporate taxes. This scheme also kept cross-border tax disputes to a minimum. Under such arrangements, even in cases where transfer pricing adjustments were made by the Chinese tax authorities, the amounts were never considered high enough by the firms in question to warrant appealing the decisions.

However, all that is likely to change with the news that China is to phase out the foreign investment tax exemptions upon acceptance into the World Trade Organization.

This has made the APA with a Japan a coup for both parties with China hoping to stabilize its foreign investment tax base as well as ensuring such investment is received on a sustainable and stable basis.

Despite recent political tension between the countries, the APA is further proof of the close working relationship that exists between the NTA and its Chinese counterpart, according to an unnamed NTA official.

### Article 821

Recently there has been a lot of talk and confusion within foreign corporations over Article 821 in the Japanese Commercial Code.

The article, with its unclear wording, has had many corporations worried about their current businesses in Japan. The article's wording will inhibit foreign corporations from conducting business in branch form in Japan. It defines foreign corporations with headquarters or main place of business being in Japan as being a Quasi-foreign corporation. As such, these corporations would no longer be entitled to conduct business in their current form.

Therefore having to restructure their business here in Japan to a KK type of company.

The Ministry of Justice has informed foreign corporations that those companies already conducting business in Japan would not be categorized as a Quasi-foreign corporation.

While still unclear, this article is expected to come into effect in 2006.

## UK – Japan Treaty

After months of negotiations, representatives from the UK and Japanese governments have agreed in principle to replace the current Double Tax Agreement between the United Kingdom of Great Britain and Northern Ireland and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed on 10 February 1969.

The proposed new treaty, while based on the OECD model guidelines, closely follows some changes made to the recently ratified US-Japan treaty, eliminating withholding tax on royalties and substantially reducing withholding tax rates on certain inter-company dividends and certain interest paid between the two countries.

The Japan-U.S. income tax treaty which was signed 6 November 2003 and took effect March 30, 2004 eliminated source-country withholding taxes on all royalty income, dividends paid to parent companies owning a majority stake in the paying entity, and some interest income.

Under the current treaty and protocol between the UK and Japan, the withholding tax rate for dividends paid by a subsidiary to its parent is 10 percent if the parent owns 25 percent or more of the shares of its subsidiary. A 15 percent withholding tax rate applies if the parent owns less than 25 percent of the shares. A 10 percent withholding tax rate applies to interest and royalties under the treaty.

In addition to the changes in withholding tax rates, the proposed treaty limits the period of retrospective audits to 7 years, as it stands under Japanese company law.

The treaty is not expected to come into force until some time in 2006, as it has to be signed and submitted to both Parliaments for their approval.



It is expected taxpayers and withholding agents benefiting from the reduced withholding rates will be required to file documents with their tax authority before they can qualify for such rates. The new

withholding rates will not be recognized by the tax authorities and penalties will result for those taxpayers who withhold at the new rates before following these procedures.

## US-Japan Pension Treaty

U.S. and Japanese citizens should note that their respective countries are currently finalizing a pension treaty between the countries. The treaty will benefit not only the individual but also foreign corporations with expatriates.



### Currently:

To be eligible for pension in Japan, an individual must pay into the system current system for 25 or more years. Anything less and the individual is entitled to a lump sum payment of up to 2.4 months of their latest salary.

In the U.S., an individual must work for 40 quarters (10 years) to become eligible for pension with a minimum of 6 quarters paid directly into the U.S. Social Security scheme.

Should the individual not meet the required amount of payment into the system, they will not be eligible. The individual is unable to combine the years paid into the respective countries in order to meet the minimum requirements.

### Effective Date:

The agreement between the countries is to take effect from October 1, 2005.

### Purpose:

The purpose of the agreement is to eliminate the double taxation of social security, which is normally paid in both locations for expatriate employees sent by their company to work overseas and also allow individuals to combine the payments/work completed in both countries in order to meet minimum requirements.

### Rules:

An individual who is self-employed or who works as an employee in either country is subject to social security regulations of that country.

An individual who is sent by the home country to work for period of less than 5 years will be exempt from paying into the social security system of the host country. The individual is required to continue paying into the social security system of the home country (the individual is unable to choose which country system to pay into) and continues to be normally employed by the home country.

The 5 years will commence on the date of the agreement, if the employee is currently residing in the host country.

The 5 years may be extended if granted by the Competent Authority in that country. A waiver extension must be applied for.


**Example Situations:**

	Actual Yrs paid into system		Total Yrs paid into system combined	Currently Meet Req.		Meet New Agreement Req.	
	US	Japan		US	Japan	US	Japan
1	8	4	12	×	×		×
2	5	21	26	×	×		
3	6	3	9	×	×	×	×

In order to take advantage of this tax exemption, an employer must request a certificate of coverage. To avoid social security taxes in Japan, form "USA/J 6" must be applied for with the Social Security Administration. The following information must be provided to receive a certificate:

- Full name of employee
- Date and place of birth
- Citizenship
- Country of employee's permanent residence
- U.S. Social Security number
- Date of hire
- Name and address of the employer in the U.S. and Japan
- Date of transfer and anticipated date of return
- Statement certifying whether or not employee and all family members who will be in Japan are covered by an employer-sponsored or private health insurance plan while in Japan.
- Indication of whether the employee will continue as an employee of the U.S. company while in Japan or become an employee of the U.S. company's affiliate in Japan.

Information on this can be found on the Social Security website.

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We welcome your feedback and suggestions. Please contact:

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