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# Doing Business in Japan

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# Doing Business in Japan

## **Abstract**

[Excerpt] The purpose of this publication is to provide foreign investors with a broad overview of the legal framework within which business is conducted in Japan. This publication deals primarily with: • The regulation of foreign investment in Japan, including the Japanese Government's policy on foreign investment; • The legal structures available for investors in Japan; • The tax system imposed by the national and prefectural governments; and • The general system of business regulation applicable in Japan. This publication has been prepared by Baker & McKenzie GJJ / Tokyo Aoyama Aoki Law Office as a general guide for those persons or corporations considering making an investment in Japan. Before specific investment is made, however, consideration should be given to specific laws and regulations that may affect the investment decision.

## **Keywords**

Japan, foreign investment, trade, commerce, business, law, imports

## **Disciplines**

Business | International Business

## **Comments**

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東京青山・青木法律事務所

# Doing Business in Japan

**2005**

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## INTRODUCTION

The purpose of this publication is to provide foreign investors with a broad overview of the legal framework within which business is conducted in Japan.

This publication deals primarily with:

- The regulation of foreign investment in Japan, including the Japanese Government's policy on foreign investment;
- The legal structures available for investors in Japan;
- The tax system imposed by the national and prefectural governments; and
- The general system of business regulation applicable in Japan.

This publication has been prepared by Baker & McKenzie GJB / Tokyo Aoyama Aoki Law Office as a general guide for those persons or corporations considering making an investment in Japan. Before specific investment is made, however, consideration should be given to specific laws and regulations that may affect the investment decision.

Baker & McKenzie is an international law firm with 69 offices in 38 countries as at January 2005. It is one of the world's largest law firms and is also unique in its global framework.

In Tokyo, the firm offers a full range of commercial law services provided by over 100 professional staff. Our clients are engaged in all areas of commercial activity, including Japanese and international public and private companies, banks and other financial institutions, professional firms, joint ventures and partnerships. We also represent many significant foreign investors and companies doing business within Japan, as well as major local companies developing markets overseas.

Our Tokyo office is available to assist you with any legal issue that you might encounter while doing business in Japan.

(June, 2005)

# 1. JAPAN - AN OVERVIEW

## Government

Japan is organized as a constitutional monarchy with a parliamentary form of government. Emperor Akihito has been the chief of state since 1989. However, the Emperor has no powers related to government. Executive power is exercised by a cabinet, composed of a prime minister and ministers of state. The cabinet is responsible to the Diet which is a two-house (*i.e.*, bi-cameral) parliament. Japan's bi-cameral Diet consists of the House of Councillors (the Upper Diet) and the House of Representatives (the Lower Diet). The Diet is elected by universal suffrage and designates the Prime Minister from among its members.

## Population

Japan has a population of over 127 million and is largely a homogeneous society with only 1% of the population coming from minority ethnic groups. The population is highly concentrated in urban areas, with approximately one quarter of the population living around the Tokyo Metropolitan area.

## Language

The only official language is Japanese. English is a compulsory subject at junior high school and senior high school and frequently spoken in business involving foreign companies in Japan.

## Information for Visitors

### Currency

The Japanese yen is a floating currency. During 2004, the JPY fluctuated in the range of ¥103 to ¥116 = US\$1.00. In January 2005, US\$1.00 was equal to approximately ¥104.

### International Time

Japan has only one time zone, and has not adopted Daylight Savings Time. Japan time is 9 hours ahead of Greenwich Mean Time.

### Business Hours

Standard business hours in Japan are generally from 9.00 am to 5.00 pm, Monday to Friday inclusive. However, many banks and financial institutions only offer over the

counter services from 9.00 am to 3.00 pm. Retail outlets in most areas are usually open on Saturdays, Sundays and National Holidays.

### National Holidays

Set out below is a list of National Holidays and their approximate dates. Where a National Holiday falls on a Sunday, the following Monday becomes a holiday, and where a business day falls between two National Holidays, that day will become a holiday\*. The two peak holiday periods in Japan are the New Year holidays, usually from around December 29 to January 4, and “Golden Week”, from April 29 to May 5. Many offices are closed during these periods, and visitors may find it difficult to get travel reservations.

- |                             |                           |
|-----------------------------|---------------------------|
| • New Years Day             | 1 January                 |
| • Coming of Age Day         | Second Monday in January  |
| • National Foundation Day   | 11 February               |
| • Vernal Equinox Day        | 20 March                  |
| • Greenery Day              | 29 April                  |
| • Constitution Memorial Day | 3 May                     |
| • Holiday*                  | 4 May                     |
| • Children’s Day            | 5 May                     |
| • Marine Day                | Third Monday in July      |
| • Respect for the Aged Day  | Third Monday in September |
| • Autumnal Equinox Day      | 23 September              |
| • Sports Day                | Second Monday in October  |
| • Culture Day               | 3 November                |
| • Labor Thanksgiving Day    | 23 November               |
| • Emperor’s Birthday        | 23 December               |

## **2. POLITICAL & LEGAL BACKGROUND**

### **2.1 System of Government**

There are 2 main levels of government in Japan: National and Prefectural. Under the Japanese Constitution, national legislative power is vested in the Diet. The prefectural

assemblies of the 47 administrative prefectures have the power to govern and enact laws within the prefecture. At the more local level is a system of city, town and village municipal assemblies.

## 2.2 Sources of Law

Japan is a civil law country, governed by laws passed by Parliament and interpreted by the courts. At the beginning of the Meiji era (1868-1912), the German and French legal systems were the model for the Japanese court and legal system. After the Second World War, a major reform of the legal system took place in Japan with many of the revised laws being modeled on American law. Today, the Japanese legal system remains a hybrid of the continental European system and the Anglo-American system.

## 2.3 Court System

The Constitution of Japan provides that all judicial power in Japan is vested in the Supreme Court and in such inferior courts as are established by law. The *Court Organization Law* establishes the following five types of courts in Japan listed in order of judicial authority, from highest to lowest:

- (1) Supreme Court;
- (2) High Courts,
- (3) District Courts;
- (4) Family Courts; and
- (5) Summary Courts.

The respective courts have their own jurisdiction as provided by law. Each court renders a judgment independently and a decision of a superior court binds the courts below in respect of the case concerned. In contrast to common law jurisdictions, there is no principle of *stare decisis* (i.e., a court is not bound by a previous decision in a different case).

## 2.4 Court Procedures - Some Features

Evidence in most cases is ordinarily given by way of statement or affidavit, prepared by witnesses in advance. There is no “deposition” or discovery procedure available for the discovery of documents by parties to litigation before a matter is heard, although there are court procedures available for the preservation of specified evidence.

The Japanese court system currently does not have jury trials for civil or criminal cases. However, a new law due to come into force in 2009 provides for a system of citizen judges (“*saiban-in*”) in serious criminal cases.

In civil suits, it is usual for judges to encourage the parties to a dispute to reach an amicable settlement prior to the court pronouncing judgement. Judges may also act as mediators and may make suggestions as to the content of a settlement agreement. An agreement reached through such court sponsored mediation procedures is registered with the court and is an enforceable contract.

## **3. FORMS OF BUSINESS ORGANIZATION**

### **3.1 Introduction**

There are a number of different business entities and structures available to foreign corporations intending to operate a business in Japan. The main business entities or structures available are:

- (1) Corporation (“KK company”);
- (2) Limited liability company (“YK company”);
- (3) Registration of the foreign corporation as a branch;
- (4) Representative office; and
- (5) General and silent partnerships.

It is important to consider the foreign corporation’s objectives for setting up a business entity or structure in Japan to determine which of these forms of business structure is appropriate. The foreign corporation must consider how large the Japanese operations are likely to be and how much capital it can, or is willing, to invest. The smaller the operations, the more likely a branch office or even a representative office would be preferable to a corporation. However, even if the operations are expected to be quite small, the foreign corporation may still require a solid presence in Japan in order to sustain long-term relationships with customers and to create new ones. In this case, considerations of business culture may suggest that a corporation is the preferred option in Japan.

A more comprehensive overview of the types of business organization in Japan and guidance on investment strategies for Japan is set out in our complimentary memorandum titled “Choosing a Business Entity in Japan” which is available upon request.

## **3.2 Corporation (“KK Company”)**

### **3.2.1 Incorporation**

The most common form used by foreign companies setting up operations in Japan is the “corporation” which is known in Japanese as a *kabushiki kaisha*. The *kabushiki kaisha* is sometimes translated as a joint stock company, and often abbreviated in English as a “KK” or “KK company”. It is similar to the US closed corporation or in the case of a KK company listed on a stock exchange, it is akin to a US public company. It is also similar to the German AG corporate form.

As pre-existing “shelf” companies are generally not available in Japan, it is usually necessary to incorporate a new KK company to establish a Japanese subsidiary. The process of incorporation generally takes about four weeks and involves the appointment of a promoter (who must be resident in Japan), a minimum of three directors (including one representative director who must be resident in Japan) and a statutory auditor. Under sweeping company law reforms expected to come into effect in 2006, it will be possible for closed KK companies (*i.e.*, those companies with restrictions on share transfers set out in their articles of incorporation) to have a minimum of one director.

The typical approach by foreign corporations setting up operations in Japan is to establish a KK company as a wholly owned subsidiary. Establishment of a KK company is generally viewed as a relatively substantial commitment by the foreign company to the Japanese marketplace.

The establishment of a KK company for operations in Japan is popular as the parent foreign corporation is not directly liable for the legal obligations of the subsidiary, except in rare circumstances. The maximum liability of the foreign parent company is generally the amount invested in the subsidiary. Additionally, it is not necessary to provide the Japanese fiscal authorities with information concerning the operations and profits of the parent corporation upon the establishment of a KK company subsidiary.

### **3.2.2 Capital**

A KK company must be incorporated with a minimum capital of ¥10 million (approximately US\$90,000). Payment of this initial capital of ¥10 million is usually made by cash. Under the new company law reforms expected to come into effect in 2006, this minimum capital requirement will be abolished but a new KK company will still need to have net assets of at least ¥3 million in order to distribute profits.

It is possible to make a contribution of assets rather than cash. However, this approach is generally not recommended due to the costly and time-consuming requirement that the assets to be contributed must be formally appraised by a court appointed inspector if their value exceeds one fifth of the total capital or ¥5 million. Recent amendments to the *Commercial Code of Japan* permit this appraisal by a court appointed inspector to be avoided where an attorney, certified public accountant or other similarly qualified person or entity is able to certify the value of the assets to be contributed. However, it remains to be seen whether this certification alternative offers any significant time or costs savings compared to the court inspection procedure.

### **3.2.3 Corporate Maintenance and Filings**

A KK company is required to hold an annual general meeting (“AGM”) within 3 months after the end of its fiscal year to approve the financial statements for the preceding fiscal period. Extracts of the approved financial statements are required to be published in the *Kampo*, or government gazette. Minutes of AGMs or other shareholder or board meetings must be filed with the Legal Affairs Bureau if there is any resolution regarding a change to one of the company’s registered matters (such as its directors or statutory auditors, address or corporate name, etc.).

## **3.3 Limited Liability Company (“YK Company”)**

The limited liability company, which is known in Japanese as a *yugen kaisha* and often abbreviated in English as an “YK” or “YK company”, allows for a less formal means of conducting corporate affairs than is the case with a KK company. The limited liability company in Japan is similar to the US limited liability company (*i.e.*, LLC) and the German GmbH corporate form.

The limited liability company offers certain advantages to a foreign investor particularly in terms of a lower minimum initial capitalization, as only ¥3 million (approximately US\$26,500) is required, and the fact that financial results are not required to be filed. Foreign tax regulations (*e.g.*, US “check the box” regulations) or other similar considerations may operate to make the establishment of a limited liability company a more desirable entity for a subsidiary than a KK company.

The incorporation procedures for a limited liability company (*i.e.*, YK company) are similar to those required for a KK company. However, a minimum of only one director is required in the case of an YK company. One or more statutory auditors may be appointed if provided for in the articles of incorporation.

Corporate maintenance and filing requirements are less than those for a KK company. YK companies are not required to hold AGMs. Filing of minutes of unit-holders' meetings is required only when there is a resolution regarding a change to one of the company's registered matters.

Under the new company law reforms expected to come into effect in 2006, it will no longer be possible to incorporate a YK company. Transitional provisions will automatically convert existing YK companies into KK companies but will initially allow them to continue to trade under the YK name.

### **3.4 Registration of a Foreign Corporation as a Branch**

Under the recently amended *Commercial Code of Japan*, a foreign corporation, intending to engage in commercial activities in Japan, may register itself as a foreign corporation with the Legal Affairs Bureau in either of the following two situations:

- (1) where the foreign corporation establishes a business office in Japan; or
- (2) where a foreign corporation does not intend to go to the extent of establishing a business office but is simply represented by an individual in Japan.

The procedures for registering a foreign corporation are relatively simple. The foreign corporation must appoint an individual representative who is resident in Japan. The foreign corporation must notify the individual of the appointment by sending a notice. Within 3 weeks of receiving such notice, the representative in Japan is required to register the foreign corporation with the Legal Affairs Bureau by submitting an application together with certain required attachments. One of these attachments is an affidavit, which must be notarized by a notary public in the country of the foreign corporation, stating the existence of the foreign corporation, the authority of the representative in Japan and the legal nature of the foreign corporation.

In both cases, the branch office is merely an extension of the head office of the foreign parent company in Japan and is not a separate legal entity. Therefore, there is no minimum capital requirement in relation to the registration of the foreign corporation in Japan.

The new revisions to the *Commercial Code of Japan* also require the registered foreign corporation to file with the Legal Affairs Bureau its balance sheet or a summary of its balance sheet on an annual basis.

If the foreign corporation is required to have financial statements approved at an annual general meeting under the laws of its home jurisdiction, it will be required to publish a Japanese language extract in the Government gazette (*Kampo*), a daily newspaper or through its website. In addition, the branch representative must file an affidavit with the Legal Affairs Bureau when there is a change to any of the company's registered matters.

### **3.5 Representative Office**

A foreign corporation proposing to enter the Japanese market may initially wish to enter the market in a very limited capacity to investigate the opportunities and possibilities. If the extent of such activities in Japan is limited to "non-commercial" liaison activities, then the appropriate structure from which to operate could be a representative office. The activities of a representative office must be limited to those activities which are conducted on behalf of the head office of the foreign corporation "not in the direct pursuit of profit". Examples of activities in which a representative office may be engaged include: information gathering, market research, advertising, and other pre-sales and post-sales activities.

The establishment of a representative office in Japan is procedurally simple with no formal registration or reporting requirements being required. There are no annual or other meeting requirements.

A foreign corporation intending to set up a representative office in Japan must proceed with extreme caution to ensure that the activities of the office do not go beyond those which permit tax-exempt status in Japan. As the distinction is not always easily drawn, it is recommended that professional advice be sought prior to setting up a representative office to ensure tax-exempt status can be obtained. Our Tax Department is available to assist should you require further advice in this regard.

### **3.6 Partnerships**

There are basically three forms of partnership available under Japanese law: (1) general or voluntary partnerships; (2) limited partnerships; and (3) silent partnerships.

### 3.6.1 General partnerships

The *Japanese Civil Code* provides for the concept of a general or “voluntary” partnership (*nin-i kumiai*) which is similar to a US style general partnership. In a general partnership, the partners conduct the partnership business jointly and share in the profits and losses *pro rata* to his or her respective contribution unless otherwise agreed among the partners. Each of the partners will have unlimited liability for the obligations of the partnership *pro rata* to his or her respective contribution unless otherwise agreed among the partners and will each own a portion of the partnership assets. The voluntary partnership has no distinct legal personality and is transparent for tax purposes. There are no filing or registration requirements.

### 3.6.2 Limited partnerships

#### (1) Limited Partnership for Venture Capital Investment

Relatively recently, limited partnerships (*yugensekinin kumiai*) were permitted to be established under the *Limited Partnership Law for Venture Capital Investment* (“LP Law”). The LP Law was enacted and came into force in 1998 and is designed specifically to promote venture capital and private equity investment. The limited partnership has several key features in common with a general or voluntary partnership under the *Japanese Civil Code*, including:

- The partnership assets are co-owned by all the partners; and
- The limited partnership has no distinct legal personality and is transparent for tax purposes.

However, there are also key differences, including:

- The limited partnership may have one or more general partners, each general partner being jointly and severally liable for all the debts of the partnership;
- The limited partners are liable only to the extent of their contribution; and
- The partnership is subject to commercial recording requirements under the *Commercial Recording Law* and changes in matters registered with the Legal Affairs Bureau must be promptly reported.

#### (2) New Limited Liability Partnerships

The new limited liability partnership (“LLP”) is established under the *Limited Liability Partnership Law*. This law was formally approved in April, 2005 and it is anticipated to

come into effect in August 2005. The new LLP, to be called a *Yugen Sekinin Jigyō Kumiai* in Japanese, will be introduced as a special type of General Partnership (*nin-i kumiai*). The LLP is anticipated to revitalize Japan's economy by permitting a more flexible business structure that will help promote R&D and business in the IT and finance sectors. The LLP will enjoy limited liability in the sense that LLP partners will only be liable to the extent of their capital contribution to the partnership. The LLP is also expected to be exempt from entity-level income tax so that it will be a true pass-through entity for tax purposes.

### **3.6.3 Silent partnerships**

Another form of partnership, referred to as a silent partnership (*tokumei kumiai*), is provided for in the *Commercial Code of Japan*. A silent partnership is not an "entity" as such but is a specialized business structure. In a silent partnership, one or more silent partners enter into an investment agreement with a person, referred to as an "entrepreneur", under which the silent partners provide funds to the entrepreneur in exchange for the entrepreneur's promise to distribute to the silent partners a specified share of the profits and losses, if there is no contrary provision in the silent partnership contract, arising from the partnership business.

There are certain tax advantages to a silent partnership which has made this business structure popular with foreign investors in certain limited circumstances (*e.g.*, when a foreign corporation is keen to invest in a particular Japanese business but intends to have no role in the management or administration of the business). However, the tax treatment of the profits to non-resident silent partners is quite complex and must also be considered in the context of the relevant applicable tax treaty. Our Tax Department is available to assist should you require advice in this regard.

## **4. COMMON INVESTMENT STRATEGIES FOR JAPAN**

There are a number of different methods of investment into Japan. We set out below four of the more common investment strategies for foreign companies entering the Japanese market.

### **4.1 Wholly owned subsidiary**

The most common investment strategy for foreign companies entering the Japanese market is to establish a subsidiary company, typically a KK company, in Japan. Japanese

subsidiaries of foreign companies are generally wholly owned by their foreign parent company directly or indirectly (*i.e.*, the foreign company ultimately owns 100% of the shares of the Japanese subsidiary).

## **4.2 Joint venture company**

A foreign corporation may wish to be only a part owner of a Japanese company together with one or more local business partners. Many foreign corporations have found this type of business structure attractive, particularly in circumstances where the success of the business is reliant on efficient distribution, sales contacts, manufacturing and technology support in Japan.

A foreign investor must exercise care when determining key issues such as equity participation and board representation especially in the event of a possible future deadlock situation. The foreign investor must ensure that the portion of shares purchased provides the level of influence over the management of the company sought by the investor.

A joint venture company can be created by:

- (1) the incorporation of a new company together with one or more Japanese business partners; or
- (2) the subscription for new shares or the purchase of existing shares in an already established company.

Foreign investors are generally permitted to purchase the shares of existing Japanese companies subject to certain notification requirements.

## **4.3 Investment in a listed company**

If the target company is listed on a stock exchange or traded in the over-the-counter market in Japan, the foreign corporation proposing to acquire shares in such an entity should be aware of the Japanese takeover bid regulations to determine whether the takeover regulations are triggered by the proposed acquisition. Please contact our office or consult our complimentary memorandum on “Takeover Bids in Japan” for more information in this regard.

## 4.4 Entering market by acquisition

A foreign investor may wish to enter the market in Japan by acquiring the assets of an existing Japanese business either directly or through a subsidiary.

- (1) Direct asset acquisition by foreign corporation. If the foreign corporation acquires business assets directly, the foreign corporation will be considered to be doing business in Japan after the acquisition of the business. Accordingly, the foreign company must register as a foreign corporation in Japan upon acquiring the business from the Japanese target company. The business office in Japan will be treated as a “branch office” for the purposes of the *Commercial Code of Japan*.
- (2) Asset acquisition by a Japanese subsidiary. If the foreign corporation purchases the Japanese assets through a Japanese company that has been incorporated for less than two years (*e.g.*, a newly established subsidiary), then issues may arise under the “post-incorporation asset acquisition” (*jigo setsuritsu*) rules of the *Commercial Code of Japan*. If these rules are applicable, the acquisition may be subject to a requirement to either obtain (1) a valuation from a certified professional such as a Japanese lawyer or accountant, or (2) a costly and time-consuming appraisal of the assets by a court-appointed inspector. Under the proposed amendments to the *Commercial Code* set out in the new company law reforms anticipated to come into effect in 2006, this cumbersome requirement of valuing asset acquisitions by a newly formed company is to be abolished.

## 5. FOREIGN INVESTMENT LAWS

Foreign investment in Japanese companies and businesses is regulated under the *Foreign Exchange and Foreign Trade Law*. Certain reporting or approval requirements may apply to “direct inward investments” depending on:

- (1) the jurisdiction in which the investor is located (*i.e.*, whether it is an approved country or not);
- (2) the industry in which the target company or business operates (*i.e.*, whether the industry in question is a regulated industry or non-regulated industry); or
- (3) in the case of asset acquisitions, the nature of the particular asset involved.

## 5.1 Share acquisitions

*General case:* In cases where the foreign investor is located in a recognized jurisdiction or the target company is engaged in business which is not a “regulated” industry, the foreign investor will be required to file an after-the-fact report with the Minister of Finance (“MOF”) and other relevant Ministers through the Bank of Japan (“BOJ”) within 15 days *after* the acquisition if, as a result of the acquisition, either:

- the investor itself holds any issued shares of a non-listed company; or
- the investor and any related companies in the aggregate hold 10% or more of the issued shares in a listed company.

The filing of this report is generally regarded as a mere formality and does not require extensive disclosure of information.

Acquisitions of shares in non-listed companies and acquisitions of less than 10% of shares in listed companies from other foreign investors are not subject to any filing or notification requirement.

*Exceptional case:* Where the foreign investor is located in a jurisdiction which is not included in the MOF list of designated jurisdictions or the target company is engaged in business in a “regulated” industry, a foreign investor that purchases any shares in a company in Japan will be required to file (i) a notification with the MOF and any other relevant Ministers through the BOJ within 3 months *prior* to the acquisition, and (ii) a report with the MOF and any other relevant Ministers through the BOJ no later than 30 days after the acquisition. Regulated industries include telecommunications (*i.e.*, Type 1 telecommunications business), agriculture, fisheries, petroleum, leather goods, aerospace, nuclear power, gunpowder and armaments industries.

## 5.2 Asset acquisitions

If a foreign investor acquires assets directly from a Japanese vendor, the acquisition will be subject to certain reporting requirements under the *Foreign Exchange and Foreign Trade Law*. The reporting requirements differ depending on the particular asset involved. For example, subject to certain limited exceptions, non-residents must report acquisitions of real property located within Japan to the MOF through the BOJ within 20 days after the acquisition. Personal property, other than gold bullion, is generally exempt from these requirements.

## **6. CURRENCY AND EXCHANGE CONTROL**

One of the stated aims of the *Foreign Exchange and Foreign Trade Law* is to subject foreign exchange and foreign trade to the minimum necessary controls and regulation. In keeping with this aim, capital flows relevant to mergers and acquisitions in Japan are largely free of government controls.

However, cash remittances of more than ¥30 million into or out of Japan must be reported to the MOF. This reporting obligation falls on residents only. In practice, however, the Japanese bank involved in the transaction will usually prepare and file a report on its customer's behalf.

The repatriation of profits and dividends by branch and subsidiary forms is unrestricted in Japan. Bond issues, whether overseas by Japanese residents or by foreign residents in Japan, do not require government approval. However, issues involving amounts of ¥1 billion or more are subject to an after-the-fact reporting requirement.

## **7. TAXATION IN JAPAN**

### **7.1 Introduction**

There are two main levels of taxation in Japan being (1) National taxes; and (2) Local taxes (*i.e.*, Prefectural and Municipal taxes). We set out below some of the main taxes imposed in Japan.

### **7.2 National Taxes**

#### **7.2.1 Corporations Tax**

In Japan, the national Corporations Tax is generally computed at a rate of 30% on all earnings. However, for small corporations capitalized at ¥100 million or less, the first ¥8 million of income is subject to tax at a rate of 22%. However, when local taxes are also taken into account with the national corporate income tax, the average effective corporate tax rate reflecting the tax deductibility of the local enterprise tax (see below) when paid, is around 41% to 42%. Different effective tax rates are applied if a company is subject to the “factor-based enterprise tax” which is based not only on income but also other value-added factors. Our Tax Department can provide more detail on the calculation of these rates, if required.

Both companies and branches are taxed on their net income (*i.e.*, after the deduction of expenses incurred in the development of their activities) but the scope of their taxable income is different. Companies are subject to corporate taxation on their worldwide income (and foreign tax credit is available if certain conditions are met), while branches are generally subject to tax only on their Japanese source income.

Payments of royalties or interest<sup>1</sup> are generally deductible business expenses when made between parent and subsidiary corporations, provided that the amount is supported by an arm's length transaction. In order to justify that the transaction is on an arm's length basis, it is necessary to prepare and maintain proper documentation which support a substantive basis for the payments.

In the case of branches, there are certain expenses which are not tax deductible. For example, in the case of the use of patents or other technology by the Japan operation, no deduction is generally allowed for royalties or interest "paid" (*i.e.*, allocated) by the branch to the head office.<sup>2</sup>

The income tax withheld on interest, dividends, and redemption premiums, *etc.*, that the corporation has received during the accounting year is creditable with respect to corporation tax in Japan. However, tax credit is not granted (1) to foreign corporations having no place of business in Japan for income tax withheld on income not subject to corporation tax, or (2) to foreign corporations with a place of business in Japan for income tax withheld on dividends.

## **7.2.2 Tax on Non-Resident Companies**

Non-resident companies ("foreign corporations") are subject to corporation tax and/or withholding income tax upon income derived from sources within Japan. Income that is treated as being sourced within Japan, unless otherwise stipulated in tax treaties for the avoidance of double taxation, includes the following:

- income from business conducted in Japan or from the utilization, holding, sale, or disposal of assets situated in Japan and other income sources within Japan;

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<sup>1</sup> The payment of royalties or interest to foreign companies is subject to Japanese withholding tax. While the domestic tax rate for these payments is 20%, the rate may be reduced by virtue of the operation of any applicable tax treaty.

<sup>2</sup> However, if these payments are supported by, or correspond to, those paid by the head office to a third party, then a tax deduction would be possible provided that certain conditions are met.

- income from businesses that consist primarily of providing personal services performed in Japan; and
- dividends or distribution of surpluses and profits from securities investment trusts (excluding bond investment trusts) received from domestic corporations *etc.*

Under the 2005 tax legislation, if a non-resident partner of a *Nin-ii Kumiai* (“NK”, a partnership under the Japanese *Civil Code*) receives a NK distribution for the period on or after April 1, 2005, the distribution is subject to a 20% withholding tax, in addition to the existing corporate tax-filing requirement. However, the withholding taxation is not applicable if the non-resident has a permanent establishment in Japan through being involved in business activities other than the NK investment. Additionally, under the 2005 tax legislation, the scope of capital gains for non-residents has been expanded, particularly in the context of shares held by a NK or other similar foreign partnership. Our Tax Department can provide more details on these recent changes, if required.

### **7.2.3 Personal Income Tax**

Individual resident taxpayers must generally pay income tax on the total income earned during the calendar year concerned. Generally, income tax rates are progressive, ranging from 10% to 37%. A local inhabitants tax is also imposed, of which rates are also progressive, ranging from 5% to 13%. However certain income, such as retirement income, designated interest income, dividend income and capital gains on listed shares, is taxed separately.

An individual who has a residence of one year or more in Japan (“resident”) must pay income tax on all of his or her income from both within and outside Japan.

A resident who has no intention of residing in Japan permanently and who has had a residence or domicile in Japan continuously for no more than five years (“non-permanent resident”), however, is subject to tax only on the total income derived from sources within Japan and on the income from other sources paid in Japan or remitted to Japan from abroad.

An individual who has had residence in Japan for less than one year (“non-resident”) must pay income tax on income derived from sources within Japan. Most of the income earned by non-residents is normally subject to a flat withholding tax (*e.g.*, 20%), but the rate may be reduced by virtue of the operation of any applicable tax treaty.

## **7.2.4 Consumption Tax**

Consumption tax is an indirect tax similar to the value-added tax (*i.e.*, VAT) in EU countries. Consumption tax is imposed on the transfer/lease of assets in Japan and services in Japan offered by enterprises. In general, consumption tax is ultimately borne by consumers. The overall total current consumption tax rate is a flat 5% (which includes a 1% Local Consumption Tax,).

There are a number of transactions which are exempt from consumption tax, for example: sales and leasing of land; sales of securities such as national government bonds, corporate bonds and stocks; money lending and other financial transactions; and housing rent.

## **7.2.5 Transfer pricing**

Japan has adopted transfer pricing rules that apply to the calculation of the taxable net income of branches and corporations. Under these rules arm's length prices shall generally be applied in calculating the applicable corporation tax in the event that a Japanese corporation has conducted a transaction with a related foreign entity for an amount that was not an arm's length price. Recent changes to this area of the law were introduced effective from April 1, 2004. Please feel free to consult our Tax Department should you require specific advice in this regard.

## **7.2.6 Payroll taxes and Social Security**

Japan applies mandatory social insurance programs such as a health insurance program, a pension insurance program and a labor insurance program. The employee's portion of the premiums for these programs is paid by means of payroll deduction, but employers are also required to pay for the employer portion of the premiums for these programs.

## **7.3 Local Taxes**

In Japan, local public entities consist of (1) municipalities (cities, towns, and villages) that are primary, basic local organizations; and (2) prefectures that are larger units but secondary local organizations. There are 47 prefectures and over 3,000 municipalities.

Taxes levied at the Prefectural Level in Japan include the following: Prefectural Inhabitants Tax; Prefectural Enterprise Tax; Local Consumption Tax; Real Property Acquisition Tax; Tobacco Tax, Golf Course Utilization Tax; Automobile Tax and Automobile Acquisition Tax.

Taxes levied at the Municipal Level in Japan include the following: Municipal Inhabitants tax and Municipal Property Tax.

When the Inhabitants Tax (imposed both at the Prefectural and Municipal Level) and the Enterprise Tax are taken into account, together with national taxes, the average effective corporate tax rate in Japan is around 41% to 42% as noted in section 7.2.1 above.

## **8. INTELLECTUAL PROPERTY**

In Japan, intellectual property law is mostly all legislated. For example, the registration and protection of patents is governed by the *Patent Law*, utility models by the *Utility Model Law*, designs by the *Design Law* and trademarks by the *Trademark Law*. The Unfair Competition Prevention Law provides trade secret protection for technical or business information, as well as protection for well-known and famous names, trademarks or other “indications” even if not registered. The law protecting copyrights is the *Copyright Law*. Japan provides protection to semiconductor chip designs under the *Law Concerning the Circuit Layout of a Semiconductor Integrated Circuit*.

Japan has also acceded to international treaties and conventions, the most important of which are the Paris Convention for the Protection of Industrial Property, the Berne Convention for the Protection of Literary and Artistic Works, the Patent Cooperation Treaty, the Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks, the Convention Establishing the World Intellectual Property Organization and the Treaty on the Trade Related Aspects of Intellectual Property (“TRIPS”).

A comprehensive overview of the intellectual property laws in Japan is set out in our “Intellectual Property Guide” which is available upon request.

## **9. LABOR LAW**

### **9.1 Introduction**

The main law governing individual employment and labor relations in Japan (*i.e.*, the law which deals with the conclusion, continuation and termination of labor contracts between workers and employees) is the *Labor Standards Law*. Individual employment relations in Japan are also governed by:

- (1) the rules of employment or work rules established by each employer;

- (2) the individual employment contracts entered into between the employer and the employee;
- (3) company custom and practice; and
- (4) relevant case law and precedent.

The basic standards for working conditions are set out in the *Labor Standards Law*. These standards are intended to establish minimum working conditions only, and employers are expected to establish and maintain working environments which exceed those standards. Any working conditions which fall below such minimum standards are invalid.

Employers who employ ten or more workers on a continuous basis at a particular workplace must draw up rules of employment, often called “work rules”, which are applicable to all of their employees. The *Labor Standards Law* specifies the items which must be included in the work rules. These rules must then be submitted to the Labor Standards Inspection Office. If an employer employs less than ten workers, it need not adopt work rules.

## **9.2 Trade unions**

Collective labor relations which concern primarily the formation and operation of worker organizations representing workers in seeking better employment conditions are mainly covered by the *Labor Union Law*. In Japan, since employees traditionally tend to have strong ties with their respective companies due to the practice of “lifetime employment”, approximately 90% of Japanese trade unions consist of “enterprise unions”. Enterprise unions are formed within a specific enterprise, company, establishment, or factory. Although most of these enterprise unions are affiliated with an industrial union in their industry, industrial unions rarely play a significant role in negotiations with companies; rather, enterprise unions take a major part in union activities. Enterprise unions are often established in large-sized companies, but typically not in smaller-sized companies.

## **9.3 Dismissal of an employee**

The dismissal of an employee in Japan can be a difficult due to the expectation of “life-time employment” for Japanese employees. Certain procedural, contractual and substantive requirements must be met when terminating an employee’s employment in Japan.

Further and more comprehensive information relating to labor law issues in Japan and, in particular, the dismissal of employees in Japan is available upon request.





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