

JANUARY 24, 2006  
2006-012

**JAPAN TAX DEVELOPMENTS:  
PROPOSALS ON TAX RATES,  
RELIEFS AND DEDUCTIONS,  
NON-PERMANENT RESIDENTS,  
DIRECTORS' PAY, AND STOCK  
OPTIONS**

by KPMG Tax Corporation, Tokyo  
(KPMG Tax Corporation in Japan  
is a KPMG International member  
firm)

Japan's Liberal Democratic Party-led ruling coalition agreed on an outline of the 2006 tax reform proposals on December 15, 2005. We set out below the main points of the outline. Please note that the tax reform bill will be submitted to the 2006 ordinary Diet session and the legislation may undergo modification.

### Changes in Tax Rates

Under the proposal, national individual income and local inhabitants tax rates will be changed as shown below. New tax rates will be applied from 1 January 2007 for income tax (tax on 2007 income) and for inhabitants tax (tax on 2006 income). The income tax bands would increase from four currently to six and the inhabitants tax would change from three tax bands to a flat tax rate (see tables below).

#### Income Tax

##### Current Law

Taxable income (¥)		Tax rate applicable to taxable income band
From	To	
0 -	3,300,000	10%
3,300,001	9,000,000	20%
9,000,001	18,000,000	30%
18,000,001	-	37%

##### Proposed Law

Taxable income (¥)		Tax rate applicable to taxable income band
From	To	
0 -	1,950,000	5%
1,950,001	3,300,000	10%
3,300,001	6,950,000	20%
6,950,001	9,000,000	23%
9,000,001	18,000,000	33%
18,000,001	-	40%

#### Inhabitants Tax

##### Current Law

Taxable income (¥)		Tax rate applicable to taxable income band
From	To	
0 -	2,000,000	5%
2,000,001	7,000,000	10%
7,000,001	-	13%

##### Proposed Law

Inhabitants tax rates will be unified at 10 percent regardless of the amount of taxable income.

## Tax Credit Based on Difference of Personal Reliefs (Inhabitants Tax)

According to the proposal, a new inhabitants tax credit regime will be introduced to alleviate the tax burden increase arising from the change in tax rates highlighted above – specifically, to mitigate any increase in the tax burden due to the difference between the personal reliefs for national income tax and those for the local inhabitants tax. This tax credit would be adopted from 2007 for inhabitants tax purposes.

(i) If an individual whose taxable income for inhabitants tax purposes is 2,000,000 yen or less, an amount as calculated using (a) or (b) below, whichever is the smaller, will be creditable:

- (a) difference between personal reliefs for income tax and those for inhabitants tax x 5 percent;
- (b) taxable income for inhabitants tax purposes x 5 percent.

(ii) If an individual whose taxable income for inhabitants tax purposes is more than 2,000,000 yen, an amount as calculated using (a) or (b) below, whichever is the greater, will be creditable:

- (a) {difference between personal reliefs for income tax and those for inhabitants tax – (taxable income for inhabitants tax purposes – 2,000,000 yen) } x 5 percent;
- (b) 2,500 yen.

## Abolition of Fixed Rate Tax Deduction

The proposal provides that the fixed rate tax deduction will be abolished and will not be applicable from 2007 for income tax purposes (tax on 2007 income) and 2007 for inhabitants tax purposes (tax on 2006 income).

The fixed rate tax deduction, which was introduced in January 1999 as part of a stimulus package intended to help push Japan out of its economic slump, was 20 percent of the tax amount for income tax purposes (up to 250,000 yen) and 15 percent of the tax amount for inhabitants tax purposes (up to 40,000 yen). The 2005 tax reform halved the fixed rate tax deduction from 2006.

## Income Deduction for Contributions or Donations

Under the current tax law, the amount deductible from income is equivalent to the amount of the contributions or donations paid during the year (subject to a ceiling of 30 percent of total assessable income) in excess of the minimum applicable amount of 10,000 yen. The minimum applicable amount would be reduced from 10,000 yen to 5,000 yen under the proposal.

Please note that contributions or donations qualifying as a deduction for income tax purposes are those to government or local authorities, institutions for educational, scientific, or other public purposes as designated by the Minister of Finance, and to institutions for scientific study or research specifically provided for in the regulations.

## Scope of Non-permanent Residents

There are two categories of Japanese residents for individual income tax purposes: (i) permanent residents and (ii) non-permanent residents. While a permanent resident is taxed on his/her worldwide income, a non-permanent resident is taxed only on his/her Japanese source income and foreign source income paid in or

remitted into Japan. Under the current tax law, a non-permanent resident is defined as a resident who has no intention to live in Japan permanently and has lived in Japan for less than five years. There have been some cases where taxpayers took advantage of such favorable treatment for non-permanent residents by leaving Japan for a short period of time and then re-entering Japan as non-permanent residents.

The 2006 tax reform will include a rule to narrow the scope of non-permanent residents. Under the new rule, a non-permanent resident will be defined as a resident who does not have Japanese nationality and has lived in Japan for less than five years in the last ten years.

This amendment will be applied to judgments of taxpayers' residency status conducted on or after April 1, 2006.

## Corporate Tax Provisions

### *Directors' Bonuses and Remuneration*

Irregular Compensation: Under the current law, any bonuses paid to company directors (e.g., members of the board of directors, officers and statutory auditors) are not deductible for corporate tax purposes. Any irregular compensation from a company to its directors is treated as directors' bonuses, while regular compensation paid on a monthly basis or a weekly basis is deductible as directors' remuneration.

Under the proposed law, the following compensation will be allowable for corporate tax purposes even if paid irregularly (i.e., neither on a monthly basis nor on a weekly basis).

- Compensation which is calculated not based on profits of the company provided that the amount and the timing of the payment of the compensation are pre-determined by a company policy, etc.
- Compensation which is calculated based on profits of the company provided that the compensation satisfies certain requirements including the following:
  - it is paid from a non-family company to its directors who are involved in the company business;
  - it is recorded as an expense for accounting purposes in the accounting year of the payment;
  - the calculation basis for the compensation is determined properly, e.g., through a decision by the compensation committee, and disclosed properly, e.g., through a securities report under the Securities and Exchange Law.

Compensation for Director of Family Company: Where 90 percent or more of the total outstanding shares of a family company are held by directors, their family relatives, or other persons connected with them, and the majority of directors engaged with the day-to-day business activities of the company are such people, an amount equal to the "standard deduction" for income tax purposes relating to the compensation for the directors will be non-deductible when the taxable income for the company is calculated.

Thanks to the new Company Law, which repeals the minimum capital requirement of a company, it will become easier to establish a company. The new rule to restrict the deduction of directors' compensation in the case of a family company aims to prevent taxpayers from "double deductions" at a company level and an individual level through setting up a company.

However, there will be a safe-harbor rule, under which the new rule will not be applied to the following cases:

- the average of the annual income of the family company before deduction of the directors' compensation for the prior three years is 8 million yen or less;
- the average of the annual income of the family company before deduction of the directors' compensation for the prior three years exceeds 8 million yen but is 30 million yen or less, and the ratio of the directors' compensation to the average annual income amount is 50 percent or less.

### ***Expenses for Stock Options***

According to the 2006 tax reform proposal, when a company issues stock options ("shin kabu yoyaku ken") as consideration for services rendered by individuals, expenses for such services will be deductible expenses at the time of exercise of the stock options unless the stock options are tax-qualified stock options for Japanese individual income tax purposes.

Under the new Japanese accounting rules for stock options, which are still draft as of the date of this newsletter, stock based compensation costs will be recognized as expenses over the period from the grant date to the vesting date of the stock option, whereas under the current accounting rules, no costs are recorded.

Subsequent to the introduction of the new Japanese accounting rules, a new tax rule will be introduced to clarify the tax treatment of the costs recorded for accounting purposes. Note, however, that it is not yet clear how to calculate the service expenses. For accounting purposes, stock based compensation costs are the value of options calculated based on the Black-Scholes-Model method, etc. However, for individual income tax purposes, income for services rendered under non-tax-qualified stock option schemes is calculated as the net amount of the fair market value of the stock at the time of exercise less the option price.

This amendment will be applied to stock options for which issuance is determined on or after the effective date of the new Japanese Company Law.

### **Tax-qualified Stock Options for Japanese Individual Income Tax Purposes**

Under tax-qualified stock options that satisfy certain conditions, income generated from the exercise of stock options is not taxed at that time, but taxed as capital gains when the stock is sold. Company officers ("shikkouyaku") will be added to the list of people subject to tax-qualified stock options.

This story is excerpted from "Japan tax newsletter: an update on current issues and trends," (December 2005), published by KPMG Tax Corporation, Japan, with permission. For a copy of this publication, please contact your local IES professional or go to the Web page for KPMG in Japan at: <http://www.kpmg.or.jp/english/tax/newsletter.html>.

\* \* \* \*

The information contained in this newsletter was submitted by KPMG in Japan. The information contained herein is general in nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. Do not act upon such information without appropriate professional advice.

*Flash International Executive Alert* is an IES publication of KPMG LLP's Washington National Tax practice. To view this publication or prior issues online, please visit <http://www.us.kpmg.com/ies/flashalerts>.