Japan tax bulletin

ASG Tax Corporation
Quarterly Newsletter
July 2007

Our newsletter keeps international companies and investors up to date with all the latest tax and business developments in Japan.

Japanese Tax Regime for Triangular Mergers Takes Effect

This article was first published in Tax Notes International on May 14, 2007 and is based on a public presentation given by the authors at the Tokyo Conference Center, Shinagawa, Tokyo, on April 23, 2007. We would like to thank Atsushi Oishi, partner at Mori, Hamada & Matsumoto Law firm for his contribution to the article.

As of May 1, Japan is enforcing company law rules that permit the execution of cross-border triangular mergers. Coinciding with this development in its corporate law, Japan's 2007 tax reforms include provisions that grant shareholders of corporations involved in a triangular merger a tax deferral on any resulting capital gains or losses. A number of conditions have to be met [(1)] for the transfer of assets from the target or liquidated company to the surviving company to be at book value (that is, allowing a deferral of capital gains taxation at the corporate level).

What Is a Cross-Border Triangular Merger?

A cross-border triangular merger is used to facilitate the acquisition of a domestic company (target or liquidated company) by a foreign company. The foreign company sets up a subsidiary in the same jurisdiction as the target and the subsidiary distributes shares of the foreign parent to the shareholders of the target company in exchange for their shares in the target company. So instead of receiving shares from the subsidiary, the shareholders will receive consideration in the form of shares from the parent company. The target company is liquidated and its assets, liabilities, and so on are transferred to the domestic subsidiary of the foreign company. The domestic subsidiary becomes the surviving entity in the transaction and assumes the business, assets, liabilities, and so on of the target company.

Legal Framework of a Triangular Merger

A typical structure of a cross-border triangular merger is described below. The key point is that the parties to a merger are the target and Japan subsidiary, not the foreign parent.

- Step 1: Japan subsidiary purchases newly issued stock or treasury stock of its foreign parent.
- Step 2: The target merges into the Japan subsidiary. The Japan subsidiary distributes stock of the foreign parent to the stockholders of the target as consideration for the merger, whereby former stockholders of the target become foreign parent's stockholders. The Japan subsidiary assumes all the assets and liabilities of the target.

In Step 1, the Japan subsidiary is generally required to actually pay cash to the foreign parent to purchase the stock. Several legal issues have to be resolved before the Japan subsidiary purchases the parent's stock without an actual payment (that is, performing the payment obligation by way of an in-kind contribution).

In Step 2, the target and Japan subsidiary (not the foreign parent) enter into a merger agreement that states that the consideration to be distributed to the shareholders of the target is stock of the foreign parent [(2)]. The merger agreement must be approved by the boards of both the target and the Japan subsidiary. Also, approval of a supermajority (more than two-thirds) of shareholders of both companies is generally required. The approval of the board or shareholders of the foreign parent would be necessary for the merger agreement.[(3)]

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Treatment Before May 1, 2007

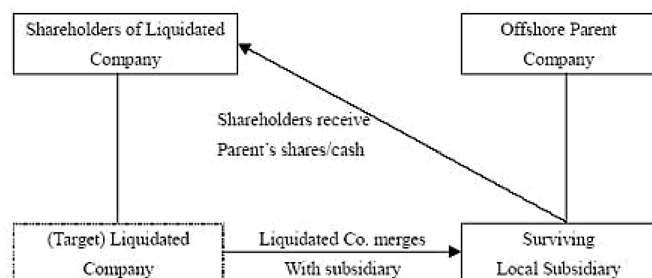
Japan's pre-reform tax law provided that for a reorganization to be tax-qualified, the consideration given to the shareholders of the target company had to be that of shares in a surviving subsidiary. Therefore, a cross-border triangular merger did not qualify as a non-taxable corporate reorganization, because the consideration was in the form of shares from a foreign parent company, resulting in the liquidated company being taxed (4) on any gains it made on the transfer of its assets to the surviving company. Moreover, the shareholders of the liquidated company were taxed on their capital gains or losses and on deemed dividends from their shares in the dissolved company.

Post-reform Treatment

The new law, which came into effect May 1, 2007, has changed the tax deferral treatment of the target company and its shareholders. Presuming the value of the shares in the target company has increased from the time of purchase, the target will realize a capital gain (the fair market value of the assets and debts minus their book value) and the shareholders will realize a deemed dividend and a capital gain (the fair market value of the shares minus book value and the amount of deemed dividend) at the time of the merger. However, the target may be able to defer taxation on capital gains if the following conditions for a qualified triangular merger are met:

- the parent company directly holds all outstanding shares of the Japan subsidiary;
- the parent company expects to continue directly holding all of the Japan subsidiary's shares post-merger; and
- the consideration given to the shareholders of the liquidated company is shares in the parent company, and not cash.

For a qualified triangular merger, the taxation on capital gains realized by the target's shareholders will also be deferred and the taxation on the deemed dividends will be exempted.



Taxation of Non-resident Shareholders of the Liquidated Company

For cross-border triangular mergers under the reform, if the shareholders of the liquidated company are non-resident shareholders and they receive shares of the foreign parent as consideration, they will be taxed on the capital gains of the shares in the liquidated company. However, this is only if the capital gains are subject to Japanese tax (5). The following are three major situations in which capital gains obtained by a non-resident with no PE in Japan are subject to Japanese tax:

- the non-resident has, at any time in the preceding three years, held 25 percent or more of the shares in the company and sells 5 percent or more of its shares in the current year;
- at least 50 percent of the company's assets consist of real property, and if the company is listed, the shareholder sells more than 5% of it shares, or if the company is unlisted, the shareholder sells more than 2% of its shares; and
- the non-resident gains from a greenmailing transaction.(6)

The reason for the disparate rules for resident and non-resident shareholders of the liquidated company is that without an immediate CGT on the non-resident shareholders, the capital gains would not easily be taxed in Japan, because gains made on the sale of non-residents' shares in the offshore parent company generally would not be Japan-source income and, therefore, would not be subject to Japanese tax.

In the case of a qualified triangular merger, deemed dividends will be exempt from tax.

Business Relatedness

A key issue arising from the reform concerns the concept of business relatedness. If the ownership level among the target and surviving companies is 50 percent or less, they are generally required to meet the business relatedness test for a merger to be qualified for tax purposes (see footnote 1).

Before the release of Japan's 2007 tax reforms, the business relatedness test for a triangular merger was expected to apply to the target and foreign companies. However, the business relatedness test will still apply to the target and surviving companies even in triangular mergers. To impose this test on the surviving company would appear to impose burdensome conditions on the foreign company looking to acquire a Japan target company, because the Japan subsidiary may not conduct any business in Japan.

The April 13 enforcement order provides a safe harbour for the business relatedness test. The order states that this test is deemed to be satisfied if the following two requirements are met:

- each of the target and surviving companies satisfy all of the following conditions (business requirement): own or lease an office; have employees; and perform activities such as sales, advertising, marketing, applying for a license, if required, and applying for registration of intellectual property, if required; and
- the target and surviving companies satisfy any of the following conditions (business relatedness requirement): the target's business and the surviving company's business are the same; any products, assets, services, or management resources of the target and of the surviving company are the same or similar; or any products, assets, services, or management resources of both the target and the surviving company will be used after the merger.

Triangular Mergers Anti-avoidance Measure

The anti-avoidance measure specific to triangular mergers provides that a merger in which:

- the offshore parent company is a "paper" company located in a low-tax jurisdiction; and
- the ownership level between the Japan subsidiary and the target is more than 50 percent

will not be recognized as a tax-qualified merger, and both the liquidated company and its shareholders will be taxed on the transaction.

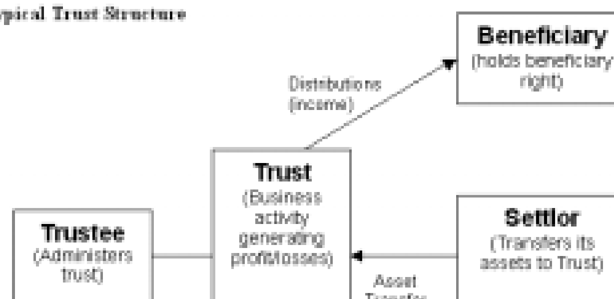
Footnotes

(1) Existing law provides that the following conditions, dependent on ownership level, must be satisfied for a merger to be recognized as being tax-qualified. For each ownership level, the sole consideration used to obtain assets and liabilities must be equity shares of the surviving company.100 percent ownership level: Must meet various anti-abuse rules (these rules also apply to the other ownership levels). Ownership level less than 100 percent but more than 50 percent: (i) Surviving company must continue the target company's business, (ii) at least 80 percent of the target company's employees must be transferred to the surviving company.50 percent or less ownership: In addition to the three qualifications listed directly above, (i) There must be an acceptable relationship between target and surviving company's businesses (business relatedness test), (ii) the target company's business size (sales, number of employees, capital, etc.) should not exceed a 5-to-1 ratio to the surviving company's size, or alternatively, at least one executive director of the target company plus a director of the acquiring company must become executive directors of the surviving company, (iii) 80 percent or more shareholders of the target company must continue to hold shares in the surviving company (if the target company has 50 or more shareholders).
(2) This form of triangular merger is often called a forward triangular merger. Although a reverse triangular merger, when the target acquires the subsidiary through a merger using the parent's stock as consideration, is popular in the United States, it is not permitted in Japan.
(3) If the target is a listed company and the stock distributed to the shareholders of the target is subject to restrictions on assignment, approvals of a majority of the shareholders (not voting rights) are necessary. Thus, if the target is a listed company, the foreign parent will also essentially have to be a listed company.
(4) The surviving company is required to file a corporate tax return of the liquidated company within two months of the date of the merger.
(5) Further, the capital gains article of the applicable tax treaty may provide taxation relief, as is the case with article 13 of the Japan-U.S. tax treaty.
(6) A typical greenmailing transaction is one in which a party buys enough shares of a company to allow them to gain control of that company and then threatens to conduct a takeover if the company does not buy back the shares at a higher rate.

Japan’s taxation of trusts - 2007 tax reforms

This article is to be published in an upcoming edition of Tax Notes International.

Japan’s Trust Law (“JTL”) has recently been the subject of significant reform, with a bill passed by the Japan Diet on December 8, 2006 introducing several new trust structures. This reform represents the most significant changes to the Trust Law since it was originally passed in 1923. In order to create a more equitable trusts taxation regime, reduce uncertainty and to close tax avoidance loopholes created by these changes to the JTL, the 2007 tax reforms included changes to the tax treatment of trusts.



The typical trust structure used in Japan is shown above, whereby a settlor transfers its assets into a trust to be held for the benefit of a third party (the beneficiary). The trustee (usually a trust bank) is responsible for administering the trust [(1)]. An individual or corporation who purchases from the settlor a right to receive profits (or losses) generated by the trust will be deemed to be a beneficiary of the trust. It is possible for the settlor to also be beneficiary to the trust.

(1) Pre-reform, the one entity could not be both the settlor and the trustee, however under the reform this is now possible.

Japanese taxation of trusts
General Principles

The general rule applying to the taxation of trusts in Japan is that income/losses generated in a trust is/are attributed to its beneficiaries (i.e. taxed at the beneficiary level) regardless of whether the trust’s income is distributed to the beneficiaries or not. In other words, beneficiaries are taxed as if they directly own the assets and liabilities in the

trust. In cases where no beneficiaries have been designated, income generated in a trust is attributed to the settlor (i.e. taxed in the hands of the settlor) [(2)].

For Collective Investment Trusts, taxation is deferred until actual distributions are made and are taxed in the hands of the beneficiaries. For Corporation Taxed Trusts, the trustee is required to file a corporate tax return and the income is subject to corporate tax, separate from the trustee's other income. These categories of trusts are explained in greater detail below.

In the case the trustee's office is located in Japan, the trustee is treated as a domestic corporation. For trustee's whose office is located offshore, the trustee is treated as a foreign corporation.

(2) Art 12, Corporate Tax Law, Art 13 Income Tax Law.

Specified Trusts *(Tokutei Shintaku)*

If a trust is classified as a Specified Trust, it will be taxed as a corporation (i.e. the trustee must file corporate tax returns and declare income/losses in the trust). The beneficiaries are also subject to tax upon receipt of distributions from the trust [(3)].

(3) Art 36, Income Tax Law.

Trusts taxed as corporations

A trust that is taxed as a corporation (the trustee is required to file a corporate tax return and pay tax on the trusts income) will either be

(i) a certain type of investment trust, or

(ii) a Special Purpose Trust.

A certain type of investment trust is an investment trust other than a security investment trust, or an investment trust of which beneficial interest securities (Jueki Syoken) are offered privately or offshore.

A Special Purpose Trust is a special purpose vehicle used for the liquidation of assets. The trustee is taxed as a corporation, as described above.

(4) Article 29-3, Corporate Tax Law

2007 Tax reforms

Two new trust categories were introduced under the reform to the Trust Law; (i) the Collective Investment Trust (CIT), and (ii) the Corporation Taxed Trust (CTT).

Collective Investment Trusts (CIT)

A CIT is either

(i) a Securities Investment Trust (SIT), of which beneficiary interests are offered publicly and within Japan, or

(ii) a Specified Beneficiary Interest Securities Issued Trust (BISIT) which satisfies certain conditions under the new trust law (i.e. approval from the National Tax Agency has been obtained, the trust does not hold excessive retained earnings, and so on).

The taxation of beneficiaries of a CIT is deferred until the trust income is distributed.

Corporation taxed trusts (CTT)

A trust will be taxed as a corporation (the trustee will be required to file a corporate tax return and be taxed on the trust's income, separately from the trustee's other income) if it is one of the following:

(i) a trust where beneficiary rights are issued (excluding CITs),

(ii) a trust where no beneficiaries are nominated,

(iii) a trust whose settlor is a corporation and certain conditions are satisfied (i.e. business trust)

(iv) an Investment Trust (except an investment trust categorized as a CIT), or

(v) a Special Purpose Trust.

In addition to introducing a number of new types of trusts, the 2007 tax reform creates taxation implications for the trustee in cases where the trust has been created in order to avoid taxation. The new trust structures available under the new JTL provided a number of loopholes which the tax reforms have attempted to close. This article will look at three new trusts; Business Trusts, Self-Declared Trusts, and Trust Issuing Beneficial Certificates.

Business trusts *(Jigyou Shintaku)*

The new trust law now makes it possible to set up a Business trust. Under the former JTL, only assets, not liabilities, were able to be transferred into a trust. However the new JTL makes it possible for a settlor to transfer both its assets and liabilities into a trust.

Self-declared trusts *(Jiko Shintaku)*

A self-declared trust is one in which the settlor is also the trustee and the settlor's assets are held in trust for beneficiaries. Such a trust is taxed under the general principles described above. This trust structure was previously unavailable. The self-declared trust will not be available for 12 months from the date the law is passed, as there are a number of requirements relating to such trusts that are yet to be announced by Japan's Ministry of Finance.

Trusts issuing beneficial certificates *(Zyueki Syouken Hakkou Shintaku).*

A trust which issues beneficial interests (such as units in a unit trust) to its beneficiaries, being an unspecified number

of individuals, may be taxed in the same manner as a Collective Investment Trust (i.e. the trust's income will only be taxed in the hands of its individual or corporate beneficiaries upon distribution) if the following conditions are satisfied.

(i) The trustee is a company and has obtained approval from the tax authorities,

(ii) The amount of the trust's undistributed income is 2.5% or less of the trust's assets,

(iii) The income period of the trust is one year or less.

In cases where such conditions are not satisfied, the trust's income will be subject to corporate tax in the hands of the trustee, separate to the trustee's other income.

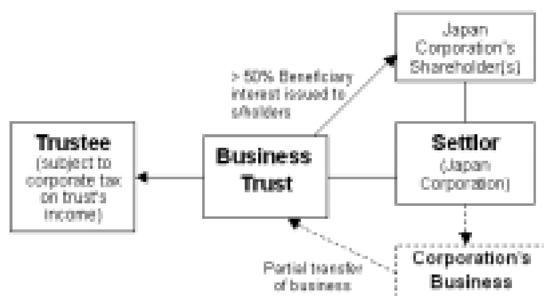
For individual beneficiaries of such a trust, income distributions are classified as dividend income, while capital gains derived from the sale of the trust's beneficiary rights are treated as capital gains from share dispositions for income tax purposes. For corporate beneficiaries the dividend received exclusion is not available for income distributions from the trust.

Anti-avoidance Measures

As discussed above, the tax reform introduces a number of measures designed to prevent tax avoidance through the use of the new trust structures available under the new JTL. In the following cases, the trustee will be liable to corporate taxation on the trust's income separate from its other income.

Case 1 Business Trust (Jigyou Shintaku)

A corporation, which is the settlor, transfers it entire business, or an important part (division) (20% or more of its assets) of its business to a trust and more than 50% of the beneficiary rights to the trust are expected to be issued to the shareholders of the corporate settlor. As this arrangement is, in effect, a corporate division, it is possible to avoid taxation at the corporate level after the transfer has been made as the income in the trust will only be taxed at the beneficiary level. Therefore, the tax reform provides the trustee will be subject to corporate tax on the trust's profits, separate from its other income.



Case 2 Long-term Self-declared Trusts

A trustee of a long term self-declared trust, which is either the corporate settlor (Jiko Shintaku) or an individual or a corporation, that has a specified relationship with the corporate settlor, will be required to file a corporate tax return and be taxed on the trust's income if the following conditions apply:

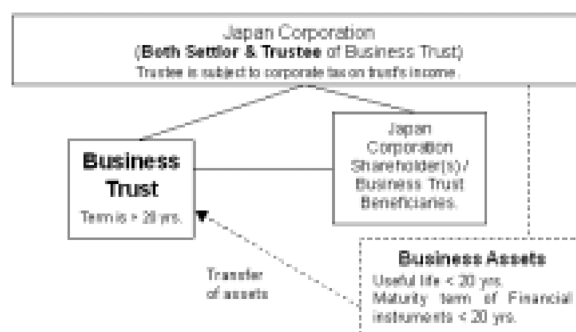
(a) the term of the trust is more than 20 years, and

(b) the main assets transferred to the trust are not:

  (i) depreciable assets with statutory useful lives of more than 20 years, nor

  (ii) non-depreciable assets, nor

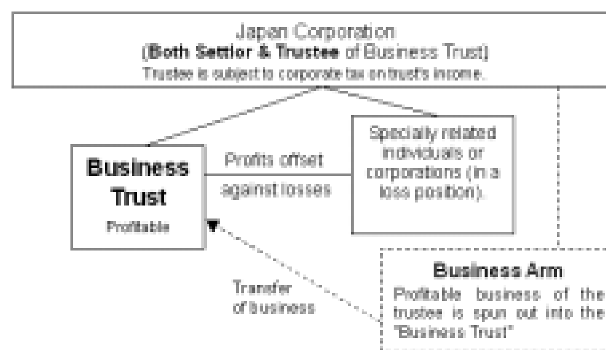
  (iii) monetary claims whose term to maturity is more than 20 years.



As this arrangement in substance does not change the corporate structure (the corporate shareholders simply becoming beneficiaries of the trust), the tax reform provides in such cases the trustee is subject to corporate tax on the trusts income, separate from its other income.

Case 3 Self-declared and Business Trusts

The trustee is either (i) the corporate settlor itself (Jiko Shintaku) or (ii) a related person of the corporate settlor and part of the beneficiary rights to the trust is owned by a related person of the corporation settlor, making it possible for profits to be allocated between the related



entities. For example, if a business trust is profitable and the beneficiary's business is making a loss, the profit from the business trust and losses from the beneficiary's business can be offset against each other. In such cases,

under the reform, the trustee will be subject to corporate tax on the trust's income / losses.

Case 4 Non-beneficiary trust

Two typical non-beneficiary trust structures are: (i) a trust is created of which no beneficiaries are nominated, and (ii) a trust is created upon the death of the settlor, as provided for in the settlor's Will.

In both cases a trust company (trustee) is directed by the will to manage the trust's assets.

Prior to the reform, the tax treatment of such trusts was unclear, however the 2007 tax reform clarifies how such structures will be taxed.

In the first structure, at the time the trust is established, the settlor will be subject to capital gains tax on the difference between the fair market value and the book value of any assets transferred into the trust. The trustee, because it is a corporation, will subject to corporation tax at the time of the trust's establishment and on any income generated by the trust during the term of the trust.

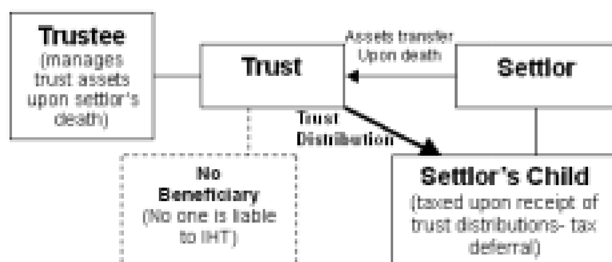
At the time the beneficiary is identified, the transfer of the right to benefit under the terms of the trust to the beneficiary is not subject to taxation. However, if the beneficiary is a relative of the settlor, the trustee is subject to inheritance tax rather than corporate tax in order to prevent the avoidance of inheritance tax (as inheritance tax is generally levied at higher rates than corporate tax).

In cases where a beneficiary has been nominated before they are born, and they are related to the settlor, the beneficiary will be subject to gift tax at the time s/he receives the right to benefit under the trust.

When the trust is terminated, the entities entitled to the trust's retained earnings will be subject to either individual income or corporate tax, depending on whether they are an individual or a corporation.

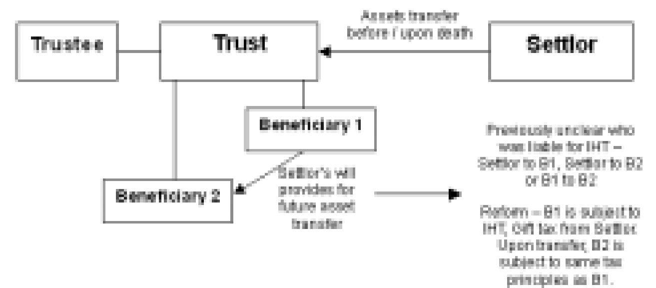
The tax treatment of the second structure is the same as described above; however as the settlor is deceased, its capital gains tax liability will be assumed by its successors.

Charitable trusts (Koeki Shintaku) are taxed in the same manner.



Case 5 Beneficiary Right Succession Trust

In this structure, the settlor's Will provides that, upon the settlor's death, the settlor's assets will be (i) held in trust for Beneficiary 1 and then (ii) transferred to Beneficiary 2 at some point in the future.



Prior to the reform it was unclear whether IHT was levied on the transfer of the beneficiary right from B1 or B2, or from the settlor to B1 or B2, however the 2007 tax reform clarifies the tax treatment. In the case the trust structure is set up before the settlor's death, gift tax is levied on B1 at that time. If the scheme is set up upon the settlor's death, IHT will be levied on B1 at that time.

With respect to the transfer of assets from B1 to B2, the same principles shall apply.

Trust losses

Individual beneficiaries

The reform clarifies the position that trust losses from real estate cannot be offset against other income categories such as salary income while trust losses can be offset against other income in the trust. However, the reform has not clarified whether it is possible to offset trust losses from real estate income against other real estate income outside the trust.

Corporate beneficiaries

If a corporate beneficiary's trust loss does not exceed its trust investment, the loss can be treated as an expense. For example, if the beneficiary's investment is 100, however its loss for 2007 is 80, the 80 can be expensed. In 2008, however if the trust losses equal 50, only 20 can be expensed as the 100 "limit" is reached. Any losses after this are deemed to be zero.

In cases where the trustee / settlor compensates the corporate beneficiary for such losses, such losses cannot be expensed by the corporate beneficiary.

Tax treatment of Leases

This article was first published in Tax Notes International on June 14, 2007.

In relation to the new accounting standards for lease transactions, which came into effect on March 30, 2007,

the 2007 tax reforms include amendments to the tax treatment of lease transactions.

Lease arrangements - Amendment to Japan's accounting standards.

	Before the amendment	After the amendment
Ownership-transfer finance lease	Sale and purchase transaction	Sale and purchase transaction
Non-ownership-transfer finance lease	Principle rule: Sale and purchase transaction Exceptional rule: Rental transaction	Sale and purchase transaction (possible to choose rental transaction for low cost or short-term leases)
Operating Lease	Rental transaction	Rental transaction

Most Japanese finance leases are classified as Non-ownership-transfer finance leases. Also, most companies have selected the exceptional rule (rental transaction) for the non-ownership-transfer finance lease due to the tax treatment shown below. Such treatment differs from international accounting standards, which provides all finance leases be treated as sale and purchase transactions. Consequently, the Japanese accounting treatment for leases was reformed to fall in line with international accounting standards.

As mentioned above, under the reform, the tax treatment of leases will basically follow the accounting treatment, with non-ownership-transfer finance lease being treated as sale and purchase transaction, which currently are treated as a rental transaction.

	Current	After reform
Ownership-transfer finance lease	Sale and purchase transaction	Sale and purchase transaction
Non-ownership-transfer finance lease	Rental transaction	Sale and purchase transaction
Operation lease	Rental transaction	Rental transaction

Lease arrangements - Depreciation

Under the reform (to apply to lease agreements entered into on or after April 1, 2008), leased assets will be depreciated over the lease term using the straight-line method. If the lessee records the lease fee as an expense, in the case of low cost or short-term leases, the expense will be treated as depreciation of the leased assets for tax purposes. As a result, the expensed amount will be treated in the same for both accounting and tax purposes.

Other 2007 tax reforms

This article was first published in Tax Notes International on 15 June, 2007.

1. Deductibility of Director's Compensation

The 2007 tax reforms include some changes to the tax treatment of directors' compensation included in the 2006 tax reforms.

Under the 2006 tax reforms, the definition of regular fixed compensation paid to directors did not provide for situations in which a change in the director's circumstances (such as a promotion) resulted in an adjustment to the directors' compensation. The 2007 tax reforms expands the definition accordingly.

Further, the advanced notification provisions (also introduced in the 2006 reforms) have been extended so the notification date is now the earlier of:

(i) one month from the date of the general meeting approving the fixed directors' compensation or

(ii) four months from the start of the fiscal year.

2. Depreciation

The new Depreciation rules, as provided under the 2007 tax reforms have eliminated the 10% purchase price residual value and the 5% non-depreciable residual asset cost.

New depreciable assets acquired after April 1 2007, may be depreciated down to a nominal value of one Japanese Yen. For existing depreciable assets, the difference between the previous 5% of residual value and the nominal value of one Japanese Yen may be depreciated on a straight line basis over five years, beginning from the fiscal year following the fiscal year in which the 5% non-depreciable amount was reached.

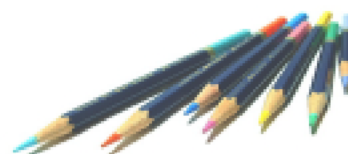
The tax base of depreciable assets for the purposes of the local fixed assets tax is unlikely to change.

In addition to the above the following changes have been implemented:

(i) A new accelerated declining balance method has been introduced; with the new statutory method of depreciation equalling 250% of the depreciation rate allowable under the straight line method;

(ii) Certain types of high technology manufacturing assets and facilities involved in the production of semiconductors, flat panel screens, and certain other high profile technology assets will have a statutory useful life of five years; and

(iii) Accelerated depreciation may be claimed in relation to investment in corporate-sponsored child care



facilities in corporate offices.

3. Family Corporation Rules

The surtax on undistributed retained earnings of Specific Family Corporations will not apply to Family (privately held) corporations with a capital of JPY 100 million or less.

4. Withholding tax treatment of domestic investors in Tokumei Kumiai arrangements

The 2007 tax reforms have expanded the scope of withholding taxation for domestic silent partners in Tokumei Kumiai arrangements established under Japan's Commercial Code.

Prior to the reform, withholding tax of 20% was only levied on TK distributions made to domestic TK investors if there were 10 or more domestic TK investors in the arrangement.

Under the 2007 tax reforms, all TK profit distributions paid on or after 1 January 2008 to domestic TK investors will be subject to 20% withholding tax, regardless of the number of the domestic TK investors. The tax will be collected at source by the TK operator.

This mirrors the current treatment of TK arrangements with non-resident TK investors.

Transfer Pricing: Pre-consultation windows established in Japan.

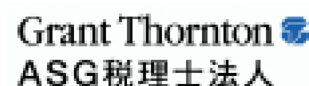
This article was first published in Tax Notes International on May 17, 2007.

Japan's Tokyo Regional Tax Bureau (TRTB) has recently established (effective April 2, 2007) a new office called "Jizen Sodan" (pre-consultation window), a dedicated PCS (Pre-confirmation System) pre-filing facility.

Jizen Sodan assists taxpayers in filing PCS applications with the tax authorities. Such applications concern arms length issues, such as selecting the appropriate method etc. Jizen Sodan had previously been in place, but without a dedicated office until now.

The number of companies who used the Jizen Sodan facility in FY2003 was 65. This has grown in the fiscal years 2004 and 2005 to 51 and 76 taxpayers, respectively. The purpose of the new office is to encourage the use of consultative opportunities by taxpayers in order to facilitate the use, and to shorten the examination time, of PCSs.

This window has also been established in other regional tax bureaus.



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