

Doing Business in Japan



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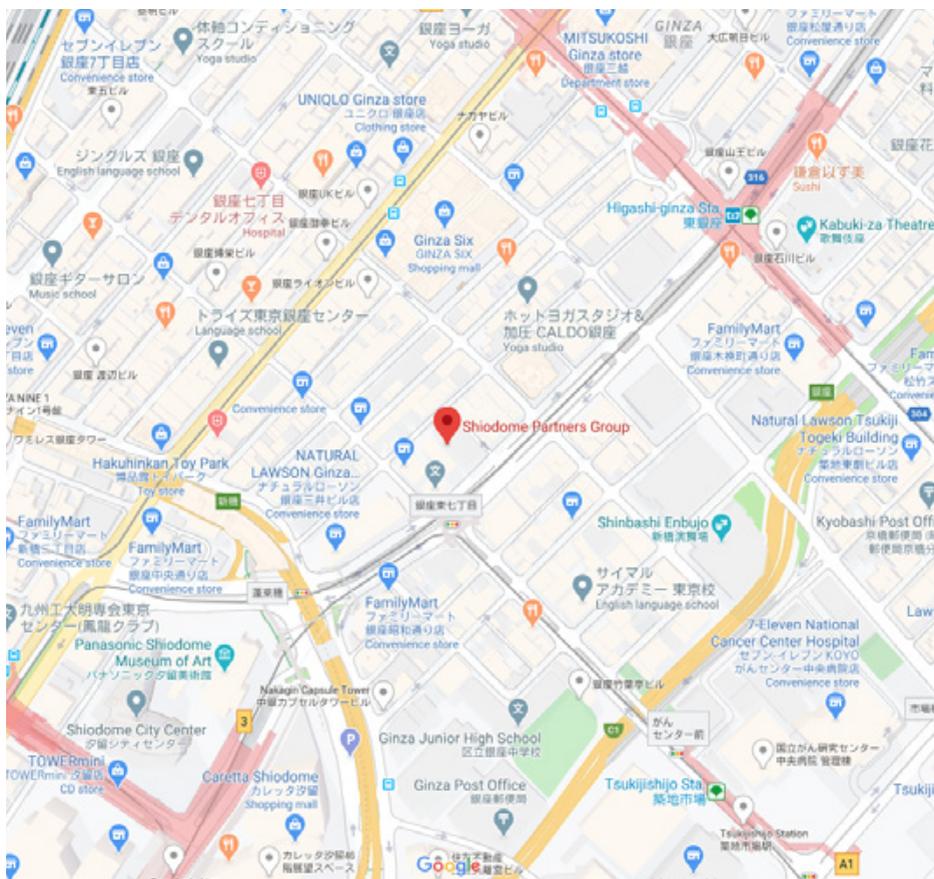
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Foreword

This booklet is produced as a service to the clients of the PKF International member firm in Japan, and as an introduction to the fiscal and commercial environment of Japan for those who are considering doing business within its jurisdiction. The contents provide a guide for understanding the business processes, not a complete description of everything a business or entity needs to know. This booklet should not be used as the basis for laws of Japan which are constantly being modified – both legislatively and judicially – clients are advised to seek specific professional advice from a PKF member firm in Japan before proceeding with any business activities in Japan.

PKF Shiodome Partners and PKF International Limited provide other booklets regarding taxation – The Worldwide Tax Guide and International Tax Alert. Since these booklets are updated periodically, recent taxation information can be found in these materials.



Introduction

Geography and Population

Japan is situated in north eastern Asia between the North Pacific and the Sea of Japan. The area of Japan is 377,873 square kilometres, nearly equivalent to Germany and Switzerland combined or slightly smaller than California. Japan consists of four major islands, surrounded by more than 4,000 islands.

Japan's population is over 126 million. Most Japanese reside in densely populated urban areas like Tokyo, the capital city of Japan. The population of the Tokyo Metropolitan Area including the city, some of its suburbs and the surrounding area is approximately 12 million.

Constitution

Japan is a constitutional monarchy where the power of the Emperor is very limited. As a ceremonial figurehead, he is defined by the constitution as “the symbol of the state and of the unity of the people”. Power is held chiefly by the Prime Minister of Japan and other elected members of the Diet, while sovereignty is vested in the Japanese people.

Legal System

The legal system of Japan is in a framework of a parliamentary representative democratic monarchy, where the Prime Minister of Japan is the head of government, and of a multi-party system. Executive power is exercised by the government. Legislative power is vested in both the government and the two chambers of parliament: The Diet with the House of Representatives and the House of Councillors.



The Judiciary is independent of the executive and the legislature. In academic studies, Japan is generally considered a constitutional monarchy.

Communication and Transportation

Telecommunication, internet as well as transportation in Japan are highly developed. The telephone direct dialling system gives instantaneous international communication from both fixed and mobile units.

Language and Currency

Japanese is the official language used in Japan. However, many Japanese can understand English since it is a language that one must learn as part of Japan's compulsory education.

The currency used is Japanese Yen (JPY).

Major Exports and Imports

Major trading partners of Japan for exports are China and the United States of America, and other countries in Asia, such as South Korea, Taiwan, Hong Kong, Singapore, and Thailand. Cars, electric devices, and machinery are the primary exports to other countries.

As for imports, China, the United States of America, Australia, Saudi Arabia, South Korea, UAE, and Taiwan are the country's major trading partners. Imported items mainly include natural resources, such as oil, iron ore and food items.

Advantages of Investing in Japan

Japan is a centre of new trends and creativity and is a coveted testing ground for new products. Today, increasing numbers of companies around the world are partnering with Japanese companies to develop products and services, create innovative technologies, and conduct R&D projects.

Japan has an enormous market, one of the world's largest in terms of economic scale. Japan's industries are globally competitive and, as can be seen in the automotive sector, the nation's industrial structure is broad-based, with a large number of smaller companies functioning to support the world heavy weights. For foreign companies, Japan is not just an attractive sales market but also a country that offers foreign companies several opportunities in all its sectors.

As the East Asian market grows rapidly, the economic integration between countries in the region continues to strengthen. Japan is becoming ever more important for companies from around the world as a location for regional headquarters and R&D bases to support their expansion into Asia.

Programmes and Support to Promote Investment in Japan

Foreign-capitalized firms operating in Japan are eligible to borrow loans from government-affiliated financial institutions for the purpose of acquiring land, buildings, machinery and equipment and for research and development.

To improve the administration procedure for investment, each ministry or institution related to investment has established a single contact point, which can indicate the division in charge of a particular procedure.

Furthermore, many local governments provide local tax abatements or exemptions, subsidies, and other incentives to firms that set up operations in their regions.

Import Control

The government levies customs duties on some goods entering Japan. In order to import goods, customs clearance must be obtained. This procedure includes import and quarantine controls on certain goods.

Exchange Control

A vast majority of industries in Japan have been liberalized from trade barriers and are welcoming foreign direct investment. Such investment is treated as “foreign direct investment in Japan” under the Foreign Exchange and Foreign Trade Act and is distinguished from financial and portfolio investment. In principle, the submission of ex post facto notification to the Minister of Finance and the Minister(s) with authority over a particular industry is already a sufficient requirement if foreign investors plan to invest in Japan.

Source of Finance

Japan is a major international financial centre with a deregulated environment attracting the cream of the world’s financial institutions and offering a full range of competitive financial services. Japan is a member of the World Bank and Asian Development Bank, which are among the financial institutions that provide loans and grants to a country’s government for the purpose of pursuing capital projects.

Business Structures

Types of Business Structures

The main business structures generally used by foreign companies to establish a business presence in Japan are:



Representative Office

Representative offices are established as locations for carrying out preparatory and supplemental tasks aimed at enabling foreign companies to engage in full-scale business operations in Japan.

These offices may conduct market surveys, collect information, purchase goods and implement publicity/advertising efforts, but they are not permitted to engage in any sales activities. The establishment of representative offices does not require registration. A representative office cannot ordinarily open bank accounts or lease real estate in its own name, thus, agreements for such purposes must instead be signed by the head office of the foreign company or the representative at the representative office in its individual capacity.

Branch Office

The branch office can begin its business operations as soon as the office location is secured, the branch office representative is determined, and the necessary information registered. A Japanese branch office is a business location that provides services in Japan. Such services are decided upon by an organisation authorized by the foreign company, and the branch office is usually not expected to engage in independent decision making. The branch office does not have its own legal corporate status, but instead is deemed to be encompassed within the corporate status of the foreign company. Therefore, in general, the foreign company is ultimately responsible for all debts and credits generated by the activities of its Japanese branch office. The branch office, however, may open bank accounts and lease real estate in its own name.

Subsidiary Company

A foreign company establishing a subsidiary company in Japan must choose to establish the subsidiary company as a joint-stock corporation (Kabushiki Kaisha or K.K.), limited liability company (Godo Kaisha or LLC), or a similar entity stipulated by Japan's Corporate Law.

All types of subsidiary companies can be established by completing the required procedures stipulated by law and then registering the corporation. A subsidiary is a separate corporation from the foreign parent company. Thus, the subsidiary will bear the liability of an equity participant stipulated by law for all debts and credits generated by its activities.

There are other methods by which a foreign company may invest in Japan using a Japanese corporation without establishing a subsidiary. One method is a joint venture with a Japanese enterprise or investment company and another method is by equity participation in a Japanese enterprise.

Limited Liability Partnership (LLP)

It is also possible to do business in Japan by using a Yugen Sekinin Jigyo Kumiai. This type of entity, considered as the Japanese version of limited liability partnership (LLP), is not a corporation, but a partnership formed only by the equity participants having limited liability. LLPs are also distinguished by the fact that internal rules can be freely determined by agreement between the equity participants, and that taxes are levied on profits allocated to equity participants without LLPs themselves being liable for taxation.

Comparison of Types of Business Operation

Legal differences between each of the above business operation are summarized in the following table.

	Representative office	Branch office (office of foreign company)	Subsidiary company (Join stock corporation)	LLP
Business Activity	Not Available	Available	Available	Available
Registration	N/A	Necessary	Necessary	Necessary
Capital	N/A	N/A	No minimum capitalisation required	
Representative Director	N/A	Branch representative required	At least 1	No legally stipulated minimum
Director	N/A	N/A	At least 1	
Corporate Auditor	N/A	N/A	1 or more may be appointed	
Accounting	N/A	Aggregation with income in home country required	Completed by accounting of Japanese partnership	

Joint Ventures

A joint venture (often abbreviated “JV”) is an entity formed between two or more parties to undertake economic activity together. The parties agree to create a new entity by both contributing equity, and sharing the revenues, expenses, and control of the enterprise. In Japan, joint ventures are mainly organized for one specific purpose like construction projects in the construction industry. There are no special regulations governing the establishment of joint ventures.

Accounting

Disclosure System

The principal objective of the disclosure requirement of a joint stock corporation (*Kabushiki Kaisha*) under the Corporation Law is to protect the interests of both creditors and shareholders.

A joint stock corporation is required to hold a general meeting of the shareholders within three months after the end date of each fiscal year to deliberate on certain corporate matters, including the approval of its financial statements. Typically, the notification of a general meeting of the shareholders must be accompanied by a business report and financial documents attested by the corporate statutory auditor or the audit committee, which is an internal organisation of a corporation not required to be composed of certified public accountants (CPA). The financial statements are required to be submitted to and approved by the shareholders at the general meeting.

These documents are subsequently mailed to the shareholders in the form of an annual report. In addition, the Corporation Law stipulates that these documents should be maintained at all times at the head office and at branches of the joint stock corporation for inspection by creditors and shareholders.

Reporting Standards

The underlying objective of financial documents prepared in accordance with the Corporation Law is to protect creditors' and shareholders' interests. Accordingly, disclosures relating to the availability of retained earnings for the distribution of dividends and to the creditworthiness and earning power of the reporting entity are of prime importance.



The financial documents prepared and submitted by a corporation to its annual general meeting of the shareholders are as follows:

- Balance sheet
- Income statement
- Statement of changes in net assets
- Notes to financial statements

In addition, the Corporation Law requires corporations to prepare certain supporting schedules to supplement the financial documents and business report.

Accounting Standards - Japanese GAAP and IFRS

The process of setting accounting standards, previously driven by the Ministry of Finance, and the Financial Services Agency after the reorganisation of government ministries and agencies, has been gradually changing.

The Financial Accounting Standards Foundation (FASF) was established in 2001, and the Accounting Standards Board of Japan (ASBJ) was organized under the auspices of the FASF as an independent, private-sector entity to develop accounting standards in Japan. Since its inception, the ASBJ has issued many accounting standards, guidance and other documents that address practical issues. In addition, in January 2005, it announced the launch of a joint project with International Accounting Standards Board (IASB) aimed at achieving convergence between Japanese GAAP and International Financial Reporting Standards (IFRS).

In October 2006, the ASBJ has decided to formulate and release “ASBJ Project Plan” focusing on accounting standards development projects, related to convergence, in an attempt to indicate the status of initiatives of the ASBJ to various constituencies in Japan and abroad.

In this report, based on the proposal concerning a time-framed approach in light of EU equivalence assessment, titled “Towards the International Convergence of Accounting Standards” issued by the Planning and Coordination Committee of the BAC in July 2006, primary emphasis was placed on mapping out the work planned to be achieved through the end of 2007, and also on classifying the prospects of convergence status as of the beginning of 2008 concerning the initiatives to be undertaken with respect to the 26 issues for which the remedies were advised by the Committee of European Securities Regulators (CESR).

In August 8, 2007, the ASBJ and the ISAB jointly announced an agreement (known as the Tokyo agreement) to accelerate convergence between Japanese GAAP and IFRS's, a process that was started in March 2005. As part of the agreement, the two boards will seek to eliminate by 2008 major differences between Japanese GAAP and IFRS, with the remaining differences being removed on or before June 30, 2011. Whilst the target date of 2011 does not apply to any major new IFRS now being developed that will become effective after 2011, both boards will work closely to ensure the acceptance of the international approach in Japan when new standards become effective.

The new project plan was issued in December 2007, in accordance with the content of the Tokyo Agreement. It classifies the project items into three categories (short-term, medium-term and long term) and indicates the schedule for each item.

Auditing System

Audits are of two types which are based on who conducts the audit: internal audits are conducted by personnel in the organisation, and external audits are conducted by outside parties who are independent from the organisation, for example, audits by a CPA. The purpose of external audits is to provide reasonable assurance to various stakeholders as to whether the financial statements prepared by companies are fairly presented, based on their audits as an independent third party.

CPA audits are required under many laws including the Companies Act, and the Financial Instruments and Exchange Law, and contribute to ensuring the credibility of the financial information that entities provide.

A major internal audit is the one conducted by “company auditors” who large entities are required to appoint under the Companies Act to oversee the activities of large entities directors. Recently, more companies have tended to employ internal auditors to audit internal control, under management supervision, in order to establish a more rigorous structure for external audits. In this case, the work of CPAs, company auditors and internal auditors is closely interrelated to enable each party to conduct their audits more effectively.

CPA external audits must be conducted in accordance with the Auditing Standards codified by the Business Accounting Council and with the implementation guidance (Auditing Standards Committee Statements) issued by The Japanese Institute of Certified Public Accountants (JICPA). The Auditing Standards codified by the Business Accounting Council together with the implementation guidance issued by JICPA are deemed to be the generally accepted auditing standards (GAAS) in Japan.

Statutory audits are required mainly under the Financial Instruments and Exchange Law and the Corporation Law. Financial statements of public corporation must be audited by independent CPAs under the Financial Instruments and Exchange Law. Furthermore, the Corporation Law requires certain corporations, for example, a large corporation capitalized at JPY500 million or more or whose liabilities are JPY20 billion or more at the fiscal year end, to be audited by independent CPAs regarding its financial documents sent together with the invitation letter to the annual general meeting of the shareholders.

The Corporation Law also provides that the corporate statutory auditor or the audit committee has a duty to examine the financial documents prior to the annual general shareholders' meeting.

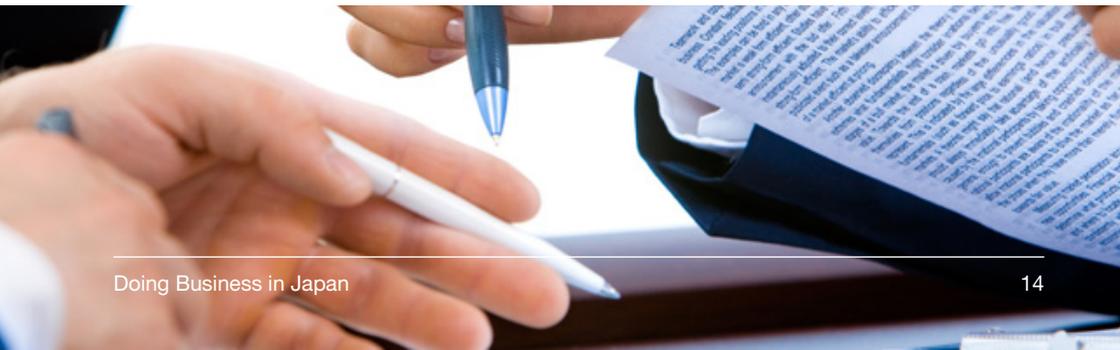
The corporate statutory auditor or equivalent is also responsible for monitoring the activities of the directors as a part of corporate governance. Some corporations request voluntary audits in order to obtain independent assurance regarding the accuracy and reliability of their financial statements in order to strengthen management's accountability or to facilitate activities.

Taxation

Japanese taxes consist of national and local taxes.

National Taxes

- Tax on income and profits
 - Individual income tax
 - Corporate tax
- Tax on consumption
 - Consumption tax
 - Other taxes (Liquor tax, Gasoline tax, Local road tax, etc.)
- Tax on inheritance and gifts
 - Inheritance tax
 - Gift tax
- Taxes on property
 - Motor vehicle tonnage tax
- Tax on transactions
 - Stamp tax, Registration and licence tax, Customs duty, etc.



Local Taxes

- Tax on income and profits
 - Prefectural inhabitant tax
 - Enterprise tax
 - Municipal inhabitant tax
- Tax on consumption
 - Special local consumption tax
 - Other taxes (Tobacco tax, Golf course tax, Bathing tax, etc.)
- Taxes on property
 - Fixed assets tax
 - Business office tax
 - Other taxes (Automobile tax, Special land holding tax, etc.)
- Other
 - Real property acquisition tax, Automobile acquisition tax, etc.

Tax Administration System

National taxes are levied and collected by the National Tax Agency (NTA), which is a semi-independent organization under the Ministry of Finance. NTA consists of the headquarters office, 11 regional taxation bureaus and 524 tax offices.

Local governments have their own tax offices, separate from national tax offices to levy and collect local taxes.

Scope of Taxable Income for Corporation

Japanese Company (subsidiary)

A Japanese company is a corporation having its head office in Japan, such as a Japanese subsidiary of a foreign company. While worldwide income (domestic and foreign source income) is subject to a Japanese corporate tax, a foreign tax credit is granted to allowed for the Japanese companies.

Foreign Company (branch office)

Only domestic source income of a foreign company is subject to Japanese corporate tax. No foreign tax credit is granted to a foreign company.

Foreign companies, i.e. companies which head office is not located in Japan, are classified into the following four types for tax purposes.

- Foreign company carrying on business through a branch office, factory, or other fixed place of business (permanent establishment) situated in Japan.
 - Subject to tax on all domestic source income and must file a tax return.
- Foreign company carrying on business not through a permanent establishment but through undertaking construction, installation or assembly activities in Japan for longer than one year or supervising such activities undertaken in Japan for longer than one year or an agent in Japan who habitually exercises the authority to conclude contracts for or on behalf of a foreign company
 - Subject to tax on income derived from such business in Japan and on certain other domestic source income and must file a tax return.

- Foreign company having no permanent establishment and not carrying on business as stated above but having certain domestic source income such as income from providing personal services in Japan, income from rent for the use of real estate and similar property in Japan, income from sale of real property in Japan, income from sale of stock of a Japanese company, etc.
 - Subject to tax levied on such income and must file a tax return. However, this may be subject to the application of a different rule under a tax treaty.
- For a foreign company other than the above
 - Certain income such as dividends and royalties are subject to Japanese withholding income tax. However, this may be subject to the application of a different rule under a tax treaty.

Representative Office

A representative office of a foreign company engaged in advertising, providing information, conducting market surveys, and performing other supplementary activities in Japan for its head office is not subject to Japanese corporate tax.

Taxation on Corporation

Tax on corporate income consists of corporate tax (national tax), corporate inhabitant tax and corporate enterprise tax (local tax).

Corporate Tax

The tax on ordinary income is the tax levied on net income accruing to a company in a business year. The business year for tax purposes usually means the accounting period of a corporation.

The tax base for ordinary income tax is the corporation's net income for each business year. Net income is the excess of "gross income" over "total costs" for each business year.

Gross income and total expenses are calculated according to the Japanese generally accepted accounting principles, such as accrual basis of accounting. There are some items which are not deductible without being recorded as expenses (depreciation costs, provision for certain allowances and reserves, etc.) and other items for on which deduction is limited or restricted (entertainment expenses, donations expenses, certain taxes, etc.).

Gross Income

Dividends received

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

The amount not included in profits will be reduced for stocks with a shareholding ratio of 25% to 1/3 and shares with a shareholding ratio of 5% or less.

Ordinary sales

Revenue from ordinary sales of merchandise is included in the amount of gross income of the business year in which delivery was made.

Long- term contract

Net profit accruing from a contract is, in principle, reported in the business year in which the contract is completed, despite the fact that it may cover more than one business year. This rule may be referred to as the completed contract rule. However, in the case of a large-scale construction with a contract amount of JPY 1 one billion or more, the percentage of completion rule must be applied if the term of construction is one year or more and certain conditions are met.

Total Cost

As a general principle, cost of sales, cost of completed construction, selling expenses, general and administrative expenses and other expenses and losses are deductible from gross income of the business year.

Taxes paid

Taxes such as enterprise tax, taxes on property or transactions, etc. are deductible for the purposes of corporate tax calculation. Other taxes such as corporate tax, inhabitant tax, delinquency tax or penalty etc. are not deductible.

Salaries, wages and bonuses

In principle, salaries, wages and bonuses paid to employees of a corporation are deductible expenses in principle. However, unreasonably high salaries paid to directors and bonuses paid to directors and similar highly ranked persons are not deductible.

Entertainment expenses

In principle, entertainment expenses are not deductible for tax purposes, even though such expenses are necessary for carrying out a business activity. However, small and- medium- sized enterprises (SME) whose paid- in capital is JPY 100 million or less are allowed to deduct entertainment expenses up to JPY 8 million or 50% of its eating and drinking expenses for tax purposes, except. This is except for SMEs which are wholly owned by a company that has paid-in capital of JPY 500 million or more after the group taxation regime is effective.

Donations expenses

Contributions to the national and local government and other designed contributions for public purposes are fully deductible. Other contributions to designated organisations are deductible up to a certain amount subject to limitations.

Bad debt loss

Receivables to be written off, which are determined as part of a restructuring construction plan or composition admissible under legal procedures, or as agreed upon in a creditors meeting, and receivables which are ultimately uncollectible due to the financial position of the debtor, are allowed to be deductible as a bad debt loss.

Depreciation cost

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

A corporation may choose one depreciation method for each group of its depreciable assets or for each office, shop factory, etc. from among the depreciation methods such as reducing balance method, straight-line method, unit of production method etc. and so on.

The applicable depreciation method which should be applicable, in principle, when a corporation has not notified a tax office of its choice is as follows:

Asset classification	Depreciation method
Tangible assets (excluding buildings)	Declining balance method
Buildings	Straight-line method
Intangible assets	Straight-line method

Depreciable assets whose acquisition cost per unit is less than JPY 200,000 can be may be deducted each business year in equal amounts over three years. The minor assets whose acquisition cost per unit is less than JPY 100,000 can may be immediately deducted as expenses in the business year of acquisition.

Credit for Foreign Tax

In order to eliminate international double taxation on income, foreign tax levied on a Japanese domestic corporation, in the ordinary course of its business, may be credited against Japanese corporation tax subject to certain limitations. This is referred to as a foreign tax credit. Furthermore, in order to treat overseas investment abroad through a foreign subsidiary in the same manner as overseas investment abroad through a branch, foreign taxes levied on a foreign subsidiary of a Japanese domestic corporation may be credited against Japanese corporation tax levied on the Japanese parent company. This is called an indirect foreign tax credit. The credit for foreign taxes is granted unilaterally.

Place for Tax Payment

A corporation is required to file returns, pay taxes and supply details of the computation of taxable income to the tax office having jurisdiction over the place where the corporation is required to pay tax.

The place of tax payment of a domestic company (subsidiary of a foreign company) is the place where its head office is located. In the case of a foreign corporation (branch office of a foreign company), the place of tax payment is the location of the corporation's main permanent establishment.

Blue Returns

A corporation may file a blue tax return with the approval of the tax office. A corporation filing a blue return must keep a journal, a general ledger and other required books, and record all transactions affecting assets, liabilities and capital in the books clearly and in good order according to the principles of double entry bookkeeping in order to be able to calculate its taxable income accurately. Furthermore, the corporation must settle accounts based on its records, prepare balance sheets, profit and loss statements and other statements, and maintain its financial statements, accounting books, and related documents for at least 7seven years (10 ten years for fiscal years in which tax losses are incurred).

Main privileges granted to corporations filing a blue return in the calculation of income include: ten year carry forward of net loss for future deduction and allowance of reserves, special depreciation and tax credits stipulated in the Special Taxation Measures Law.

A corporation is required to apply for approval to file a blue return at the latest by the day prior to the first day of commencement of the business year.

With respect to the first business year of a new corporation, the application for approval must be made by the day within three months from the date of incorporation or by the last day of the first business year, whichever comes is earlier.

Return and Payment of Corporate Tax

Interim return and tax prepayment

A corporation, except if it meets certain conditions, whose business year is longer than six months should file an interim return covering the first six months of its business year. The return should be filed, and the tax amount should be paid to the tax office within two months after the end of the first six months.

Final return and final payment or refund

A corporation is required to file a final tax return within two months after the end of its business year, whether or not it has a positive income for that business year. Corporate tax on ordinary income for a business year, minus the amount of prepayment, must be paid to the tax office within two months after the end of the business year. Refund from the overpaying of the prepayment, tax credits, etc. will be made on request after a final return has been filed.

Corporate Inhabitant Tax

Corporate inhabitant tax is a local tax levied on a Japanese company and a foreign company with a permanent establishment in Japan. Corporate inhabitant tax includes a per capital levy which the amounts of which are fixed based on the capital amount and the number of employees, and a corporate tax levy of certain tax rates of the corporate tax amount.

Corporate Enterprise Tax

Corporate enterprise tax is a local tax levied on a Japanese company and a foreign company having a permanent establishment in Japan and conducting business activities continuously in Japan. Corporate enterprise tax is basically levied on the taxable income in each business year as per Corporation Tax Law subject to certain exceptions. However, the size-based taxation is applied to large corporations with a capital exceeding JPY 100 million.

For such large corporations, enterprise tax consists of the traditional enterprise tax levied based on the taxable income and based on the capital, etc. as well as on value added (wages, interest and rental expenses).

Scope of Taxable Income for Individuals

Resident Status of Foreigners

- Non-permanent resident

A resident is an individual who has a domicile (centre of living) in Japan or has had a residence (the individual's presence in Japan) in Japan for one year or longer.

A resident who has no Japanese citizenship and has no intention to reside permanently in Japan but has a domicile or residence consistently in Japan for less than 5 years within a the period of 10 years period is a non-permanent resident.

- Permanent resident

A resident other than a non-permanent resident is a permanent resident.

- Non-resident

An individual other than a resident is a non-resident.

Taxation on Individuals

The scope of taxable income of individuals is as follows:

- Permanent resident
Worldwide income: total of Japan-sourced and foreign-sourced income
- Non-permanent resident
Japan-sourced income and foreign-sourced income paid in or remitted to Japan
- Non-resident
Japan-sourced income

A resident taxpayer including a non-permanent resident is subject to assessment of income tax by way of filing a tax return. Withholding tax income tax levied on certain types of income is creditable against assessment of income tax. A non-resident's tax liability is generally settled by way of the withholding income tax, except on real estate income or capital gains from land transfer, etc.

Individual Income Tax

Type of Income and Taxation of a Resident

- Business income
Business income is income derived from activities of wholesale, retail, manufacturing and income of attorneys and certified public accountants, etc.
Generally accepted accounting principles are applicable to the computation of business income, subject to with a few exceptions. The following descriptions indicate some rules applicable to individuals, some of which are different from the rules applicable to corporations:

- Payments to a taxpayer’s family members are deductible only within certain limits, whatever their nature might be (salaries, rent, interest, etc.).
- Entertainment expenses for carrying on a business and those directly related to the business are deductible, and not subject to restrictions as in the case of the corporation tax
- If the taxpayer is a blue return taxpayer and keeps an accounting records book in compliance with the principles of orderly bookkeeping, the blue return special deduction of a certain amount is allowed.

- Employment income

Employment income consists of total salary and bonuses after deducting certain employment income items.

An employer making salary payments is required to withhold a certain tax amount from the salary and bonuses when a payment is made and to remit the tax withheld to the tax office by the 10th of the following month. For small businesses employing with less than 10 persons on the payroll, a special measure is provided for which allows them to pay withholding income tax in six-month instalments twice a year (by July 10th and by January 20th).

An employer making salary payments must make a year-end adjustment for an employee whose annual salary does not exceed is not more than JPY 20 million.

- Real estate income

Real estate income is income derived from rental of real estate (land, building), ships, aircrafts, etc. A taxpayer may deduct depreciation costs, interest expenses, fixed asset taxes, etc. from the real estate income.

Other than the items mentioned above, the following are the other types of income:

- Interest income
- Dividend income
- Retirement income
- Capital gain from sale of shares/sale of land and buildings, etc.
- Occasional income (gift from a corporation, rewards, etc.)
- Timber income
- Miscellaneous income (income which is not classified as in any other income)

Primary Income Deductions for Income Tax Purposes

Some deductions may be made from the amount of ordinary income. Here are the main income deductions are:

- Deduction for medical expenses
- Deduction for social insurance premiums
- Deduction for life insurance premiums
- Deduction for certain donations
- Exemption for spouses
- Exemption for dependents
- Basic exemption

Final Tax Return

A resident taxpayer must file a final tax return for income of a calendar year between February 16th and March 15th of the subsequent following year, unless the income does not exceed the amount of total income deductions, or unless the resident has only has the employment income of JPY20 million or less which was subject to withholding taxation. If a taxpayer is required to file a final tax return, the excess of the annual tax liability over the total of prepayments of assessed income tax and withholding income tax should be paid on or before March 15th in the year following the taxable year. In principle, if a taxpayer is no longer a resident of Japan, the taxpayer must file the final tax return with the tax office and pay income tax before leaving Japan.

Individual Inhabitant Tax

Individual inhabitant tax consists of prefectural inhabitant tax and municipal inhabitant tax levied on a resident who has a domicile in Japan as of January 1st in each year. Unlike the income tax, inhabitant tax is levied on the income derived in the previous year. Taxable income is calculated in accordance with rules in the income tax law rules unless particularly specified under the local tax law.

Inhabitant tax return is not required to be filed in principle if an income tax return has been filed. A taxpayer receives an inhabitant tax bill from the local tax office. The tax levied on the income of the previous year must be paid in four instalments in June, August, October and January of the following year. However, inhabitant tax on employment income is withheld by an employer over 12 months starting from June to May of the following year.

Consumption Tax and Special Local Consumption Tax

Consumption tax is categorised as a value added tax applied to almost every domestic transaction and every import transaction except for financial transactions, capital transactions, medical services, welfare services and educational services.

Basic formula for calculating the tax due is as follows:

$$\text{Tax due} = \text{total amount of consumption tax on sales} - \text{total amount of consumption tax on purchases}$$

Taxable Transactions

- Domestic transactions
Domestic transactions in which consideration is paid for the transfer or lease of assets or the provision of services for business purposes will be subject to taxation.
- Import transactions
Foreign goods received or retrieved from a bonded zone will be subject to taxation.

Non-taxable Transactions

- Transfers and leases of land
- Transfers of securities and payments prescribed in the foreign exchange and trade law
- Leases of assets with interest
- Transfers of postage stamps and merchandise coupons
- Services rendered by the government, local governments, public corporations, and public interest corporations
- International postal services and foreign exchange services
- Medical services under social medical system and sale of assets by a social welfare organization
- School tuition, entrance fees and textbooks
- Rent of residential houses

Tax Exemption for Export Transactions

Export of goods, international communication and overseas transportation conducted by an enterprise are tax-exempt.

Export sales are not subject to consumption tax. The consumption tax component included in the purchase cost is creditable against the taxpayer's consumption tax liability, so that all export activities are tax-free. On the other hand, in a non-taxable transaction, the consumption tax component of the purchase cost cannot be credited.

Taxpayer

A taxpayer for a domestic transaction is an enterprise (including a non-resident and a foreign company) which sells taxable assets and performs other taxable transactions. A company or an individual removing imported goods from a bonded area is also classified as a taxpayer for consumption tax purposes.

Tax-Exemption for Small-Scale Enterprise

Where the amount of taxable sales of an enterprise in its base period (the calendar year two years prior to the current year for an individual; the business year two business years prior to the current business year for a company) is not more than JPY 10 million, the enterprise will be exempt from tax on the transfer of taxable assets, etc. during the taxable period. In the case of a newly established company, sales in the first and second business year are exempt from consumption tax. However, a newly established company whose capital amount is JPY 10 million or more is subject to consumption tax in the first two years.

Return and Payment of Consumption Tax

- Interim return and tax prepayment

A taxable enterprise, whose final tax amount of the previous tax period is more than a certain amount must file an interim return and pay the relevant prepaid tax.

- Final return and final payment or refund

A taxable enterprise is required to file a final tax return within two months after the end of its tax period. Consumption tax liability, minus the amount of prepayment, must be paid to the tax office within two months after the end of its taxation period.

When the consumption tax on the tax base is less than the consumption tax on purchase, or where the consumption tax after crediting the consumption tax on purchase is less than the interim consumption tax prepayment, the shortfall amount can be refunded upon the filing of a final tax return.

Withholding Tax on Payments to Non-residents

A non-resident or a foreign company is subject to withholding tax at the rate of 20.42% on the payment of various Japanese-sourced types of income. However, the application of a tax treaty supersedes domestic tax law provisions so a lower rate may be applicable. specifies definition of income, a reduced tax rate or no tax, the tax treaty has priority over the domestic law.

Tax Treaty

Japan has concluded tax treaties within 135 countries (as of December 1, 2019). The purposes of tax treaties is to avoid international double taxation on the same income and to prevent tax avoidance. In general, tax treaties include the following rules:

- Definition of a resident, non-discrimination rule, source of income rule
- Permanent establishment and taxation of business income, income from international transportation
- Definition and taxation rule for dividends, interest, royalties, real estate income and capital gains
- Independent professional income, employment income and tax-exemption on short stay, professors, students, government officers, diplomats
- Mutual consultation by competent authorities, exchange of information

Status of Residence

Entry procedures

Foreigners wishing to enter Japan must have a valid passport and, in principle, a visa which suits the purpose of their visit issued in advance by a Japanese diplomatic mission.

Upon landing in Japan, foreign nationals must be examined by their port of entry, obtain any entry permit and have their status of residence and period of stay determined.

Types and Categories of Visa and Working Status

The main types of status of residence relating to inward investment in Japan and the activities allowed by each type are as follows:

Business Manager

Activities to commence the operation of international trade or other business or to operate (business manager acting as the company's CEO or representative) or manage (directors and head of departments, etc. under a CEO or representative) international trade or other businesses on behalf of foreign nationals (including foreign corporations) who have begun such an operation. The business in question must meet certain conditions of scale. Applicants who wish to engage in business management must fulfil certain conditions concerning work status and personal history.

Intra-company Transferee

Activities on the part of personnel who are transferred to business offices in Japan for a limited period of time from business offices that are established in foreign countries by public or private organisations with head offices, branch offices, or other business offices in Japan, and who engage in the activities described in “Engineer/Specialist in Humanities/International Services”. Applicants must fulfil certain conditions concerning personal history and work status.

Legal/Accounting Services

Activities to engage in the legal or accounting business. Applicants must be attorneys or public accountants certified to perform their duties in Japan, or those with other legal qualifications recognised by Japan.

Engineer/Specialist in Humanities/International Services

- Activities to engage in services that require technological skill and/or knowledge pertinent to physical science, engineering, or other natural science fields, on the basis of a contract with a public or private organisation in Japan. Applicants must fulfil certain conditions concerning personal history and work status.
- Activities to engage in services that require knowledge pertinent to jurisprudence, economics, sociology, or other human science fields.
- Activities to engage in services that require specific ways of thought or sensitivity based on experience with foreign culture, such as interpreting, translation, copy writing, fashion design, interior design, sales, overseas business, information processing, international finance, design, or public relations, and advertising based on a contract with a public or private organisation in Japan. Applicants must fulfil certain conditions concerning personal history and work status.

Skilled Labour

Activities to engage in service that require industrial techniques or skills belonging to special fields on the basis of a contract with a public or private organisation in Japan. Applicants must fulfil certain conditions concerning personal history and work status.

Relation between Types of Operation in Japan and Working Status

A foreign company establishing a presence in Japan may do so generally in one of three ways: by establishing a representative office, a branch office or a corporation.

The relationship between each type of operation and the working status of the representative will depend on the requirements and criteria for each status. Generally, however, the relationship is as follows:

*Representative of a representative office or branch office –
Intra-company transferee
Representative of a corporation – Business manager*

The working status of a foreign national employed by a representative office, branch office or corporation will either be a 'intra-company transferee' or a status suited to their academic and occupational background and their job duties in Japan.

Protection of Intellectual and Industrial Property

Legislation on Trademark and Design

Japan's trademark system provides for the protection of the marks and logos that are used in commerce on goods or services. By enabling trademarks to identify the source of goods or services, and to identify their qualities and publicise them, the trademark system protects the commercial reputation of persons using trademarks, thereby contributing to the development of Japan's industries and protecting the interests of consumers. Japan's trademark system is regulated by the Trademark Law.

Japan's Trademark System

Equality for both Japanese and Foreign Nationals

Japan's Trademark Law offers equal protection for both Japanese and foreign nationals. The same trademark registration process and conditions apply to those residents in Japan and overseas. Therefore, by offering proper trademark protection to people who do not currently live in Japan and companies presently without head offices or branches in the country, Japan's trademark system encourages future expansion into the Japanese market by overseas businesses.



First-to-file Rule

Trademarks do not have to be currently in use (either in Japan or overseas) in order to be registered in Japan. If the trademark owner has the intention of using the trademark in the future, it can be registered in Japan as long as certain criteria are met. Thus, it is very important for any foreign business that thinks it might expand into Japan at some time in the future to consider applying for the registration of trademarks in Japan before entering the Japanese market. Note, however, that trademarks must be used within three years after registration, or they may be nullified. Using your trademark just once within those three years though is enough to prevent your trademark rights from being cancelled.

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