

Doing business in Japan

An overview of the key issues from a Tax,
Legal, Bookkeeping, and practical perspective



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Introduction

Japan is the world's third largest economy and continues to be a stable market both economically and politically. In recent years, the country has made efforts (albeit with some interruption during the COVID-19 pandemic) to attract more foreign talent and regional headquarters. With some reassessment of global supply chains and moves towards more regionalization, Japan is increasingly being viewed as an attractive location to invest in, and operate from, by numerous sectors. With certain traditional headquarters jurisdictions in Asia-Pacific facing political and economic uncertainty, companies may wish to examine Japan as a potential base for their regional operations as well as expanding activities in the Japanese market.

Japan is presently one of Asia-Pacific's most important inbound destinations for various categories of fund investments. For investors in this sector, understanding the Japanese regulatory and tax environment is of crucial importance.

The authors hope that this brochure will provide a useful overview of relevant rules and procedures for doing business in Japan. For further information, readers are invited to contact any of the individuals listed on page 31.

Please note that though the content of this booklet is considered appropriate on 1 January 2023, it may be partially revised, deleted, or supplemented in response to future changes in laws, regulations or prevailing practices.

Exchange rate of JPY133:1USD applied



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Potential forms of entity



Potential forms of entity

There are three main options for operating in Japan:

- (i) Set up a Representative Office
- (ii) establish a subsidiary company - i.e., a separate legal entity in Japan, or
- (ii) file for the registration of a foreign company - i.e., a Japan branch.

Representative office

It is easiest to set up a representative office (RO). However, a RO should not engage in any commercial transactions. Its activities are limited to information gathering, market research and general liaison activities.

As the RO is an extension of its foreign head office, it typically cannot open a bank account or lease real estate in its own name.

A RO is therefore generally only suitable for a foreign company that is wanting to better understand the Japanese market and locate potential customers before conducting business in Japan through one of the other types of entity.

Provided a RO does not engage in commercial transactions it will not be subject to corporate income taxes in Japan. However, if a foreign company has direct sales in Japan and its RO is involved in the direct sales, the RO could be subject to tax as a branch and/or legal and regulatory risks.

Japan branch of a foreign company

In contrast to a subsidiary, a branch is an extension of the foreign parent and is not a separate legal entity. Accordingly, a liability associated with business activities conducted by the branch in Japan is directly attributable to the foreign company. For this reason, many foreign companies only use a branch if it is providing services to group entities, rather than to third party customers.



A branch is permitted to operate in any business category unless applicable regulatory law for the business to be conducted requires an independent Japanese legal entity. A Japanese branch of a foreign company can have a bank account located in Japan after the branch registration is completed.

A foreign company with a permanent establishment (PE) (e.g., branch) in Japan is subject to Japanese corporate income tax (CIT) for the taxable income attributable to the branch (or PE).

Japanese companies

There are two major types of limited liability companies in Japan. One is a joint stock company (*kabushiki kaisha* or KK) and the other is a limited liability company (*godo kaisha* or GK).

KK

KK is the most widely-used form of a corporation for both small, private companies and large, listed companies. Historically, KK has been the main choice of corporations in Japan. It is still often considered to have more prestige than a GK, by Japanese customers, goods and service suppliers (including banks), and employees/directors.

GK

GK, which was introduced in 2006, is somewhat similar to an LLC in the US. The use of a GK is increasing, especially among US headquartered multinationals as it should provide more flexibility for US federal income tax purposes than a KK.

Accounting principles and financial statements

Japanese generally accepted accounting principles typically apply.

Generally, a private company is not subject to a statutory reporting requirements. However, if the form of a company is a KK, a balance sheet needs to be disclosed. Also, if the KK is a large company, which is defined as a company with a share capital of at least JPY500 million (US\$3.8 million) or liabilities of at least JPY20 billion (US\$150 million), the KK is required to disclose its financial statements and appoint a statutory auditor.

Foreign exchange control

In general, foreign exchange transactions are not subject to government control. Though there are some limited reporting requirements.

Currency

The currency is the Japanese Yen (JPY). A Japanese entity is required to have financials in JPY for various reasons, including tax return reporting.

Dividend distribution

The Company Act requires dividends to be distributed out of distributable surplus, subject to a legal reserve requirement.

Interim dividend

Interim dividend distribution is allowed.

Typical Japan issues/requirements from new entry to on-going business development

	Incorporation <i>Phase 1</i>		Post-incorporation <i>Phase 2</i>		Growth <i>Phase 3</i>
Accounting	Finance structure formulation		Bookkeeping	Preparation of depreciable assets ledgers	Financial management and governance, and business advisory
Tax	Tax structure formulation	Tax notification preparation	Drafting monthly and annual reports	Preparation of accounts settlement documents	
			Collection and storage of SST numbers	Drafting statutory statements	
			Depreciable asset tax return preparation	Corporate and consumption tax return preparation	On-going tax compliance, governance and business advisory
Payroll calculation			Payroll calculations including gross up method		
Social insurance	Support for drafting social insurance related notifications, new employment regulations, employment contracts, etc.		Collection and storage of SST numbers	Drafting statutory statements	
			Drafting social insurance related documents, etc.		
Legal affairs	Incorporation procedures		Drafting annual compliance documents		Legal compliance and advisory for business activities
Individuals			Income tax return preparation		

Japanese tax issues



Residence

A corporation (such as a KK or GK) that is incorporated or has its head office in Japan is treated as a resident corporation. Neither central management and control nor effective management criteria are used to determine the tax residence of a corporation.

Permanent establishment (PE)

The definition of a PE under Japanese domestic tax law is basically similar to that of the Organisation for Economic Co-operation and Development (OECD) model treaty.

However, there are a number of Japanese tax treaties that are based on the older (pre-base erosion and profit shifting) version of the OECD model treaty.

Where there is a difference between the definition and treatment of a PE under the domestic law and the relevant Japan tax treaty, usually the latter will be applicable,

Basis of taxation

Resident corporations are subject to Japanese CIT on their worldwide income, with an exemption for dividends received from certain subsidiaries (please see *Taxation of dividends, interest, royalties and capital gains* section).

Non-resident corporations without a PE are subject to Japanese CIT on their Japan-source income only, such as certain rental income, certain capital gains, etc.

A foreign corporation with a PE in Japan is subject to Japanese CIT on its attributable income. A PE of a foreign corporation is assumed to be a separate and independent entity from its head office, and the arm's length principle is applied to income and costs attributable to that PE, including from certain intra-company transactions (potentially varying depending on the specific tax treaty with Japan).



Corporate income tax rates

	Applicable for Fiscal years beginning on or after 1 April 2018
National CIT	23.2%
Local inhabitant tax	1.624%-2.413%
Local enterprise tax (includes special corporate enterprise tax)	3.600%-3.780%
Alternative minimum tax	Not applicable
Surtax on undistributed retained earnings	Only applicable for certain undistributed profits of a "family corporation"

The basic rate of national corporation tax is 23.2%. Local corporate income taxes, which are local inhabitant tax and enterprise tax, are also imposed. The resulting effective corporate income tax rate for companies subject to the 23.2% rate is approximately 35%.

Business Scale Taxation (Gaikei Hyojun Kazei), is applicable for a corporation where its registered capital amount is more than JPY100 million (approximately US\$0.8 million). The tax rates shown above are for such a company, which has an effective rate of approximately 31%.

The tax law prescribes which adjustments to accounting income are required in computing taxable income. Expenditures incurred in the conduct of the business, except as otherwise provided by the law, are allowed as deductions from gross income.

The applicable corporation tax rate for certain non-resident capital gains is 25.59%. Please refer to page 16.

Net operating losses (NOL)

NOL can be utilized in the following manner:

- ▶ Carryback: one year (generally only qualified small or medium-sized enterprises)
- ▶ Carryforward: 10 years (9 years for losses incurred in tax years beginning before 1 April 2018)
- ▶ Limit of utilization: up to 50% of current year's taxable income (100% for qualified small or medium-sized corporations)

NOLs may be further restricted in the event of a change in ownership (greater than 50%) and (for example) where there is a discontinuance of the business and commencement of a new business.

Transfer pricing (TP)

Japan's TP laws stipulate that pricing between internationally affiliated entities should be based on the arm's length principle. Entities are internationally affiliated entities if a direct or indirect relationship involving 50% or more ownership or substantial control exists, or other facts exist which allow one entity substantial control over the business of another. Japan allows the selection of the most appropriate TP method in each specific case, including use of the discounted cash flow method where no other methods can be used (typically for intangible asset transactions). Effectively, in an audit, the burden of proof as to the reasonableness of the pricing can be passed to the taxpayer, and if the taxpayer fails to provide proof or to disclose pertinent information to the tax authorities, taxable income may be increased at the discretion of the tax authorities. Interest and penalties are also levied on any increased tax liability.

It is possible to apply for an advance pricing agreement (APA). Both unilateral and bilateral APAs are available and are used frequently to provide increased certainty and comfort for taxpayers. Where a taxpayer has received a transfer pricing assessment as a result of an examination, a taxpayer may apply for a Mutual Agreement Procedure between Japan and the relevant treaty partner country to relieve double taxation which may arise. Administrative appeals and litigation are other possible ways to contest a transfer pricing assessment.

A statement providing details of transactions with foreign related parties (Schedule 17-4) must be attached to the annual corporate income tax returns.

Japan has adopted TP documentation and reporting rules that include country-by-country reporting (CbCR), master file and local file.

A Japanese company that is the ultimate parent of a multinational group having a group revenue of JPY100 billion (approximately US\$8 billion) or more in the preceding fiscal year must file a CbC report. Japanese entities (including a PE of a foreign company) may be required to file the CbC report for the Group under certain conditions.

Interest limitation rules

Thin-capitalization rules

Japan limits the deduction for interest expenses for companies with foreign related-party debt if generally the debt-to-equity ratio exceeds 3:1.

Interest on the excess portion of loans is permanently non-deductible.

Earnings-stripping rules

Japan's earnings stripping rule limits the deductibility of interest expenses where the net interest payments of a Japanese company exceed 20% of the adjusted taxable income (basically, Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA)) in a fiscal year. As non-taxable domestic and foreign dividend income is not included in adjusted taxable income, the impact on a holding company with income that mainly comprises dividends from its subsidiaries is particularly significant.

Net interest payments are "relevant interest payments" net of "eligible interest income". Relevant interest payments are, broadly, total interest payments (including interest paid to third parties) excluding interest that is subject to Japanese corporate income tax/income tax (not merely withholding tax) in the hands of the lender. Eligible interest income is generally calculated as: Total interest income (subject to certain adjustments) x (total relevant interest payments/total interest payments).

This rule also does not apply to interest on bonds meeting certain requirements. Furthermore, de minimis thresholds are applicable.

Interest deductions disallowed under this provision are carried forward for up to seven years.

If thin capitalization rules and earnings stripping rules both apply, the rule that results in a larger disallowance is applied.

Tax incentives

Japan offers various tax incentives, including special depreciation and tax credits, such as:

- ▶ Research and development
- ▶ Investments in domestic machinery, energy-saving facilities and 5G technology
- ▶ Salary increases

Foreign tax credit

A foreign tax credit is allowed for direct foreign taxes (subject to limitations). A deemed paid foreign tax credit (indirect foreign tax credit) is generally not available.

In addition, under tax treaties, a tax-sparing credit may be available to domestic companies with a branch or subsidiary in a developing country.

Controlled foreign corporation (CFC)

Typically, a Japanese subsidiary of a non-Japan headquartered group will not own shares in a foreign company. However, if it does, Japan's CFC rules could apply.

Under the CFC rules, a foreign corporation with a majority of shares owned by Japanese residents is treated as a tax haven company if such foreign corporation meets either of the tests below:

- ▶ A paper company, cash box or blacklist company that has an effective tax rate of less than 30%
- ▶ A foreign corporation that does not meet the economic activity criteria and has an effective tax rate of less than 20%

If a foreign corporation's effective tax rate is less than 20% and meets the economic activity criteria, only certain passive income is included in the Japanese corporation's taxable income.

Generally, the income of a tax haven company is included in the Japanese shareholder's taxable income in proportion to its ownership if the shareholder owns at least 10% of the tax haven company.

Groups of companies

For fiscal years beginning before 1 April 2022, a domestic parent corporation and its 100% domestic subsidiaries could elect to enter into the Consolidated Tax Return System (CTRS), which applies to national corporation tax only. A consolidated group would have to elect to join the CTRS, which was subject to the approval of the Japanese tax authority. It must also obtain the approval of the tax authority to terminate its CTRS.

Generally, a subsidiary had to mark to market certain assets immediately before entering the CTRS. A subsidiary's NOL would also expire at the time of entering into the consolidation group. An exception to these rules was available in certain cases.

Replacing that consolidated taxation regime, a new group income and loss-sharing regime is applicable to fiscal years beginning on or after 1 April 2022, i.e., from 1 January 2023 for calendar year-end companies. The new regime maintains the basic framework of the current CTRS (for example, the offsetting of profits and losses) while also reflecting the consideration given to reducing the administrative workload of companies. The new regime is also better aligned with the tax rules governing corporate reorganizations, in terms of market value taxation and the restriction on utilization of net operating losses on an initial tax consolidation or entry into an existing tax group, this should reduce both the number of entities subject to market value taxation and the number of entities affected by the restriction on the utilization of net operating losses.

Japan's corporation tax law also contains special taxation rules for intragroup transactions among 100% group companies, under which certain gains and losses are tax deferred. This taxation system is separate from the CTRS or the Group income and loss sharing rules, and its application is mandatory.

General anti-avoidance rules (GAAR)

Japan has no GAAR, but it does have specific anti-avoidance rules for (1) closely held corporations, (2) corporate reorganization, (3) corporate tax consolidation and (4) calculation of Japan-sourced income attributable to a PE in Japan.

Japanese tax authorities may use the substance-over-form concept to deny tax treaty benefits for transactions motivated only for tax treaty benefit.

Consumption tax

Scope

Consumption tax (similar to VAT or GST) applies to the following transactions:

- ▶ The supply of goods or services made in Japan by a “taxable person”
- ▶ The importation of goods into Japan
- ▶ The purchase of services subject to reverse charge

A “taxable person” is any business entity or individual that makes taxable supplies of goods or services in the course of doing business in Japan. However, the JCT legislation currently provides for a “small business exemption”, the application of which depends on the taxable turnover realized in previous fiscal years. Additional criteria apply to newly established corporations. A business falling under the small-business exemption may elect for taxable person status.

Cross-border digital services are subject to specific rules. The concept of digital services covers most content and services provided through an electronic network, e.g., e-books, online newspapers, music, videos, game applications and software provided via the internet, and online advertising.

A distinction is made between business-to-business (B2B) and business-to-consumer (B2C) supplies, based on the nature of the service, as well as the terms and conditions of the contract. For B2B digital services: a reverse-charge mechanism applies; while for B2C digital services: the nonresident supplier is required to register for JCT, file tax returns and pay JCT.

Rates

The generally applicable tax rate is 10%. An 8% reduced rate applies to fresh and processed foods except for alcoholic beverages and food/beverages served at a restaurant. 0% applies to export transactions.

Tax returns and payments

Taxable persons must file JCT returns (at least) annually. The filing deadline is within two months (with a potential one month extension) after the fiscal year-end.

A corporation must pay the JCT due within two months of the year-end, regardless of receiving an extension to the filing deadline.

JCT invoices

JCT law does not currently explicitly require a taxable person to issue a tax invoice for taxable supplies made to other taxable persons. However, in order to deduct input tax, the recipient must hold an invoice containing certain mandatory information.

From 1 October 2023, holding a qualified invoice will, in principle, be required to deduct JCT. Qualified invoices will include the supplier’s registration number, applicable rates, breakdown of the price by rate and the total amount of JCT. The new JCT qualified invoice system requires JCT taxpayers to register as a qualified invoice issuer to be able to provide a qualified invoice, enabling buyers to claim a credit for input JCT. Only registered businesses will be allowed to issue qualified invoices.

Stamp duty

Stamp duty is imposed when certain types of documents are executed, e.g., when executing real estate and business transfer agreements. The maximum stamp duty liability is generally up to JPY600,000 (approximately US\$5,000).

Stamp duty is not imposed on the disposal of shares of a Japanese corporation.

Other taxes on corporations

Capital duty (registration tax)	<ul style="list-style-type: none">▶ KK - 0.7% of stated capital (minimum JPY150,000 or US\$1,100)▶ GK - 0.7% of stated capital (minimum JPY60,000 or US\$500) When making additional capital injections the minimum dutiable amount is JPY30,000
Registration tax on transfer of real estate	2% on the appraisal value (1.5% for land)
Real estate acquisition tax	4% on the appraisal value (3% for land)
Depreciable fixed assets tax	1.4% on the net tax-book value of the depreciable fixed assets as of 1 January
Business premise tax	0.25% on total salary and JPY600 (approximately US\$5) per square meter of floor space in business use

Records

A taxable person must record transaction details (date, description, name of counterparty, consideration) in its books.

Taxpayers can currently use paper retention. However, successive tax reforms have been encouraging taxpayers to move to electronic retention by 31 December 2023, with explanations required for any delays.

However, where the taxpayer uses the group's global IT system, it could become a challenge to change the IT system only for the benefit of the Japanese subsidiary to enable it to meet the e-retention technical requirements.

We therefore suggest that a taxpayer considers these e-retention (and JCT invoicing) issues as soon as possible, because it may take longer than expected to fully review the updates required and the impact of the organizational and system issues and adjust if necessary.

Taxation of dividends, interest, royalties and capital gains

For Japanese corporate income tax purposes, interest income and capital gains or losses are included in ordinary taxable income to which normal tax rates apply.

A dividend paid by a wholly owned domestic corporation is fully exempt from CIT. If ownership in a dividend-paying domestic corporation is less than 100% but more than 33.33%, dividends, net of any related interest expense incurred for acquisition of the shares, are excluded from gross income. Fifty percent of domestic dividends are taxable if the domestic shareholder holds a 33.33% interest or less in a Japanese distributing company. If the ownership percentage is 5% or less, 80% of domestic dividends are taxable. Currently, dividends paid by a Japanese domestic company to its Japanese shareholder(s) are subject to Japanese withholding tax at a rate of 20.42%. The withholding tax can be netted against the dividend recipient's total CIT liability, or if the withholding tax exceeds the CIT liability, then this excess is refundable. Dividend payments received on or after 1 October 2023, by a domestic company that directly owns at least one-third of the shares in another domestic company making the distribution will no longer be subject to this dividend withholding tax.

Ninety-five percent of foreign dividends (with 25% or more ownership) are generally excluded from taxable income (no credit or deduction is available for foreign withholding tax). The ownership threshold of 25% may be reduced under certain tax treaties. This exemption for dividends paid by a foreign subsidiary will not be available for dividends that are deductible in the country where the foreign subsidiary is located.

Capital gains from the transfers of certain shares held by a foreign company are subject to corporation taxes, unless exempted by an applicable tax treaty. Under certain conditions, for example: (1) shares in a Japanese corporation owned at least 25% directly or indirectly (tested for the past three years) and sold at least 5% in a given year, and (2) shares in a "real estate rich" company (basically a corporation where at least 50% of whose assets consist of real properties located in Japan). The rate for the non-resident capital gains taxes is approximately 25.59%.

Generally, there are no adverse Japanese tax implications on an indirect transfer of shares of a Japanese corporation, unless that company is a real estate rich company.

Withholding tax on dividends, interest and royalty payments

Japan levies a non-resident withholding tax on dividends, interest and royalty payments at the domestic tax rate of 20.42%, unless reduced or exempted by an applicable tax treaty. Certain other payments made to a foreign company may also be subject to withholding tax if they constitute Japan-sourced income.

Tax treaties

As of March 2023, Japan had signed 84 income tax treaties, all of which are in force. The existence and use of a relevant treaty may affect an application of general tax law, especially in relation to cross-border transactions and permanent establishment issues. Companies should therefore also refer to the appropriate tax treaty in addition to general tax provisions.

Tax treaty application and timing

A treaty application form for withholding tax reduction or exemption has to be filed with the tax authorities through a withholding agent (generally the payee company) before a payment is made to non-residents.

In case of a non-resident capital gains tax exemption, the application has to be filed with the tax authorities within two months from the overseas company's fiscal year-end.

In general, a residency certificate has to be attached to an application form for claiming a tax treaty benefit that is subject to a limitation on benefits clause.

Tax administration

Tax year-end, tax return filing date, and interest/penalties

- ▶ The fiscal year stated in the articles of incorporation is used as the tax year.
- ▶ Corporate tax returns have to be filed within two months after the tax year-end. A one month extension (or a two-month extension for tax returns/tax returns under the group income and loss sharing rules)) is normally available on application to the tax authorities, during which time interest will be applied to the tax liability.
- ▶ Penalties may be imposed on taxpayers that fail to file tax returns in a timely manner, pay taxes when required or underreport their total tax due.

Statute of limitations

- ▶ The statute of limitations is five years in general
- ▶ The statute of limitations is seven years for TP assessment
- ▶ The statute of limitations is ten years for correcting the amount of NOL; and
- ▶ Seven years in relation to fraud

Tax rulings

An informal (or formal) tax ruling from the tax authority is available in many situations to confirm a taxpayer's analysis and conclusion regarding the expected tax treatment of a specific fact pattern. The taxpayer initiates the ruling with the tax authorities. Typically, the taxpayer then prepares a summary paper and meets with the relevant tax examiners to discuss it. Though the ruling is not legally binding, the tax authorities should respect the conclusion of the informal ruling during a tax audit, provided the facts and circumstances are the same as stated in the informal ruling request.

Tax authority

The National Tax Agency is the main tax authority in Japan. There are also Regional tax bureaus and local tax offices.

Legal matters relating to establishing a new entity



Key legal characteristics

There are many similarities between the main legal characteristics of a KK and GK, however, a GK is generally considered slightly easier/cheaper to maintain.

The following table shows the key legal characteristics of a KK and GK:

	KK (non-public KK)	GK
Separation of ownership and management	Yes Shareholders appoint director(s)	No Members (i.e., equity holders) directly manage the business (but see below)
Minimum amount of capital	JPY1, however, from a practical perspective significantly more is likely to be required	JPY1, however, from a practical perspective significantly more is likely to be required
Limited liability status of shareholders/members	Limited to the extent of capital contribution	Limited to the extent of capital contribution, but the managing member could be liable to third parties, if it fails to perform its duty to manage the business
Minimum number of shareholders/members	One	One
Transfer of shares/equity interests	Shares in a KK are generally freely transferable unless restricted by the articles of incorporation. The articles may provide that share transfers require the company's approval (a KK with such a provision is referred to as a "non-public KK") ¹	The default rule requires the members' unanimous approval for any transfer of equity interests
Executives	<ul style="list-style-type: none"> ▶ At least one director needs to be appointed. Directors need to be a natural people, but there does not need to be a Japan resident director ▶ The default rule bestows each director the power to represent the KK, but they can appoint one or more representative directors ▶ If a KK wishes to form a board of directors, at least three directors need to be appointed, of which at least one must be a representative director 	<ul style="list-style-type: none"> ▶ The default rule bestows each member the power to represent the GK, but the members can appoint one or more representative members ▶ If the representative member is a legal entity, such member must appoint a natural person as an executive officer, who executes the business of the GK ▶ There does not need to be a Japan resident director/member
Term of office of directors/members	Maximum 10 years	No limitation
Board of directors/members	Not required	Not required

Steps of incorporation

The incorporation of a KK or GK usually takes three to four weeks. The required documents and their contents differ for each case.

The key steps for the typical incorporation procedures¹ are as follows:

	KK	GK
1.	(If required) submit a prior notification on inward direct investment to the relevant Ministries via the Bank of Japan and wait for the clearance ²	
2.	Prepare an affidavit for the promoter (i.e., the initial shareholder) with notarization in the promoter's country if the promoter is a foreign legal entity	Prepare an affidavit for the representative member with notarization in the representative member's country, if the representative member is a foreign legal entity
3.	Prepare the KYC documents for a substantial controller for the notarization, adopt the articles of incorporation and have them notarized by a Japanese notary public	Adopt the articles of incorporation (notarization is not required)
4.	Deposit capital in the promoters' bank account at a bank licensed in Japan, minimum JPY1	Deposit capital in the representative member's bank account, minimum JPY1
5.	Appoint one or more directors and the representative director (as necessary)	Appoint a representative member (as necessary). If the representative member is a legal entity, it must appoint a natural person as an executive officer (shokumu shikkosha) who will actually execute the business
6.	Submit an application for company registration to the Legal Affairs Bureau (Ministry of Justice). It generally takes one week to complete the company registration	
7.	Submit a post facto report on inward direct investment to the relevant ministries via the Bank of Japan	

¹ Alternative methods of incorporation may be available if there is a logistical issue, etc.

² In certain cases (especially, where the business to be operated by a new company falls under certain business regulated under the Foreign Exchange and Foreign Trade Act and/or the products or services to be handled by the new company are subject to export controls), a prior notification and clearance procedures would be required.

Branches of foreign companies

In order to establish a branch in Japan, a foreign company needs to appoint at least one individual representative (who must be resident in Japan). The branch needs to be registered with the Legal Affairs Bureau.

The key steps for the typical procedures of branch establishment are as follows:

1. (If required) submit a prior notification on inward direct investment to the relevant Ministries via the Bank of Japan and wait for the clearance³
2. Appoint one or more branch representative(s). At least one of the branch representatives must be resident in Japan but citizenship is not required
3. Prepare an affidavit on the foreign company with notarization in the foreign company's country
4. Register the branch with the Legal Affairs Bureau (Ministry of Justice) within three weeks from the appointment of the branch representative. It generally takes one to two weeks to complete this branch registration

Steps 2 to 4 for setting up a branch in Japan usually take three to four weeks, after the necessary information is provided.

The branch can be opened upon the appointment of the branch representative, except that if prior notification and clearance are required in certain cases.

Representative office (RO)

As mentioned previously, it is easier to set up a representative office. However, a RO may not engage in any commercial transactions. Its activities are limited solely to information gathering, market research and general liaison activities.

A foreign corporation can set up an RO in Japan. The RO is not required to be registered with the Legal Affairs Bureau. However, a notification to the Financial Services Agency must be made prior to the establishment of the RO of foreign banks, insurance companies, securities companies or other financial institutions.

³ In certain cases (especially, where the business to be operated by a branch falls under certain businesses regulated under the Foreign Exchange and Foreign Trade Act and/or the products or services to be handled by the new entity are subject to export controls), a prior notification and clearance procedures would be required.

Bookkeeping requirements and practical issues



Bookkeeping and filing requirements

Once the new Japanese entity is legally established then bookkeeping processes and initial tax filings are likely to be the next matters for a foreign group to consider.

The following table shows the key financial information that may be required:

Name of financial information	Due date	Issues to note/consider
Financial statements under the Companies Act	Within three months from fiscal year-end	Financial statements must be approved by the board and shareholders before the tax filings and basically cannot be changed thereafter
Financial statements - public notice	As soon as approved by shareholders' meeting	
Submission of various tax notifications and elections	Varies, but we recommend that these are filed as soon as possible after the entity has been established	The prompt submission of an election to be a blue tax return filer is particularly important as this status provides a Japanese entity with certain tax protections and potential benefits
Corporate income tax returns	Within three months from fiscal year-end (with one month extension)	Tax returns extensions extend the filing deadlines by only one month (i.e., up to three months from the fiscal year-end)
Consumption tax return	Within three months from fiscal year-end (with one month extension)	
Business premises tax return	Within two months from fiscal year-end	
Depreciable asset tax return	By the end of January	
Statutory report and annual vendor statement	By the end of January	Fund transfers from/to foreign parents/Japanese subsidiaries, and payments to certain vendors could be subject to withholding taxes or reporting to the Bank of Japan.

Brief comments on other practical issues

Below are some practical issues that companies/groups should also consider, and which EY would be pleased to assist with or (if appropriate) to introduce another potential service provider.

Urgent and/or time-consuming matters

- ▶ Obtaining industry specific licenses, permits, etc., all such documents are likely to be only available in Japanese
- ▶ Hiring competent local staff and/or directors who can communicate in Japanese and relevant foreign language for communication with headquarters. Employment contracts and work rules must follow the Japanese Labor Law and associated regulations. In most cases, those made by the headquarters should be carefully reviewed and localized
- ▶ Registration into social insurance arrangements (i.e., health insurance, social security, etc.) which can be complex and involve confidential documents
- ▶ Opening a bank account and associated online banking set-up can be surprisingly difficult and time-consuming especially as an account with a Japanese (not foreign) bank is required to make statutory payments. Only certain online banking menus are offered in English, and English language support is generally limited. Vendor names are only offered in Japanese characters within the Japanese banking system
- ▶ Ordering company seals that may need to be registered, e.g., seal for banking use
- ▶ Securing an (virtual) office and paying up to 12 months of deposit

Other considerations

- ▶ Identifying certain people at Global/Regional level that can understand/monitor both the accounting and tax issues in Japan (what is recorded in the books may affect the tax situation)
- ▶ Putting in place systems and procedures that satisfy Japanese regulations surrounding electronic transaction data, electronic invoices, records storage requirements and the handling of My Number (personal social security information) data

Taxation of expatriates in Japan



Tax resident status

Individuals resident in Japan are subject to both national income tax and local inhabitants tax. National income tax is levied on the current year's taxable income at progressive rates that reach 45% for taxable income exceeding JPY40,000,000. Local Inhabitants tax is imposed only if an individual taxpayer is resident on following 1 January. It is assessed based on the prior year's taxable income and at a flat rate of 10%. An earthquake reconstruction surtax is effective for the 25 year period between 1 January 2013 and 31 December 2037. During this period, there will be a 2.1% surtax levied on the national income tax liability.

Types of tax residents

For tax purposes, individual taxpayers are classified into three residency categories: permanent residents, nonpermanent residents and nonresidents.

- ▶ Permanent residents are individuals who are Japanese nationals or non-Japanese nationals who have been present in Japan for at least five years within the past 10 years. Permanent residents are subject to tax on their worldwide income. Japanese citizens living in Japan are always permanent residents irrespective of period of stay.
- ▶ Nonpermanent residents are individuals of non-Japanese nationality who have not resided or have not maintained their domicile in Japan for more than five years within the past 10 years. These individuals are subject to tax on income earned in Japan (e.g., employment income from services performed in Japan, regardless of payroll location) plus any non-Japan source income that is paid in or remitted to Japan.
- ▶ In terms of capital gains, please refer to a section of "capital gains from sale of stocks and securities for nonpermanent residents". Nonresidents are individuals who do not meet the requirements for residents. They are taxed at a flat rate of 20.42% (20% and 2.1% surtax) of compensation for services rendered in Japan. Under certain circumstances, treaty benefits may reduce the Japanese tax burden.



Filing of tax return and payment of tax liability

The Japanese tax year is equivalent to the calendar year. Tax returns are due for filing by 15 March of the following year and extensions are not granted by the tax authorities. Japan has a withholding tax system that applies to compensation paid in Japan. Employers are required to withhold national income tax based upon prescribed tax tables, and to withhold local inhabitants tax based upon assessments received from the local authorities. In the case of employees whose gross annual income paid in Japan is JPY20,000,000 or less, withholding on the final compensation payment for the year is adjusted to match the actual annual national income tax and in most cases a tax return is not required after the adjustment is made. Compensation paid outside of Japan and income other than compensation are not considered for purposes of this adjustment. If an individual has such income during the year, a tax return is required to be filed.

National income tax and local inhabitants tax (where due) are withheld from compensation paid in Japan. Estimated payments of national income tax when required are payable in two installments on 31 July and 30 November. Local inhabitants tax applies when individual is resident in Japan on following 1 January. The tax is assessed based on the preceding year's taxable income. Local inhabitants tax, where it is not collected via withholding by the employer, is payable in four installments on 30 June, 31 August, 31 October and 31 January of the following year, or in a lump-sum payment on 30 June.

National income tax rates (Amounts in JPY)				
Taxable income		Tax on lower limit	Tax rate on excess over lower limit	Effective marginal tax rate with surtax
Exceeding	Not exceeding			
0	1,950,000	0	5%	5.105%
1,950,000	3,300,000	97,500	10%	10.210%
3,300,000	6,950,000	232,500	20%	20.420%
6,950,000	9,000,000	962,500	23%	23.483%
9,000,000	18,000,000	1,434,000	33%	33.693%
18,000,000	40,000,000	4,404,000	40%	40.840%
40,000,000	No limit	13,204,000	45%	45.945%

Local inhabitants tax rates (Amounts in JPY)			
Taxable income		Per capita	Tax rate
Exceeding	Not exceeding		
0	-	5,000	10%

Surtax for earthquake reconstruction

A 2.1% surtax on national income tax liability will be levied for both residents and non-residents for 25 years from 2013. Further, JPY1,000 will be charged to residents when they pay their local inhabitants tax for 10 years from 2013.

Compensation

As a general rule, most elements of compensation are taxable. However, certain items are accorded special treatment.

Employer-provided housing

Favorable tax treatment is available for Japanese tax purposes if the lease is in the employer/company's name. The employer pays the rent directly to the landlord and the individual pays the employer an amount equal to the "legal rent" for the premises from after tax monies. The legal rent is computed as follows:

- ▶ Director: The greater of one-half (35% if also used for business purposes) of the monthly rent paid by the employer or an amount computed by a formula involving the area and assessed value of the rented property. The favorable tax treatment will not apply, and the director's housing will be taxed at full value if the private living space exceeds 240 square meters and if either of the following two conditions are met:
 - (a) amenities are located on the premises such as a swimming pool, tennis courts or other similar facilities, or
 - (b) if luxury amenities are provided that cater to the director's personal tastes.
- ▶ Employee: One-half of the amount computed by a formula involving the area and assessed value of the rented property. Experience indicates that this amount will be approximately 5%-15% of the rent actually paid by the employer.

Home leave reimbursement

The cost of one trip per year for the employee and family is not taxable if the destination is the expatriate's or spouse's country of citizenship or domicile.

Dependent's education

Under certain circumstances, education reimbursements may be excluded from Japanese taxable income. Rulings have been issued by the tax authorities that, if an employer contributes an amount to a specified international school and the school provides "scholarships" to the employee's children, there will be no income imputed to the employee.

Moving expense reimbursements

Reimbursements for reasonable moving expenses are excludable from income for arrival and departure year.

Dividends

Dividends from listed stock (including those listed overseas) are taxed at 20.315%. However, if the dividend is paid through a Japanese paying agent it is not necessary to report this on the tax return as statutory withholding of 20.315% would have been made.

Dividends from non-listed stock, and dividends earned by shareholders who own 3% or more of certain listed stock, are included in taxable income and taxed at progressive rates. 20.42% (20% and 2.1% surtax) tax is withheld on dividends paid through a Japanese paying agent. Individuals may deduct a certain amount of interest paid during the calendar year if money had been borrowed to acquire stock.

Interest

Japan-source interest is taxed at a rate of 20.315% through the withholding tax system at source and is not included in taxable income when filing the annual tax return. Interest earned overseas is taxed at progressive rates.

Capital gains

Capital gains from the sale of real property are also subject to tax. There are special rates available depending on the nature of the real property, the amount of the gain, and the length of time the property was held.

Capital gains from the sale of stocks and securities are taxed at 20.315%.

Nonpermanent residents' capital gains from the sale of stocks/securities are in principle taxable in Japan even if the proceeds are not remitted to Japan. However, if certain conditions for BOTH 1) and 2) below are met, the capital gains will not be taxable in Japan.

Exit tax

This is a special tax on “unrealized gains” at the time of final departure from Japan, on certain financial assets.

If some conditions are met, residents will be subject to the exit tax on income from certain financial assets (stock and bonds, unsettled derivative transactions, interest in LLCs, etc. - hereinafter, taxable assets) as if the individual sold or settled the taxable assets at fair market value at the date of departure.

Residents who meet both of the following conditions are subject to the exit tax:

- 1) Residents who hold taxable assets at the time of departure with assessed value of JPY 100 million or greater.
- 2) Residents who have lived in Japan for 5 or more of the 10 years immediately prior to the date of departure.

** Number of days residing in Japan under visa categories in Table 1 of Immigration Control and Refugee Recognition Act (typically, company-sponsored work visas) are not included in the days for 2).*

** Number of days residing in Japan under visa categories in Table 2 are included in the days for 2. Such Visa categories include Permanent resident, Spouse of Japanese national and Child of Japanese national, etc.*

Deductions

Employment income (EI) deduction

Permanent and nonpermanent residents are both entitled to claim an employment income deduction according to a table. The minimum deduction is JPY550,000 and the maximum amount is JPY1,950,000 for employment income of JPY8,500,000 or more. An additional JPY150,000 deduction is possible for taxpayers meeting certain criteria.

Personal exemptions

Self-deduction

Resident taxpayers are entitled to a self-deduction. The deductible amount is shown in the following table:

Taxpayer's total income		Deduction	
Exceeding	Not exceeding	National income tax	Local inhabitants tax
-	24,000,000	480,000	430,000
24,000,000	24,500,000	320,000	290,000
24,500,000	25,000,000	160,000	150,000
25,000,000			

Spousal deduction

A spousal deduction is available. This ranges from JPY770,000 for earnings of up to JPY9,000,000 to nil for individuals earning more than JPY10,000,000.

Other deductions

Other deductions are available subject to certain criteria and limitations, including:

- ▶ Dependent deduction
- ▶ Medical expenses
- ▶ Social insurance premiums
- ▶ Life insurance premiums

Foreign tax credits

If a resident of Japan has non-Japan source income that is subject to tax in Japan, foreign tax credits are allowed to reduce the Japanese tax liability on such foreign income. The credit is limited to the lesser of Japanese tax on the income, based on the ratio of non-Japan source income to total income and the amount of foreign taxes paid on it. Special rules apply to claim this credit and it is permitted only on a cash basis.

Tax treaty impact

Japan has concluded income tax treaties with many countries. The existence of treaties may affect an application of general tax law. In order to determine the application of Japanese individual income tax (and also Inheritance tax, please refer to next section), expatriates who are resident of treaty countries should refer to the related tax treaty in addition to general tax provisions.

Inheritance tax and Gift tax

The Japanese Inheritance Tax Law covers inheritance tax and gift tax. Inheritance tax is imposed on an individual who acquires property by inheritance or bequest upon the death of the decedent.

Gift tax is imposed on an individual who acquires properties by gift (or economic benefit by deemed gift). Gift tax is supplementary to inheritance tax. Both taxes are national taxes and no local tax is assessed on the transfer of property due to inheritance or a gift.



Computation of inheritance tax

Inheritance tax is imposed on the aggregate value of all net taxable properties acquired by inheritance or bequest minus basic exemption. However, the individual heirs are taxed, not the estate. Inheritance tax is calculated, assuming that each statutory heir inherits based on its statutory share, regardless of how and to whom the property is to be distributed. Then, the total amount of tax calculated is allocated between those who actually received the decedent's properties in accordance with his or her will or as agreed upon by the heirs. The total amount of tax is calculated based on the statutory heirs and legatees, whereas the tax liability is attributed to those who actually acquired the properties.

Computation

The computation is based on the following steps:

- ▶ Aggregate the amount of taxable properties assumed to be acquired by all heirs and legatees (net of the liabilities succeeded), "aggregated taxable estate value"
- ▶ Deduct the basic exemption of JPY30 million plus JPY6 million multiplied by the number of statutory heirs from the above "aggregated taxable estate value"
- ▶ Allocate the aggregated taxable estate value to each statutory heir according to their statutory share
- ▶ Calculate the inheritance tax separately for each statutory heir's portion allocated above by the application of the following progressive rates (JPY):

Amount	Rate
Up to 10m	10%
Above 10m up to 30m	15%
Above 30m up to 50m	20%
Above 50m up to 100m	30%
Above 100m up to 200m	40%
Above 200m up to 300m	45%
Above 300m to 600m	50%
Above 600m	55%

- ▶ Aggregate the inheritance tax calculated above, "aggregated inheritance tax"
- ▶ Allocate the aggregated inheritance tax to each of the heirs and legatees based on the ratio of the value of the taxable properties actually acquired by him or her against the aggregated taxable estate value
- ▶ A 20% surtax is imposed on heirs or legatees of anyone who is not the decedent's spouse, the decedent's parents or the decedent's children. Where the decedent's grandchild became the decedent's adopted child, he or she is also subject to a 20% surtax.
- ▶ Deduct applicable tax credits for each heir
- ▶ The property acquired by a gift from the deceased within three years of the death of the deceased is regarded as estate property, subject to inheritance tax. Any gift tax imposed on the acquisition of such property is creditable against the inheritance tax liability.

Gift tax

Gift tax is imposed on individuals who acquire property by gift during the lifetime of the donor. It is also imposed on economic benefits received by deemed gift. The taxable base of gift tax is determined as the value of properties obtained by a gift (or by a deemed gift) during each calendar year, after an annual basic exemption of JPY1.1 million is applied. Progressive tax rates ranging from 10% to 55% are then applicable.

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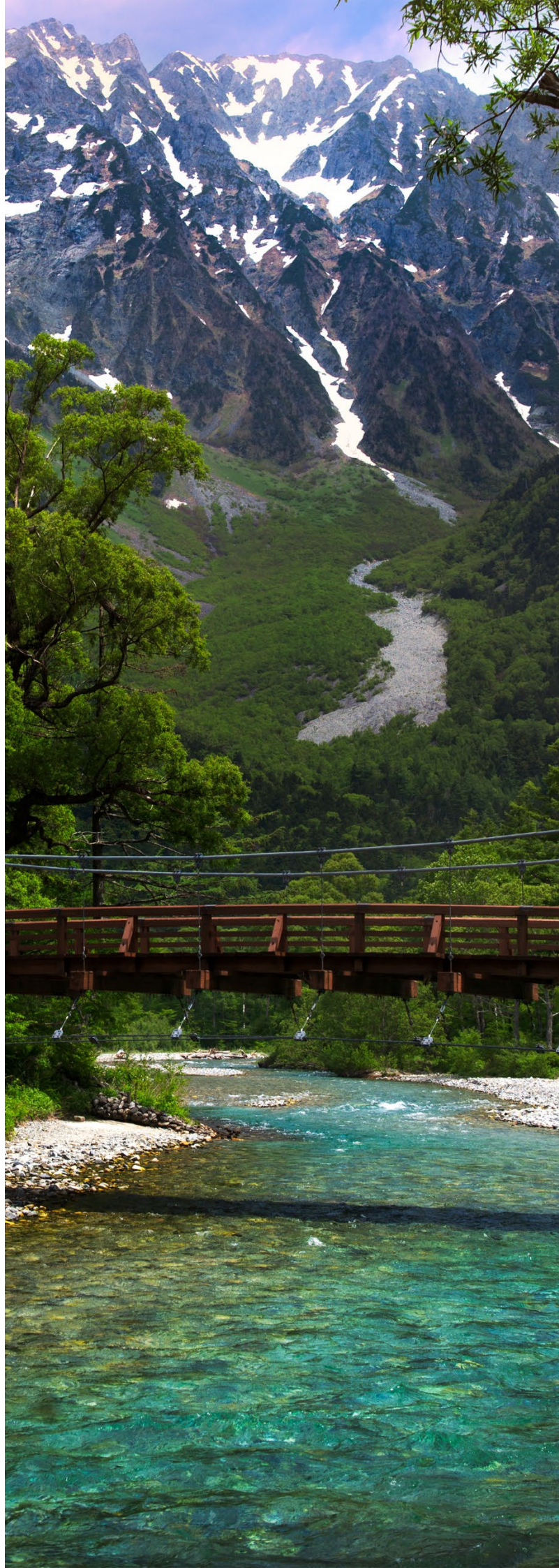
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