

Japan Tax Bulletin

Tax Reform on Retirement Income

May 2021

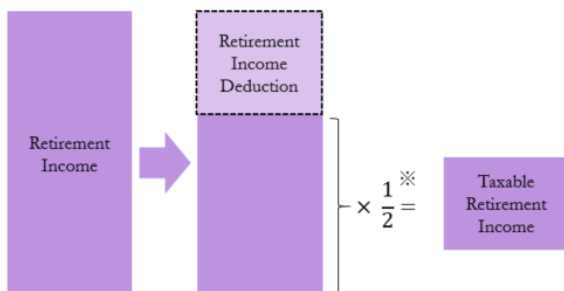
Under Japan's traditional employment practice represented by lifetime employment and seniority-based wage systems, employees' wages increased at an accelerated speed during the later years of career. Coupled with defined benefit retirement plans, employers paid large amount of lump-sum or annuity retirement allowance to reward retiring employees for their lifetime loyalty, commitment, services and contributions. Retirement allowance was positioned by employees and by the wider society as means to secure retirement life. Positioning retirement income as means for employees to build their retirement nest, retirement income is treated favourably for tax purposes.

Over time, however, cases have rose where employers "reduce" employees' salaries and pay the reduction in the form of retirement allowance to benefit from the special tax treatment for retirement income and reduce employees' income tax. 2021 Japan Tax Reform responded to these undesirable application of the favourable tax treatment. Effective 1 April 2021, the 50% standard deduction to arrive at taxable retirement income will be disallowed for employees with less than five years of service.

1. Current tax system

Taxable retirement income, other than for specified directors¹, is 50% of the amount calculated after deducting the retirement income deduction from retirement income received. The retirement income deduction is based on the number of years of service.

For specified directors with a service period of less than five years, the 50% standard deduction to arrive at taxable retirement income is disallowed for retirement income relating to the periods when they were a specified director.



Taxable Retirement Income x Tax Rate - Deduction = Income Tax
Income Tax x 102.1% = Final Tax on Retirement Income

※ Taxable retirement income is not reduced by 50% for specified directors.

| Service Years | Retirement Income Deduction |
|---------------|---|
| < 20 years | JPY400,000 for each year of service (minimum of JPY800,000) |
| > 20 years | JPY8 million + JPY700,000 for each year in excess of 20 years |

If the "Application Concerning Receipt of Retirement Income" ("Application") has been submitted to the payer of the retirement allowance before the date of the retirement allowance is paid, in principle, most recipients are not required to file a tax return. This is because income tax and local tax will be deducted after subtracting the retirement income allowance.

If the Application is not submitted before the payment date, 20.42% of income tax and 10% local inhabitant tax is deducted from the retirement allowance, and the filing of a tax return is required to settle the income tax. The procedures relating to the "Application" will not change after the reform.

2. Reformed tax system

The reform applies to employees with shorter than five years of service under the employer paying the retirement allowance. In such cases, the 50% standard deduction only applies to the first JPY3 million of retirement income after 50% standard deduction is applied. Amount in excess of JPY3 million after the 50% standard deduction will no longer be eligible for the 50% standard deduction.

3. Applicable Period

For National Income Tax, the change applies to retirement allowances from 2022 onwards.

For Local Inhabitant Tax, the change applies to retirement allowances paid on or after 1 January 2022.

4. Examples

Examples below show the effect of the reform for employees with less than five years' service and over five years' service.

¹ Specified directors (directors, executive officers, accounting advisors, auditors, board members, auditors, liquidators, etc.), members of the National Diet, members of local assemblies, national and local public officials as defined in Article 2, Paragraph 15 of the Corporation Tax Act.

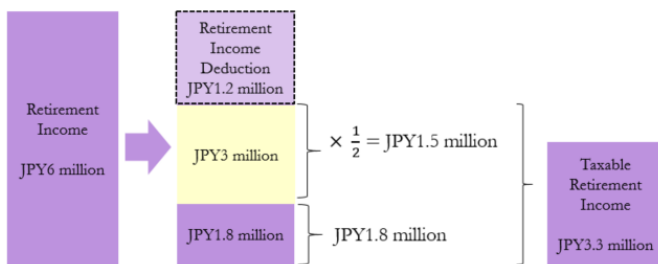
<Example 1>

- Resigned after three years of service as an employee
- Receives JPY6 million as a retirement allowance

Calculation of retirement income

• Retirement Income Deduction
 JPY400,000 x 3 years = JPY1.2 million

• Taxable Retirement Income
 JPY6 million - JPY1.2 million = JPY4.8 million
 JPY4.8 million - JPY3 million = JPY1.8 million
 (JPY3 million x 1/2) + JPY1.8 million = JPY3.3 million



<Example 2>

- Retired after 6 years of service as an employee
- Receives JPY8 million as a retirement allowance

Calculation for Retirement Income

• Retirement Income Deduction
 JPY400,000 x 6 years = JPY2.4 million

• Taxable Retirement Income
 (JPY8 million - JPY2.4 million) x 1/2 = JPY2.8 million

