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Japan Ruling Party Releases Tax Legislation Proposals

On December 12, 2008, the Liberal Democratic Party (the "LDP"), Japan's ruling party, publicly released an outline of tax legislation which it will propose for enactment during 2009, key points of which are summarized below. Reflecting the seriousness of the ongoing financial crisis and the subsequent recession, the outline proposes to cut taxes deeply, such as an increase in the mortgage interest deduction, cuts in automobile *ad valorem* taxes and tax exemptions on capital gains arising from real estate, in order to protect people's livelihoods and to boost the economy. The LDP proposal has not yet been reflected in proposed legislation for consideration by Japan's Diet, and some or all of the proposals may not be included in proposed legislation or ultimately enacted.

1. Lifting of Temporary Suspension of NOL Carry-Backs

The longstanding "temporary" suspension of the carry-back of net operating loss will be lifted for certain small and mid-size enterprises ("SMEs"), for NOLs sustained in taxable years ending on or after February 1, 2009. For this purpose, SMEs eligible for the carry-back are corporations with paid-in capital of ¥100 million or less at the end of each relevant taxable year (and certain charitable organizations). The suspension of NOL carry-backs will remain in place for corporations that are not SMEs. Non-SME corporations with NOLs may consider reducing their capital to meet the definition of SME in order to benefit from the carry-back.

2. Introduction of Participation Exemption, Abolishment of Indirect Foreign Tax Credit

A participation exemption system will be introduced in replacement for the current indirect foreign tax credit system. Under the new participation exemption regime, 95% of dividends received from foreign subsidiaries by domestic corporations will be excluded from taxable income for corporate tax purposes. This exemption will apply to dividends from foreign subsidiaries

25% or more of whose outstanding shares are directly held by the parent domestic corporation. Foreign withholding tax on the dividends will not be deducted from the income, nor will it qualify for a direct foreign tax credit.

The introduction of the participation exemption should not generally affect the operation of Japan's CFC rules (the "anti-tax haven tax system") which will continue to treat earnings of "tax haven" CFCs as immediately includable in taxable income of the Japanese shareholder. (Dividends paid from such "previously taxed income" of a CFC are already excludable from taxable income.) However, in one key change from prior practice, where a tax haven subsidiary (such as a holding company) receives a dividend from a lower tier subsidiary that is not a tax haven company, such dividend can be excluded from the income of the tax haven subsidiary when computing its taxable income for purposes of its parent's deemed income inclusion.

3. No PE for Investments via Investment Partnerships

Foreign limited partners investing in Japan through investment partnerships will not be treated as having a PE in Japan. The new provision would function as a safe harbor rule and remove current uncertainties as to whether foreign inbound investment through investment partnerships creates a PE. Specifically, nonresident individuals or foreign corporations that:

- A) Are limited partners,
- B) Do not execute operations of the partnership,
- C) Have less than a 25% interest in the partnership,
- D) Are not closely related to the general partner, and
- E) Have no PE arising from a business other than the business conducted by the partnership

will be treated as having no PE if they follow certain procedures. This safe harbor rule will apply from April 1, 2009.

4. New Medical Insurance Deductions

Resident individuals will be able to take a deduction from premiums paid for qualified privately-run medical insurance plans up to ¥ 40,000 per year for national income tax purposes (and up to ¥28,000 per year for local income tax purposes), in addition to the long-standing full deduction for publicly-run medical insurance plans. This new deduction will come into effect from 2012, and may substantially increase the purchase of privately-run medical insurance plans in Japan.

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