Setting up your Business in Japan
Issues to consider

In the "Japan Revitalization Strategy," the Japanese government outlined its target of increasing foreign direct investment stock of JPY 35 trillion by 2020. Foreign companies offer excellent human resources and technologies into Japan for the creation of additional employment and innovation. For foreign companies, the greatest appeal in doing business in Japan has been its "huge sophisticated market" of customers who demand high-quality products and services. In addition to this, Japan is now being recognized as an "other international bellwether" in the sense that success in the Japanese market often leads to success in Asian and global markets. (Source - JETRO). The Summer Olympic and Paralympic Games will be held in Tokyo from 24th July to 9th August 2020 and from 25th August to 6th September 2020, respectively.

However when you are looking to set up a business in Japan, there are a number of issues which must be considered. This document takes you through some of the common questions we come across and gives you practical information about some of the issues you need to consider.

What type of Business Structure should we use?

There are advantages and disadvantages for each option, so there is no one correct answer. It's all dependent on your specific business circumstances and needs. A brief overview of the popular entity structures are explained below:

Branch of your overseas business

- Not a separate legal entity but an extension of the overseas company
- The head office of the foreign company is ultimately responsible for all debts and credits generated by the activities of its Japanese branch
- If you are considered to have a permanent establishment in Japan, then profits from the branch are liable for Japanese Corporation taxes
- Not required to file **parent company accounts**, but are required to report on the financial situation of the company itself
- Must register necessary information such as a representative resident in Japan and a business address in Japan with the Legal Affairs Bureau

Limited Company:

- Provides limited liability to Japanese operations
- Gives a perception of a local business, with longevity
- Must choose a company type to establish a subsidiary in Japan as a joint-stock company (Kabushiki Kaisha ("KK")) which is the most common company type, limited liability company (Godo Kaisha ("GK")) which is not a pass through entity for Japanese tax purposes unlike the U.S. LLC, or similar entity recognized by the Japanese Companies Act
- National corporation tax to be paid on company profits as well as company size
- Must register necessary information such as a representative and a business address

in Japan with the Legal Affairs Bureau
- The initial paid-in-capital may be as small as one yen
- KK is required to give public notice of its accounts and reassignment of directors, but not required for a GK
- Accounts require an audit if the company is listed or the entity is considered a large company whose capital stock exceeds JPY500 M or whose total liabilities exceeds JPY20 B

Limited Liability Partnership:

- "Yugen Sekinin Jigyo Kumiai" is considered the Japanese version of limited liability partnership
- Must register necessary information with the Legal Affairs Bureau
- At least one of the partners must be a resident in Japan
- Members (partners) have limited liability
- Profits are allocated to members who then pay income tax on these profits personally
- The tax residence of the member and where the profits in the LLP originated will determine jurisdiction and how these profits are taxed

How much Corporation Tax will the business pay?

Current national corporate tax rates in Japan are:

	Tax rate (%)		
	For the fiscal year beginning on or after 1st April		
	2015	2016	2018
Companies with paid-in capital of more than JPY 100 M	23.9%	23.4%	23.2%
Companies with paid-in capital of JPY 100 M or less:			
Annual taxable income up to JPY 8 M (Note 1)	15%	15%	15%
Annual taxable income over JPY 8 M	23.9%	23.4%	23.2%

Note 1: This reduced rate is not applicable if the company is directly or indirectly wholly-controlled by a large company (companies with paid-in-capital of JPY 500 M or more).

In addition to the national corporate tax, national regional corporate tax, local corporate enterprise tax and local corporate income tax will also be levied on the corporation. Local corporate enterprise tax is calculated based on taxable income. National regional corporate tax and local corporate income tax are calculated based on the amount of national corporation tax. In addition, there is a per capita local inhabitant tax that is levied based on the size of the company (i.e. the amount of paid-in capital and the number of employees).

In March 2016, new tax reform laws were enacted in Japan, which reduced national corporate tax rate effective from the fiscal years beginning on or after 1st April 2016. As a result, the effective statutory corporate tax rate was reduced from 32.11% to 29.97% and 29.74% for the fiscal years beginning on or after 1st April 2016 and for the fiscal years beginning on or after 1st April 2018, respectively.

A consolidated tax return filing system applies to only to Japanese companies in a wholly-owned group and does not apply to foreign companies.

Recent tax legislation requires a subsidiary in Japan to look at the entire group in determining the filing status and eligibility for certain deductions, etc. For instance, although subsidiaries or branches itself may be categorized into small and medium sized company, they will become a large company if the capital of the ultimate parent company is 500 million yen or more.

What if we use Japan to set up our holding company?

If a holding company is being considered as the location of a multinational company's regional headquarters, a range of tax and non-tax issues must be considered before selecting its location.

Business costs are coming down in Japan in comparison with Singapore, Hong Kong, Shanghai and other large cities. Japan's reputation as a "product development and R&D center" is also rising through collaboration with Japanese companies and research institutions in recognition of the research and technology development capabilities and reliable IPR protection. (Source - JETRO)

In addition, in order to to promote activities to attract R&D bases and supervisory bases of global enterprises to Japan, the Act on Special Measures for Promotion of Research and Development Business, etc. by Specified Multinational Enterprises (the "Act for Promotion of Japan as an Asian Business Center") was enacted in 2016. Some support measures were implemented, such as acceleration of examinations and proceedings for patent applications (accelerated from approx. 22 months to approx. 2 months in 2011) and acceleration of entry examinations for the Certificate of Eligibility for Status of Residence applied for by foreign nationals who intend to work in Japan (accelerated from one month to approx. 10 days).

Furthermore, certain corparate income tax credits are available for eligible R&D expenditures.

Payments of dividends by a Japanese subsidiary to the foreign parent are usually subject to Japanese withholding income taxes of 20.42%, or at reduced rates under tax treaties. Repatriation of branch profits is normally not subject to Japanese withholding income taxes.

What if we make cross-border transactions between group companies?

Japan follows internationally recognized **Transfer Pricing** (TP) rules where cross-border trading and financial transactions between affiliated entities have to be conducted on an arm's length basis. The price and terms should be the same as if the transactions had been between completely independent parties.

TP documentation rules within Japan are basically in line with the OECD's Base Erosion and Profit Shifting (BEPS) project Action 13.

Typical transactions between affiliated entities that are covered by the TP regulations are:

- Sale and purchase of goods
- Provision of management services
- Property rental charges
- Transfer of intangible assets e.g. trademarks, patents
- Sharing of knowledge, expertise, business contacts, etc.
- Provision of financial support e.g. inter-group loans and charging a “market” interest on loans

A business will need to prepare a Transfer Pricing Report providing the arm’s length basis of transactions. The report will include a functional and risk analysis, analysis of the adopted pricing model and benchmarking of the arm’s length basis.

SME’s are also subject to the Japanese transfer pricing regime, so not only “large” entities but also SMEs should consider the need to undertake a detailed TP analysis. As most large entities have already been targeted, more SMEs are now receiving inquiries by the National Tax Agency.

Even if an entity is exempt from the Japanese transfer pricing regime it may fall under the scrutiny of the other international tax jurisdictions where it transacts. There may also be other tax regulations which ensure transactions are undertaken at commercial value.

What kind of Statutory Benefits need to be paid?

If an individual is a resident in Japan then they are subject to Japanese tax laws (both national income tax and local inhabitant tax) and participate in the Japanese social insurance and labor insurance programs.

Individuals are categorized as permanent residents, non-permanent residents or non-residents, depending on their nationality and the time for which they have had a residence in Japan. Permanent residents are taxed on their worldwide income. Non-permanent residents are individuals who do not hold Japanese citizenship and have maintained domiciles in Japan for five years or less during the preceding ten years. They are taxed on their income from sources in Japan and on their income from foreign sources remitted to Japan. Non-residents are taxed solely on their income from sources in Japan, subject to the terms of any relevant tax treaties.

We recommend any new entrants to Japan who plan to spend time working in Japan seek professional tax advice regarding their tax status and obligations.

Current Personal Income Tax rates in Japan:

An individual's taxable income is essentially their gross income less their claimable deductions. There are a number of tax credits against income taxes owed. However such tax credits are only available to taxpayers who are residents of Japan. An individual's taxable income is subject to national income tax at the following progressive rates:

Band of income (JPY) (A)	Tax rate (%)	Deduction (JPY)	Tax amount (JPY)
–1,950,000	5%	–	(A) x 5%
1,950,000 – 3,300,000	10%	97,500	(A) x 10% – 97,500
3,300,000 – 6,950,000	20%	427,500	(A) x 20% – 427,500
6,950,000 – 9,000,000	23%	636,000	(A) x 23% – 636,000
9,000,000 –18,000,000	33%	1,536,000	(A) x 33% – 1,536,000
18,000,000 –40,000,000	40%	2,796,000	(A) x 40% – 2,796,000
40,000,000 –	45%	4,796,000	(A) x 45% – 4,796,000

(NB: rates are for the year ended 31st December 2015 and thereafter)

Note: There will be an additional earthquake restoration surtax (2.1% of income tax) from 2013 through 2037.

In addition, a local inhabitant tax is levied on an individual's taxable income for local inhabitant tax purposes at a flat 10%. In addition, a per capita inhabitant tax of JPY 5,000 is payable by the registered head of the houshold.

Rates for Statutory Benefits:

With few exceptions, employers and employees have to pay into social insurance and labor insurance programs. Social insurance consists of health insurance, nursing care insurance, pension insurance and child care allowane. Labor insurance consists of employment insurance and workers' compensation insurance.

	Rate/mo	
Social Insurance:		
Health insurance (Note)	9.96%	Celling set at JPY 1,390,000
(employer)	(4.98%)	
(employee)	(4.98%)	
Nursing care insurance (Note)	1.58%	Celling set at JPY 1,390,000
(employer)	(0.79%)	
(employee)	(0.79%)	
Pension insurance	18.182%	Celling set at JPY 620,000
(employer)	(9.091%)	
(employee)	(9.091%)	

Child care allowance (employer) (employee)	0.2% (0.2%) n/a	Celling set at JPY 620,000
Labor Insurance: Employment insurance (employer) (employee)	 1.1% (0.7%) (0.4%)	
Workers' compensation insurance (employer) (employee)	0.25-8.8% (0.25-8.8%) n/a	Rate depends on industry
General contributions (employer) (employee)	0.002% (0.002%) n/a	

(NB: rates as of 1st September 2016)

Note:
The above rates are for Tokyo. Rates vary for each prefecture.

It is the employers' legal responsibility to participate in governmental programs. Employers pay their portion of insurance premiums to the authorities together with the employees' portion of insurance premiums which are deducted from employees' salaries.

Japan has a Social Security Agreement with Germany, the United Kingdom, South Korea, the United States, Belgium, France, Canada, Australia, the Netherlands, the Czech Republic, Spain, Ireland, Brazil, Switzerland, Hungary and India as of January 2017. When an overseas national of these countries are seconded to Japan for a defined period of time and they continue to pay social security in their home country, then the employer and employee are exempt from paying into Japanese pension insurance.

What is Value Added Tax (VAT) and should the business be registered?

Japanese consumption tax, simillar to European VAT, is applicable to most transactions in goods and services consumed/rendered in Japan and goods imported into Japan. Such tax is assesed at each stage of the manufacturing, wholesale, and retail processes.

The current tax rate is 8% (consisting of a 6.3% national tax and 1.7% local tax), which was raised from 5% effective 1st April 2014 and expected to be raised to10% from 1st October 2019. The basic formula to calculate the tax liability is as follows:

Tax liability = Total amount of consumption tax on sales (8% of taxable sales) – Total amount of consumption tax on purchases (8% of taxable purchases)

There are a number of non-taxable transactions for reasons based on social policy concerns, including the leasing and selling land, medical treatment, education and certain financial transactions. Consumption tax is based on the principle of taxing goods and services where they are consumed/rendered, and therefore exemptions are provided for exports of goods and services, and international communication and transportation services.

Vendors/service suppliers must register as consumption taxpayers if they have annual taxable sales transactions in excess of JPY 10 M in the base year (two years prior to the current year or the first six months in the preceding year). If taxable sales in the base year does not exceed JPY 10 M, an entity can elect whether or not they would like to be treated as a consumption taxpayer. A residence or domicile in Japan is not a pre-requisite to be subject to consumption taxes.

On 31st March 2015, the 2015 tax reform bill was enacted in Japan and the Consumption Tax Law on cross-border electronic commerce by foreign companies to Japanese customers was revised. For B to B transactions, a reverse charge system was introduced, which requires a service recipient in Japan to file a consumption tax return on behalf of the foreign service providers. For B to C transactions, under certain circumstances, a foreign service provider who does not have its offices in Japan is required to appoint tax representative to whom tax documents can be delivered, and file a consumption tax return.

Can we provide Share-Based Compensation plans to our staff?

An increasing number of foreign based companies see Share Option plans as being an important way of attracting, motivating and retaining key staff.

Japan has a number of qualified and non-qualified share option plans which give tax benefits to employees and employers alike even though most plans are considered non-qualified. Certain requirements need to be satisfied to adopt an overseas stock option plan to be categorized as a qualified plan.

When directors or employees of Japanese subsidiaries or branches of foreign companies exercise their rights based on stock options or similar share-based compensation schemes, the Japanese entities are required to submit special information returns to the national tax offices by 31st March of the following year.

However there are many types of plans and the taxation can be quite different. Careful planning needs to be undertaken as soon as share-based compensation plans are being considered in Japan.

How else can we compensate our employees?

Japan has a very comprehensive range of compensation and benefit options available for companies to offer their employees.

Private pensions, private medical insurance, supplemental life and disability insurance coverage are now commonplace benefits provided by many Japanese businesses to their workforce.

In addition to the traditional commutation allowance, other benefit packages are also gaining popularity, such as giving employees flexibility on their work hours and work place. Many expats are often provided corporate housing, tuition for children, and home leave allowances. Care must be taken on bonus payments to directors, which are generally non-deductible.

To discuss your requirements please contact the International Office at +44 (0) 1245 449266 or email us directly.

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The information in this document was prepared as at 28th February 2017.