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Okamoto & Company International Accounting Office / Hanato Tax Accountant Office

## Convergence of Japanese GAAP with IFRS

Recently, the number of Global Fortune 500 companies reporting their financial statements on IFRS (International Financial Reporting Standards) have increased to 200, surpassing those being reported on US GAAP (176). The impact of IFRS is growing each year. Many countries, including the US, are making serious efforts to converge with IFRS (and the IFRS is attempting to converge with US GAAP when appropriate).

Since 1997, Japan has also made efforts to move towards (or converge with) IFRS. This started with reforms to consolidation policies, income taxes, employee benefits and financial instruments. The accounting policy on impairment of fixed assets has started and is now being required for companies with fiscal years ending March 2006.

Accounting for business combinations and share-based payments will take into effect from April 2006. Business combinations will be classified as either "acquisition (purchase method)" or "uniting of interests (pooling of interests)." Good will arising from the purchase method will not be re-evaluated each year but will be amortized on a straight-line basis not to exceed 20 years. Unfortunately, there appears to be much political pressure to eliminate the pooling of interests method in Japan.

### Going Forward

The ASBJ (Accounting Standards Board of Japan) is leading a project to examine the following international accounting standards with its relation to J-GAAP by March 2007.

Topics include:

#### IAS2

Measurement of inventories – J-GAAP allows the cost method of accounting as an alternative to the lower of cost or market

#### IAS24

Related party disclosures – J-GAAP does not require disclosure of the entity's parent and its ultimate controlling entity, nor does it require companies to disclose control relationships if there have been no transactions between the related parties.

Other topics such as segment information (IAS14), unification of policies within the group (IAS27), investment properties (IAS40) will also be examined.

## Selected Topics from the 2006 Tax Reform Act

With the recovery of the Japanese economy on the way, the 2006 Tax Reform Act has looked for new sources of revenue in the age of a declining birth rate, aging population, and globalization. The possible reduction of employment deductions and the increase in the consumption tax rate are currently hot topics being considered. The following summary does not cover all aspects of the Act, but lists the topics we felt you would be of most interest to our clients.

### 1. Directors' Bonuses

Deductions for performance based bonuses were non-deductible in the past, however, under the new Act, if the following conditions are satisfied, they will be considered deductible:

- (1) Non-family corporation.
- (2) Directors are engaged in the operation of the company's business.
- (3) Compensation is recognized as an expense for accounting purposes in the year when the tax deduction is claimed.
- (4) Compensation that is appropriately determined by the benefit committee and which is disclosed in the financial statement report.
- (5) Disclosed in the Securities Report, et al.
- (6) Compensation which meets other specific requirements.

### 2. Directors' Salaries

If a notice to the Tax Office stating the amount and timing of additional salaries to be paid is submitted in advance, the entity can also deduct this amount.

### 3. Directors' Compensation in a Family-owned Corporation

If certain directors and related persons own more than 90% of the total issued shares, and if such directors and related persons make up a majority of the group of managing directors, an employment deduction of the managing director's salary cannot be tax deductible from corporate taxable income.

### 4. Meeting and Entertainment Expenses

Special taxation measures for meeting and entertainment expenses will be extended for two more years. Specifically, unless the meals are with company personnel a rule will be implemented where expenses under 5,000 per person will be allowed.

### 5. Family Corporation

The definition of a family corporation will change. In the past, the

top three shareholding groups (i.e. includes related individuals and corporations) were reviewed to determine whether the group holding, directly and/or indirectly, exceeded 50%. Only the top shareholding group is now considered.

#### 6. Revision of income tax

##### (1) Change in individual income and inhabitant tax rates

In order to transfer a portion of tax revenue from the national government to the local government, the individual income and inhabitant tax rates will shift as shown below.

The new tax rates will be applicable from the 2007 calendar year.

[Before revision]

- National income tax - (unit : millions of yen)

Taxable income	Tax rate
~ 3.30	10%
3.30 ~ 9.00	20%
9.00 ~ 18.00	30%
18.00 ~	37%

- Inhabitant tax -

Taxable income	Tax rate
~ 2.00	5%
2.00 ~ 7.00	10%
7.00 ~	13%

[After revision]

- National income tax -

Taxable income	Tax rate
~ 1.95	5%
1.95 ~ 3.30	10%
3.30 ~ 6.95	20%
6.95 ~ 9.00	23%
9.00 ~ 18.00	33%
18.00 ~	40%

- Inhabitant tax -

Taxable income	Tax rate
Flat tax based on taxable income	10%

##### (2) Special tax reduction

The special tax reduction will be abolished from 2007 for income tax and 2007 for inhabitant tax (tax on 2006 income).

##### (3) Housing loans for home acquisitions

Special tax treatment that applies when salaried workers take out loans for home acquisitions will be extended for two years.

##### (4) Definition of non-permanent resident

Under the current tax law, the definition of a non-permanent resident is someone who has no intention to live in Japan permanently and has lived in Japan for less than five years. 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 is applicable from April 1, 2006.

##### (5) Tax credits for housing loans

The tax credit amounts for housing loans will be gradually reduced for acquisition of houses in 2006 or later as follows:

When taking up residence	Credit period	Housing loans subject to credit at the end of year	Year/Credit rate	Max.Credit (Annual)	Max.Credit (Total)
2006	10 years	Up to 30 million yen	1 <sup>st</sup> year to 7 <sup>th</sup> year 1% 8 <sup>th</sup> year to 10 <sup>th</sup> year 0.5%	300,000 yen 150,000 yen	2,550,000 yen
2007	10 years	Up to 25 million yen	1 <sup>st</sup> year to 6 <sup>th</sup> year 1% 7 <sup>th</sup> year to 10 <sup>th</sup> year 0.5%	250,000 yen 125,000 yen	2,000,000 yen
2008	10 years	Up to 20 million yen	1 <sup>st</sup> year to 6 <sup>th</sup> year 1% 7 <sup>th</sup> year to 10 <sup>th</sup> year 0.5%	200,000 yen 100,000 yen	1,600,000 yen

#### 7. Thin Capitalization Rule

(1) Certain bond repurchase obligations can be excluded from the definition of debts from overseas controlling shareholders. In this case, the debt-equity ratio will be reduced from 3:1 to 2:1.

This rule applies to fiscal years ending on or after April 1, 2006.

##### (2) The Thin Capitalization Rule will also now apply to

- loans from third parties, but guaranteed by the overseas controlling shareholders,
- loans from third parties in which bonds from its overseas controlling shareholders are held as security,
- any combination of (1) and (2) above.

This rule applies to fiscal years beginning on or after April 1, 2006.

#### 8. New Japan-United Kingdom Tax Treaty

On February 2, 2006, The United Kingdom and Japan signed a new income tax treaty. As a result, withholding tax rates will be reduced as follows:

Dividends : within group companies - from 10% to 0% or 5%  
other companies - from 15% to 10%

Interest : from 10% to 0% or 5%

Royalties : from 10% to 0%

The limitation on Benefit (LOB) conditions must be satisfied to obtain the above tax benefit. The new tax treaty will go into force for taxable transactions on or after January 1, 2007.

#### 9. Submission of Statement of Business

The Company is now required to attach a "Statement of Business" to its corporate income tax returns from the fiscal years beginning on or after April 1, 2006.

#### 10. Acceptance of postmark dates

Postmark dates on or before the due date will be now considered valid for certain tax application forms. This new rule is applicable for forms posted on or after April 1, 2006.

#### 11. Late filing penalties

##### (1) Penalty tax for the late filings

The penalty for the late filing will be 15% for corporate income taxes for liabilities up to 500,000 yen and 20% for the portion in excess of 500,000 yen.

However, if the return filed within two weeks after the due date, and the tax is paid timely, the penalty will be waived. These rules will apply for returns with a due date on or after January 1, 2007.

##### (2) Penalty for the late payment of withholding tax

If the national withholding tax is paid within one month after the due date, if there has been no history of late payment within the past year, the penalty will be waived.

This waiver will apply for withholding taxes with a due date on or after January 1, 2007.

## The New Corporate Law

The new Corporation Law ("new Law") was implemented on May 1, 2006. The new Law is designed to stimulate the formation of new entities and allow more flexible corporate management. The purpose

of this revision is to modernize both formally (i.e. language used was modernized by converting from classical literary Japanese to modern colloquial Japanese) and substantially the overall corporate legislation in response to the changing social and economic circumstances. The main changes under the new Law are as follows:

#### 1. Changes to the entity types

(1) Abolishment of Yugen Kaisha (Yk)

(2) New form of corporation : LLC

The new Law provides for a new form of legal entity namely, the Limited-liability Company or LLC, called "Godo-Gaisha" in Japanese. However, unfortunately the Godo-Gaisha is not a pass-through entity level.

#### 2. Requirements in establishing companies

(1) Elimination of minimum-capital requirement

(2) Elimination of capital deposit certificate

(3) Relaxation on the treatment of investments in kind

#### 3. Corporate organizational structure

Prior to the new Law, all Kabushiki Kaisha (KKs) were required to place at least three board members and at least one statutory auditor regardless of the corporate size and closed shareholdings. Under the new Law, companies with an articles of incorporation, which stipulates a restriction on stock transfers (i.e. closely-held corporation) can flexibly choose a corporate organizational structure which fits their needs. For a closely-held corporation, a corporate structure of one director with no statutory auditor is permitted.

#### 4. Treatment on the distribution of dividends

Under certain circumstances, dividends can be distributed multiple times in a year. Furthermore dividend payments may be approved, subject to certain conditions, by a resolution of the board of directors.

#### 5. Revised form of financial reports

Under the new Law, "the Statement of proposition for appropriation of earnings" was abolished. A new "Statement of Changes in Shareholders' Equity" is now required.

#### 6. Directors' responsibility on internal controls

The board of directors must adopt a resolution on the fundamental policies for internal control. This requirement applies to all large companies (i.e. corporate with capital of 500 million yen or more, or with liabilities of 20 billion yen or more) .

#### 7. Other revisions and issues

(1) Pseudo-foreign companies

The new Law stipulates that pseudo-foreign companies principally cannot continue to conduct transactions in Japan to prevent businesses from evading Japanese corporate legislation. The pseudo-foreign companies (called giji gaioku-gaisha) are defined as companies incorporated outside of Japan but primary operations are based in Japan.

(2) Introduction of board of directors decisions by written vote

(3) Terms of directors and corporate auditors

Under the new Law, the terms of directors and statutory auditors can be extended up to 10 years as long as the KKs are a closely-held company.

(4) Redefining the "subsidiaries"

(5) Notification to shareholders through website

Notices to shareholders such as invitations to shareholders' meeting and financial reports can now be made through the company website under certain conditions (such provisions must be included in the articles of incorporation).

(6) Flexibility in bond issuances

(7) Revisions to facilitate corporate reorganizations

Although there is more flexibility in the new Law, the enforcement is known to increase. We recommend you discuss any concerns on the above with your legal advisor.

## Working Overtime

### Rules of employment and Article 36 agreements

Lately the frequency of labor disputes have increased in office environments. If a company decides to dismiss an employee because of his/her poor performance, the possible consequences must be carefully considered. Although disputes with employees appear to be sudden, the root of the problem exists before the employee starts with the company.

Does your company have a formal rule of employment (i.e. Employee workrules)?

For those who have, are you aware that the employer cannot instruct the employee to work overtime if the company does not conclude an Article 36 agreements (known commonly as "Saburoku Kyoutei")?

Has your company submitted these documents to the Labor Standards Inspection Office?

### Dismiss

The company must have rational and justifiable reasons, otherwise the company will be considered abusing the rights of the Labor Standards Act, Article 18, No.2, when attempting to dismiss an employee. Enacted in 2004, these ordinances require "a reason for dismissal". You cannot dismiss an employee if he/she does not fall under a dismissal reason of the rules of employment.

### What is Article 36 ?

Labor Standards Act Article 36 is an article of the Labor Standards Law of Japan which provides for collective agreements concerning overtime work and work performed on holidays. The company shall not have an employee work more than forty hours in any one week or eight hours in one day, unless Article 36 agreements are submitted to the Labor Standards Inspection Office.

If there is a labor dispute, authorities refer to the rules of employment and Article 36 agreements before the Labor Standards Inspector

begins his/her official inspection. In order to remain compliant with this new regulation, it is imperative that the company adopts Article 36 agreements into its rules of employment.

Annual review of the rules of employment and Article 36 are recommended to minimize labor problems, especially those involving overtime.

Effective April 2006

#### Job Security Act for Seniors

1. This Act requires companies to incrementally increase the mandatory retirement age to 65 years old.

from April 2006 62 years old

from April 2007 63 years old

from April 2010 64 years old

from April 2013 65 years old

2. If companies are adopting retirement ages below 65, one of the following must be adopted.

(1) Increase the retirement age to 65

(2) Implementation of the "Continued Employment System"

(3) Abolish the retirement age clause

Numerous corporations appear to be implementing the "Continued Employment System."

#### National pension monthly premiums

13,860 yen / month

#### Child-rearing subsidy

5,000 yen each per month for the first and second children, 10,000 yen for subsequent children through Grade 6

(Note : household income restriction exists)

#### Determination of monthly standard remuneration for Social Insurance

(Effective July 2006)

The required number of workdays to be considered for this determination has decreased from 20 days to 17 days.

#### Notification of change to monthly standard remuneration for Social

Insurance (Effective July 2006)

The company must report more than two-grade changes to his/her monthly remunerations if an employee works more than 17 days (versus 20 days previously).

## **Notification**

Kreston International – In March 2006, Okamoto & Company has become a member firm for Kreston International Limited (www.kreston.com). Founded in 1971, the network was established to offer reliable and convenient access to quality services through its 428 member firms located around the globe. It is one of the largest accounting networks in the world.

PCAOB registration – Effective March 2005, we have become a registered member firm with the Public Company Accounting

Oversight Board (PCAOB) in the US. The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. We are now one of the few non Big Four firms in Japan permitted to audit subsidiaries of US public companies.

Office Manager Seminar – Due to the popularity from last year's seminar, we plan to hold another seminar in September / October 2006. Details will be provided at a later point in time.

China Desk – In an effort to provide meaningful services to potential Chinese companies entering Japan, we have created a "China Desk" and a Chinese version website. We currently employ two Chinese professionals and also have numerous Chinese speakers.

Statement of Business – All Japanese companies with tax years beginning after April 1, 2006 and companies established after April 1, 2006, including branches of foreign companies, are required to complete and submit a Statement of Business annually with their Corporate tax returns. Please refer to the Tax Reform Act section for details. The preparation fees for such return will be from 50,000 yen / year.

10<sup>th</sup> anniversary Holiday – Okamoto & Company started business in 1992 and on February 1996, became incorporated. To celebrate 10 years since incorporation, we have designated Friday, June 23, 2006 as a firm holiday. Accordingly, we will be unreachable that day. Your understanding is appreciated.

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