The EU-Japan Business Dialogue Round Table

Working Party 1

On:

"CREATING AN OPEN ENVIRONMENT FOR TRADE AND INVESTMENT"

(Full text of Recommendations)

Working Party Leaders:

Mr. Katsuhiko Honda
Japan Tobacco Inc.

Mr. Richard Collasse
European Business Community (EBC)

May 27-28, 2003
Brussels

CONTENTS

Introduction…………………………………………………………………………..……. 3

Recommendations to the EU and Japan

1-EJ-1 Call for the negotiation of a Framework Agreement on the Enhancement of Foreign Direct Investment (FDI) between the EU and Japan……………………………… 5

(1) Expression of unequivocal support toward the enhancement of FDI……. 5
(2) Eliminating tax-related barriers to investment…………………………… 6
(3) Facilitating business development: human resource perspectives……….. 10
(4) Facilitating corporate reorganization: legal and tax perspectives…………12
(5) Facilitating new business development through regulatory reform……… 13

Recommendations to the EU

1-E-1 EU Policy on taxation and company organization…………………………………16
1-E-2 Smooth movement of workers in the EU…………………………………………..19
1-E-3 Speedy decision making of the EU after its enlargement………………………… 21
1-E-4 Reasonable settlement of tariff classifications…….……………………………… 22
1-E-5 Proposed European Commission regulation on chemicals control……..………… 23
1-E-6 Community patent……………………………………………………………….24

Recommendations to Japan

1-J-1 Promoting economic growth…………………………………………………… 27
1-J-2 Championing business activity at the local level…………………………………. 27
1-J-3 Cross border stock swaps (and related tax implications)…………………………. 28
1-J-4 Legal services…………………………………………………………………... 29
1-J-5 Regulatory transparency………………………………………………………... 29
1-J-6 Telecommunications……………………………………………………………30
1-J-7 Universal banking………………………………………………………………34
1-J-8 Food additives…………………………………………………………………...34
1-J-9 Insurance…………………………………………………………………….……..35
1-J-10 In-vitro diagnostics…………………………………………………………….….. 36
1-J-11 Animal health……………………………………………………………………... 37
1-J-12 Tax reform to facilitate investment in Japan…...…………………………………. 38

INTRODUCTION

This report contains recommendations to the Governments of the EU and Japan for improving the environment for trade and investment both between and within their respective jurisdictions, with a particular focus this year on increasing levels of foreign investment.

These recommendations are made based on a mutual understanding that open markets and an increase in trade and investment is important to our future prosperity. Individual economies benefit from the economic stimulus of increased competition, productivity and innovation; companies benefit from the markets and resources of the global economy; and consumers benefit from increased access to innovative products and services at competitive prices. Experience has shown that foreign investment has had an extremely positive impact on economic development through the introduction of new capital, technology, managerial know-how, and opportunities for employment.

These recommendations are also made based on a mutual understanding that the governments of the EU and Japan are actively promoting a mutual increase in foreign direct investment, through both mutual efforts and their own initiatives. In Japan, Prime Minister Koizumi has called for a doubling of FDI within five years. The Japan Investment Council (JIC) has been tasked with developing concrete policy measures designed to achieve this goal, and an action plan was adopted earlier this year. For its part, the EU is also making efforts to promote EU expansion as a prime opportunity for new investors.

At the EU-Japan level, explicit reference has been made to the need to further promote FDI under the heading "EU-Japan Initiatives on Investments" in a joint statement released as part of the recent EU Japan Summit held in Athens on May 1-2, 2003. The Joint Statement solicits input from the private sector, in particular the EU Japan Business Dialogue Roundtable, and the recommendations contained in this report represent a contribution to this effort.

In this year's Report, we call for the negotiation of an FDI Enhancement Agreement between the EU and Japan establishing a framework for mutual efforts to promote and facilitate an increase in foreign direct investment. It is envisaged that such an Agreement would go beyond commitments agreed to at the recent EU Japan Summit, which focused primarily on increasing investment promotion efforts, to address the many ideological and structural barriers inhibiting foreign direct investment between the EU and Japan in areas such as taxation, corporate reorganization, human resource allocation and the regulation of commercial activity.

We urge the governments of the EU and Japan to respond positively to these recommendations, which would facilitate the establishment of a truly open environment for trade and investment.

RECOMMENDATIONS TO THE EU AND JAPAN

1-EJ-1 Call for the negotiation of a Framework Agreement on the Enhancement of Foreign Direct Investment (FDI) between the EU and Japan

(Joint Recommendation)

The European and Japanese sides of Working Party 1 of the EU Japan Business Dialogue have for some time been making individual and joint recommendations to the EU and Japanese governments on the specific obstacles hampering the enhancement of foreign direct investment. It is a fact that the implementation of these recommendations has not always been as successful as desired due to various issues particular to the respective socioeconomic situation in the EU and Japan. In order to achieve the ambitious goal of further economic development, the EU and Japanese governments should continue to search for solutions based a more fundamental understanding to cooperate at the highest level.

Efforts to promote a mutual enhancement of direct investment should be a priority in the relations between the EU and Japan in order to further economic development and facilitate EU–Japan business activities.

Believing it important that the EU and Japanese governments reach an agreement on a general direction towards enhancing direct investment, the Working Party has decided to make a joint call for the conclusion of a "Framework Agreement on the Enhancement of Foreign Direct Investment (FDI) between the EU and Japan" (hereafter called "The FDI Enhancement Agreement"). In preparing the joint recommendation, the Working Party has referred to a report produced separately by the Japan Business Council in Europe (JBCE).

It is envisaged that the FDI Enhancement Agreement would contain the following commitments:

(1) Expression of unequivocal support toward the enhancement of FDI

Summary of recommendations:

1. The agreement should clearly state the benefits to the EU and Japan of a mutual increase in FDI

2. The agreement should contain a commitment to cooperate at the highest level to promote the benefits of foreign investment to the general public.

Background:

It is very important that the EU and Japan demonstrate their unequivocal support for an increase in foreign direct investment through the conclusion of this Agreement. The benefits of foreign direct investment need to be promoted more to the general public, and the impetus for this should come from the highest level of government.

Relationship with previous progress reports:

The recommendation to negotiate an FDI Enhancement Agreement is a new recommendation, and as such is not referred to in previous progress reports.

(2) Eliminating tax-related barriers to investment

Summary of recommendations:

1. An agreement should be made on the following issues to prevent double taxation:

    a) An agreement should be concluded providing for a exemption from withholding taxation on dividend payments between parent and subsidiary companies and on interest and royalty payments among affiliated companies between the EU and Japan.

    b) It should be agreed that EU-Japan investments would be mutually exempt from controlled foreign corporation (CFC) taxation. Based on the agreement, the treaties for the avoidance of double taxation concluded between each EU Member State and Japan should be revised to provide for the mutual exemption of CFC taxation. Abuse of this exemption should be addressed through provisions to prevent such abuse set forth in the treaties.

    c) Agreement should be reached to expand the application of the foreign tax credit system. In view of the fact that strategic business partnerships will likely expand in the future, the EU and Japan should agree on a substantial increase in the total number of tiers to which the credit system is applicable and on a reduction of the minimum share holding requirement from, for example, the present 25% in Japan to around 10 or 5%. Based on this agreement, the foreign tax credit systems should be revised in the EU Member States and Japan.

2. An agreement should be made on the following issues regarding transfer pricing taxation:

    a) Agree to extend the application of the EU Arbitration Convention that provides for arbitration in case of disagreements among the tax authorities of the EU Member States to include transactions between the EU and Japan.

    b) Agree to harmonize and simplify documentation requirements and develop mutually acceptable standards of best practice concerning methodologies including clearer interpretation of OECD Guidelines in order to reduce costs associated with complying with transfer pricing regulations.

    c) Agree to establish guidelines on unilateral and bilateral advance price agreements (APAs) for transactions taking place between the EU and Japan and to enable management of the advance pricing agreement system based on harmonized rules

across the entire EU. At the same time, work towards improving the system so that it functions more smoothly.

Background:

1. *Avoiding double taxation*

a) *Withholding tax on intra-group dividend, interest and royalty payments* – In January 2003, EU Member States reached a political agreement at the EU Economic and Financial Affairs Council on the adoption as a package of the draft Directive on Interest/Royalties, the draft Directive on Taxation of Savings, and of the Code of Conduct regarding harmful corporate tax competition.

To enhance direct investment between the EU and Japan under the FDI Enhancement Agreement, the EU and Japan should agree to mutually exempt dividend payments between parent-subsidiary companies and interest and royalty payments among affiliated companies between the EU and Japan from withholding tax. To implement the Agreement, the EU Member States and Japan need to revise relevant bilateral treaties for the avoidance of double taxation in order to lower the relevant withholding tax rates to 0%.

b) *Mutual exemption of controlled foreign corporation (CFC) taxation* – Corporate tax rates are generally decreasing in Europe. In some Member States, with the combination of double avoidance rules and preferential measures, effective rates are already below 25%, which triggers Japan's CFC rules. As Japanese companies are conducting business activities more widely and deeply in the European market, Japanese companies are establishing more holding companies and headquarters in Europe. This trend is expected to increase and Japan's CFC taxation may be applied to regional headquarters serving as holding companies. If Japanese CFC taxation is triggered, Japanese companies, when transferring returns on investment to their European holding companies, will find these earnings subject to unitary taxation in Japan, resulting in a decrease in the amount to be reinvested by the holding companies. This will hinder the promotion of direct investment and eventually decrease the competitiveness both of the economies.

To prevent this, the EU and Japan should agree to mutually exempt investments from controlled foreign corporation (CFC) taxation under the FDI Enhancement Agreement and should revise existing bilateral treaties to provide for this exemption. Each treaty should include a clause designed to prevent the abuse of this exemption.

c) *Expansion of the foreign tax credit system* – Under Japan's foreign tax credit system, foreign tax credits are permitted only to the first and the second tier foreign subsidiaries of Japanese parent companies, and then only on the condition that the parent company has a shareholding of 25% or more in the first or second tier subsidiary.

On the other hand, in the United States, for example, the foreign tax credit system is applied to up to the sixth tier for foreign subsidiaries. Accordingly, if a U.S. company establishes multiple holding companies in Europe, their tier structure would not adversely affect their tax position.

Double taxation caused by a limit in the number of tiers makes it difficult for Japanese companies to develop international business and to compete in international markets.

In addition to the substantial increase of the total number of tiers to which the credit system is applicable, a reduction in minimum shareholding requirements form the present 25% in Japan to around 10%, or even 5% should be agreed under the Framework Agreement, in view of the fact that strategic business alliances will increase in the future. Based on this agreement, the foreign tax credit systems should be revised in the EU Member States and Japan.

2. *Transfer pricing* – Companies still find it costly and complicated to comply with transfer pricing requirements due to divergent national procedures, despite increasing international convergence on this issue, as reflected in such agreements as the OECD transfer pricing guidelines. In Europe, the use of APAs is increasingly being adopted by EU member states, but regulations vary from country to country. In the European Commission communication entitled "Towards an Internal Market without tax obstacles - A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities"(COM (2001) 582), it is recognized that compliance with transfer pricing tax requirements are costly. In Japan, tax authorities continue to make transfer pricing assessments based on secret comparables, which is inconsistent with the transfer pricing methodology of APAs, where company level profitability of public companies is commonly used.

    a) *Extension of the EU Arbitration Convention* – As a last resort for solving serious problems should they arise between the tax authorities of EU Member States and Japan, the current EU Arbitration Convention (Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises) should be revised so that it may be applied to transactions between the EU and Japan. Japan should then accede to the revised Convention.

    b) *Documentation requirements and interpretation* – The interpretation of transfer pricing rules and documentation requirements should be harmonized, simplified and clarified between the EU and Japan, and among the EU member states, through the establishment of EU-Japan transfer pricing "best practice". The EU and Japan should agree to pursue this goal and make aggressive efforts in this regard.

    c) *Expansion of the use of APAs* – The EU and Japan should agree on the introduction of unilateral and bilateral APAs for EU-Japan transactions and should share guidelines on APAs. The EU should urge the EU Member States to make a

commitment towards the harmonization of rules across the EU and should expand the application to transactions between all the Member States and Japan.

Relationship with previous progress reports:

1. *Avoiding double taxation*

   a) *Withholding tax on intra-group dividend, interest and royalty payments* – The recommendation to exempt parent-subsidiary company dividend payments and interest and royalty payments among associated companies within the EU or Japan from withholding tax is a new one and there are no comments directly related to this recommendation in previous progress reports.

   For tax treatment of mergers and dividend payments between parent-subsidiary companies within the EU, the EU's Progress Report states the following: "The Commission intends this year to present the two proposals noted above amending two existing Directives on the tax treatment of mergers and of dividend payments between parent and subsidiary companies, so as to broaden their scope with regard to both the types of companies and the types of transactions covered."

   b) *Mutual exemption of controlled foreign corporation (CFC) taxation* – This is a new recommendation and there are no comments directly related to this recommendation in previous progress reports.

   c) *Expansion of the foreign tax credit system* – This is a new recommendation and there are no comments directly related to this recommendation in previous progress reports.

2. *Transfer pricing*

   a) *Extension of the EU Arbitration Convention* – While this is a new recommendation, Japan's Progress Report states that smooth resolution of taxation problems, if any, have been pursued through mutual discussion based on bilateral tax treaties.

   b) *Documentation requirements and interpretation* – The EU's Progress Report states that the Joint Forum on Transfer Pricing (JFTP) established in July 2002 will result in pragmatic, non-legislative solutions within the framework of the OECD Transfer Pricing Guidelines. Also, the Report emphasizes that the JTPF is not scheduled to address any possible co-operation between the EU and Japan in the field of transfer pricing. Japan's Progress Report states that the Japanese side has been making efforts to promote mutual understanding and cooperation by actively participating in the debates at the Working Party No. 6 of the OECD's Committee on Fiscal Affairs and that further promotion of mutual understanding and cooperation with foreign tax administrations is planned.

Regarding the simplification and standardization of document requirements, the EU's Progress Report states that the issue of documentation requirements will also be addressed at the JFTP meeting, while Japan's Progress Report refers to the engagement in the monitoring of compliance of laws and regulations and their practical implementation in OECD member states with the Transfer Pricing Guidelines set as international guidelines in 1995.

c) *Expansion of the use of APAs* – Regarding the harmonization of rules across the entire EU, the EU's Progress Report states the following "In its October 2001 Communication on company tax "Towards an Internal Market without tax obstacles", the Commission outlined a twofold strategy to tackle transfer pricing problems, notably in the form of high compliance costs and potential double taxation, that companies face when doing business across borders. On the one hand, the Commission intends to encourage Member States to expand Advance Pricing Agreements and, on the other hand, it will seek to favor better co-ordination of policies within the EU, notably through the JFTP."

(3) Facilitating business development: human resource perspectives

Summary of recommendations:

1. An agreement should be reached to speed up work and residence permit acquisition procedures for intra-company transfers between the EU and Japan, to enable transferred personnel to submit applications for permits after entering the destination country, and to grant the same rights to spouses.

2. Under the FDI Enhancement Agreement, a commitment should be made to conclude social security treaties between all the Member States and Japan at the earliest possible date. In addition, ways to expedite the conclusion of such treaties should be studied, including the possible conclusion of a model social security treaty between the EU and Japan.

Background:

1. *Work permits* – It is essential for companies to be able to transfer their human resources in a flexible manner in order to facilitate the rapid develop of business. Under the FDI Enhancement Agreement, the EU and Japanese governments should agree to simplify and speed up the work and residence permit-granting procedures for intra-corporate transferees to enable workers to submit applications for permits after entering the assigned countries, and to grant the same rights to their spouses.

2. *Social security treaties* – To enhance direct investment between the EU and Japan, it is necessary to transfer human resources. However, double payment of pension costs and double taxation caused by differences in the social security systems between the EU Member States and Japan discourage companies in making direct investments.

So far, the United Kingdom and Germany have concluded bilateral social security treaties with Japan and the agreements have been implemented. Presently, France and Belgium are negotiating with Japan to conclude similar agreements. Under the Framework Agreement, the EU and Japanese governments should agree to make strenuous efforts for the prompt conclusion of social security treaties between all the Member States and Japan. Ways to expedite the conclusion of such treaties should be examined, including the possible conclusion of a model social security treaty between the EU and Japan.

Relationship with previous progress reports:

1. *Work permits* – For work and residence permits granted to intra-corporate transferees, the EU's Progress Report states that the draft Directive on the Conditions of Entry and Residence of Third-Country Nationals for the Purpose of Paid Employment and Self-Employed Economic Activities (COM 2001(386)) proposes common criteria, rules and procedures regarding the conditions of employment and economic activities of third-nationals, but that the draft Directive is currently under negotiation in Council and it is not yet possible to give a clear forecast for the adoption of the draft Directive.

   Japan's Progress Report explains that the requirement for the maximum residence period (five years) of intra-corporate transferees was discontinued in January 1998, but the requirement of "one year or longer employment in the head office located in a foreign country" remains. The Report explains that the requirement has been maintained for preventing newly employed workers who have no expertise or knowledge from being transferred to Japan just to secure workforce in the country, and which Japan deems a rational requirement.

2. *Social security treaties* – This recommendation is a new one and there are no related comments in previous progress reports.

   The EU's Progress Report makes the following statement regarding the double payment of pension costs within the EU: "Community provisions in the field of social security, in particular the Regulation (EEC) No. 1408/71 coordinate but do not harmonize national security systems. Therefore, Member States are free to determine the details of their own social security systems, including which benefits shall be provided, the conditions for eligibility and the value of these benefits, as long as they adhere to the basic principle of equality of treatment and non-discrimination as laid down in the Regulation." The Progress Report also states, "The Community provisions referred to above currently apply only to nationals of Member States of the European Union," and describes that a Council Regulation amending Regulation 1408/71 as regard its extension to nationals of third countries, who legally reside and pay social security contributions under the legislation of a Member State was agreed in December 2002. According to the Report, the Regulation will become effective in the spring of 2003.

(4) Facilitating corporate reorganization: legal and tax perspectives

Summary of recommendations:

The FDI Enhancement Agreement should set out a framework for facilitating EU-Japan business reorganizations. Company laws and tax laws should be improved to facilitate cross-border reorganizations involving share exchanges and/or the transfer of assets between the EU and Japan on a tax-neutral basis.

1. The EU Merger Directive should be expanded with regard to the types of companies and the types of transactions covered, including transactions involving Japanese companies. The requirement for firms to hold shares in "shell" companies after reorganization should be abolished in every EU Member State.

2. The Japanese Commercial Code and company laws in the EU member states should be amended to allow for cross-border share exchanges between the EU and Japan. Relevant tax laws should also be amended so that tax may be deferred.

Background:

The EU's Merger Directive (90/434/EEC) permits the deferral of corporate income taxes on unrealized capital gains from the transfer of assets made at the time of certain cross-border business reorganizations. However, some of the Member States require that the shares obtained in exchange of assets be held for a number of years – even dormant "shell" companies that do not conduct business and have no business assets. In these countries, if a "shell" company that has no business assets and does not conduct business is created as a result of exchanging all their business assets with shares, this "shell" company still needs to be maintained only for the purpose of holding the shares obtained at the time of business reorganization.

For companies, this incurs maintenance costs, and additionally, some of the dividends from a European headquarter and its operating subsidiaries that were established at the time of business reorganization in Europe may need to pass through the aforementioned "shell" subsidiary when passed to the Japanese parent company. If the share holding of the shell subsidiary is below the criteria for the withholding tax exemption under the Parent-Subsidiary Directive, withholding tax may be levied on the dividends, which will lead to a further increase in cost.

This also causes problems with Japan's foreign tax credit system. Japan's foreign tax credit system is only applicable to second tier subsidiaries. The extra tier created by the need to maintain a "shell" company prevents Japanese firms from foreign tax credit on repatriated dividends.

For the FDI Enhancement Agreement, in consideration of these issues, the timely and smooth business reorganization of Japanese companies within the EU, intermediate holding companies generated in the process of reorganization should be exempted from the

requirement of the minimum shareholding period on condition that the Japanese parent companies hold the shares of their European headquarters after reorganization.

In case of cross-border mergers, shares in the acquiring company may be issued to the shareholders of the acquired company in exchanged with the shares in the acquired company. In this case, the shareholders may suffer taxes on the unrealized capital gains. To facilitate flexible mergers, company and tax laws should be improved to enable cross-border share transfers on a tax-neutral basis.

In Japan, Japanese commercial and tax laws have undergone sweeping changes over the past five years allowing for a much wider range of corporate reorganizations on a tax-neutral basis then was previously allowed. Unfortunately, many of these reforms do not apply to cross-border reorganizations. For example, cross-border share for share exchanges are not possible under the Japanese Commercial Code.

Relationship with previous progress reports:

Regarding the Merger and Parent-Subsidiary Directives, the EU's Progress Reports states the following: "The Commission services are not satisfied with the current scope and the practical implementation of the Merger Directive (90/434/EEC). In line with its commitment in its Communication on company taxation "Towards an Internal Market without tax obstacles" (COM (2001) 582), the Commission intends to broaden the scope of the Merger Directive with regard to the types of companies and the types of transactions covered. Technical consultations with Member States with a view to amending the Directive commenced in 2002. The Commission intends to present its proposal for amendments to the Directive in summer 2003." There is no reference, however, to the holding of "shell" shares as described above.

Japan's Progress Report points out that it is necessary to carefully review the proposed measures for cross-border business reorganization and for share exchange to ensure proper and fair taxation and to prevent tax evasion.

An interim measure allowing for a so-called "triangular merger" between Japanese and foreign firms has recently been introduced into Japan's corporate revitalization laws, though no tax-deferral mechanisms have been made available to these types of reorganizations.

(5) Facilitating new business development through regulatory reform

Summary of recommendations:

Direct investment should be enhanced by revising regulations concerning market access, including regulations on the transfer of assets, services and intellectual property and regulations on capital, as well as by establishing an open business environment that does not place new market entrants at a competitive disadvantage. The FDI Enhancement Agreement should include:

1. An acknowledgement of the negative affect that regulatory barriers have on foreign investment and should contain further commitments from both the EU and Japan to the creation of competitive internal markets through regulatory reform.

2. A commitment between EU and Japanese regulatory authorities to cooperate on creating an open regulatory environment for trade and investment.

3. A commitment that the authorities of the EU and Japan will work to eliminate unreasonable product and service approval procedures.

Relationship with previous progress reports:

The EU's Progress Report states the following: "Since the last progress report, the Commission has come forward with a number of initiatives in the field of "better regulation". They follow up on the Lisbon European Council conclusions of March 2000 on simplifying the regulatory environment as well as the action points set out in the White Paper on European Governance of July 2001. First of all, a Better Regulation Package was adopted in June 2002, including an Action Plan setting out a number of measures to be taken to simplify and improve the regulatory environment." The Report also states, "The Commission prepares a comprehensive new medium-term (2003-2006) Strategy for the Internal Market intended to tackle the remaining gaps and weaknesses, which undermine the Internal Market's effectiveness," and mentions that on the basis of the results of the report on the state of the Internal Market in services (July 2002), the Commission is preparing a new strategy.

Japan's Progress Report states that measures have been taken to ensure and improve transparency and fairness regarding regulations, based on the Administrative Procedure Law, the Freedom of Information Law, and on the Public Comment Procedure as well as on the advance confirmation procedure for the application of laws and regulations implemented by administrative bodies, as described in the Three-year Regulatory Reform Promotion Plan (revised). For the international harmonization of the product approval criteria, the Report also states that multiple reforms are being promoted based on the Plan.

RECOMMENDATIONS TO THE EU

1-E-1 EU policy on taxation and company reorganization

(Japan-side recommendation)

Summary of recommendations:

1. It is necessary to speedily construct a foundation for a common consolidated corporate tax base within the EU based on uniform tax accounting rules. In its application, the distinctions between the types of companies, such as EU-listed companies in EU, unlisted public companies, or private companies, should not be made.

2. As for the Merger Directive, tax deferral of unrealized gains on cross-border goodwill transfer between group companies should be allowed. Tax deferral on real property transactions and transfer of other intangible assets should also be allowed.

3. We support the Report presented by the High Level Group of Company Law Experts (November 2002), which calls for prioritizing a Tenth Company Law Directive, aimed at building a "legal framework for cross-border mergers", and its early implementation.

4. We welcome the political agreement (January 2003) on the adoption of the directive aimed at exempting withholding taxation on payments of interests and royalties between affiliated companies, and expect an early adoption and implementation.

5. We hope a timely adoption of the directive, which allows offsetting the losses of subsidiaries/branches against the profits of the parent company.

Background:

A number of Japanese companies are working on the integration of their business operations in Europe. One typical example is the organizational change in line with the ongoing EU market integration – including consolidations of specific business functions, such as sales or accounting functions, into one location in the EU.

1. The relation between transactions within group companies and the amounts of corporate taxes is an important factor in business decision-making. For this reason, multinational companies have a high hope that they should be able to file consolidated tax returns based on a single set of tax accounting rules within the EU.

   At present, corporate tax systems are not harmonized across the Member States. For example, when a company has the headquarters in country A, a branch in country B, and a subsidiary in country C, each organization is treated as an independent entity in the respective jurisdiction where each resides. Accordingly, they must compute each taxable income based on the corporate tax system of the country where each resides. There are limited possibilities for businesses to offset profits and losses between group companies.

   Due to different tax regimes within the EU, businesses face three problems: the cost of complying with tax regimes of multiple countries, the cost of complying with transfer

pricing regulations, and the larger taxable income due to the inability to file consolidated tax returns.

(Note) The cost to comply with the transfer pricing regulations means a cost to prove that transaction prices between the head office in country A and a branch in country B, for example, are the prices charged between independent companies and that pricing is not arranged in a way so that profits will arbitrarily accumulate in one of either entities.

The European Parliament/European Council Regulation (Regulation/EC/1606/2002) mandates companies listed within the EU to prepare consolidated financial statements in accordance with the International Accounting Standards (IAS) starting from 2005. Taking this opportunity, the European Commission has floated the idea that the financial statements prepared according to IAS could be used as the starting point of a common consolidated corporate tax base. In March 2003, the European Commission published a consultation document 'The application of International Accounting Standards (IAS) in 2005 and the implication for the introduction of a consolidated tax base for companies' EU-wide activities' and asked for comments from interested parties.

In Regulation/EC/1606/2002, it is left to each Member State whether it allows to adopt IAS for the purposes of unconsolidated accounts or accounts of unlisted companies. In view of guaranteeing fair competition, however, the election of a common corporate tax base should also be extended to unlisted public and private companies, not limited only to listed companies.

2. The cross-border transfer of goodwill is inevitable, when a company undertakes a cross-border reorganization, particularly, of sales functions. Under the current EU Merger Directive, taxation on goodwill transfer cannot be deferred. As a result, businesses cannot enjoy the benefit of a single market within the EU, and some businesses have actually decided not to go through the reorganization.

   The Annex to the European Commission Communication "Towards an Internal Market without tax obstacles: A strategy to provide a consolidated tax base for EU-wide business operations COM(2001)582" recognized the problem that the Merger Directive does not allow deferral of unrealized profits on goodwill transfer. It further referred to a proposal to allow deferral by leaving the right of taxation to the Member State from which the goodwill is to be transferred.

   The European Commission should recognize the benefits of comprehensive corporate reorganizations aligned to the single market, and thus, revise the Merger Directive to significantly widen the scope of tax deferral to include not only the above-mentioned goodwill but also real property transfer tax and unrealized gains in the transfer of other intangible assets, which often arise upon corporate reorganizations.

   "A shell company" is an entity, which does not possess any business assets as a result of its assets transfer in exchange for shares and does not engage in any active business

operations. Currently, when a “shell company” is created as a result of corporate reorganization, some of the Member States require minimum share holding periods as conditions for allowing tax deferral. These requirements should be abolished immediately.

3. Although the measures have been taken on the taxation regime for corporate reorganizations with the adoption of the Merger Directive in 1990 (Council Directive 90/434/EEC), a legal framework for cross-border reorganization is still not in place. At present, only the introduction of Statute for a European Company (Council Regulation EC/2157/2001) aimed for the establishment of the SE, has been decided starting from October 2004. Thus, the current situation is such that technically, smooth cross-border reorganizations within the EU are not necessarily achievable.

   In 1985, the Tenth Company Law Directive aimed at building a framework for cross-border mergers of public companies on the company law front was proposed. This proposed Directive, however, was withdrawn in December 2001, because of a fresh draft Directive underway.

   We support the recommendations set out in the final report issued by the High-Level Group of Company Law Experts issued in November 2002. We call for an early adoption and implementation a Tenth Company Law Directive and a Fourteenth Company Law Directive, which deals with cross-border transfer of the registered office, with some revisions such as inclusion of private companies.

4. Although the dividend payments between parent companies and subsidiaries within the EU are exempt from withholding tax, interest or royalty payments are currently not exempted from withholding tax. Thus, when a subsidiary pays interest or royalties to its parent company, withholding tax is imposed on the amount paid.

   The ECOFIN Council in January 2003 reached a political agreement for the adoption of a tax package which consists of: a draft Council Directive to abolish withholding tax on interest and royalty payments made between parent companies and their 25% subsidiaries in different EU Member States; a draft Council Directive to harmonize tax on savings; and a code of conduct to eliminate harmful competition on corporate tax.

   We welcome a political agreement on the adoption of the draft Directive to abolish withholding tax on interest and royalty payments and call for its early adoption and implementation.

5. A Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States was proposed in 1990. However, in December 2001, the European Commission withdrew this proposal citing that the Member States had expressed strong reservations to the introduction of this EU policy.

The offset of losses of permanent establishments and subsidiaries against the profits of parent companies is one of the important benefits of the Single Market for businesses operating in the EU. Therefore, the European Commission and the Member States should take prompt action and speedily realize the offset of losses and profits.

Relationship with previous progress reports:

1. The European Commission referred that it had "initiated a wide-ranging discussions on the further comprehensive measures to remove obstacles from tax regimes including the issue of consolidated tax base". As for the future prospect, it stated, "it is too early to indicate the prospect on the possible implementation of consolidated tax base and the Commission plans to announce the outcome of its policy around October 2003."

2. The European Commission commented on the Merger Directive and the Directives that deal with groups of companies as follows:
   "The European Commission is not satisfied with the existing Merger Directive or the Directives on groups of companies in terms their scope of application or specific operations, and thus intends to expand their applications to more various types of companies and transactions. We have initiated technical consultations with the Member States in 2002 with a view to submitting a revised proposal in the summer of 2003. "

3. See (2) above

4. See (2) above

5. The European Commission referred to its future prospect as "After the withdrawal of the draft Directive, we intend to start discussions with the Member States on the technical possibility and plan to announce our intention on the legal framework in this area in 2004."

1-E-2 Smooth movement of workers in the EU

(Japan-side recommendations)

Summary of recommendations:

1. Elimination of double taxation on contributions and payout of occupational pensions

2. We welcome a political agreement (December 2002) on the draft Council Regulation to extend the totalization of basic pensions to non-EU nationals when they move across the EU countries and expect its early implementation.

Background:

As Japanese companies have been increasingly engaging in reorganizations within Europe, growing needs have arisen for them to move their employees, particularly key employees,

across borders. The delay in the co-ordination of social security systems in the area of occupational pensions (equivalent of “Kosei Nenkin”, the employee pension in Japan) has been an obstacle for business operations from the viewpoint of possible double taxation and smooth cross-border movement of workers.

1. As businesses expand their operations within the EU, a growing number of workers will have to move across the borders. In such cases, the continuation of occupational pensions and the prevention of double taxation on pension contributions will become important and influential issues not only in terms of costs but also for securing personnel. For example, when a worker intends to adhere to his/her existing occupational pension even after moving to another Member Nation, his/her contributions may become taxable income in the country where he/she is to move into, because there is no EU-wide agreement to mutually recognize qualified pension plans of other Member States. This gives rise to a double taxation problem since the future payout is also subject to income tax.

   A proposal for a directive on the activities of institutions for occupational pension, which will enable the creation of an EU-wide pension fund, is at an advanced stage of the legislative process. We call for early solutions to the disadvantages on the social security system including the treatment of occupational pensions when employees move across the borders within EU, as well as the issue of double taxation.

2. The Council Regulation (1408/71) determines the treatment of basic pension when people move between Member States. This regulation is only applicable to those who have the nationality of a Member State or refugees, and their families. Japanese nationals, even if they live in a Member State and contribute to its social security, cannot benefit form this regulation and are put in a disadvantageous situation – because of non-application of totalization of pension rights etc. – if they move between Member States.

   In December 2002, the Social Affairs Council reached a political agreement on the proposal for a Council Regulation aimed at extending the provisions of Regulation 1408/71 to third-country nationals (COM 97/561). We welcome this political agreement and expect early implementation of this Regulation.

Relationship with previous progress reports:

The European Commission stated, “Community provisions in the field of social security, in particular Regulation (EEC) 1408/71, co-ordinate but do not harmonise national security systems. Therefore, Member States are free to determine details of their own social security systems, including which benefits shall be provided, the conditions for eligibility and the value of these benefits, as long as they adhere to the basic principle of equality of treatment and non-discrimination as laid down in the Regulation.” Further it states, “The above EU regulation currently applies only to nationals of Member States of the European Union. An agreement however has been reached in December 2002 on the Council Regulation amending Regulation 1408/71 extending the benefit to nationals of third countries, who legally reside

and pay social security contributions under the legislation of a Member State. This indicates that the enactment of the amended Regulation is to take effect around the spring of 2003.

1-E-3 Speedy decision making of the EU after its enlargement

(Japan-side recommendations)

Summary of recommendations:

1. We hope the realization of the EU's institutional reforms that will enable speedier decision-making, particularly, the abolishment of unanimity requirements in the legislation of taxation policy.

2. In the process of the enlargement of the EU, we call for sufficient preparations, publication of roadmaps, timetables or progress, etc. for the smooth transition of customs duties and value-added taxes in the new Member States.

Background:

Taxation is one of the most important areas where speedy development is required for the smooth business operations in the EU. For this reason, we would like to see speedier decision-making in the taxation policy of the EU.

During the transition period of the new Member States accretions, it is also necessary to have sufficient transition measures and clear timetables regarding important trade environment issues, such as custom duties and bilateral preferential treatments.

1. At present, unanimity by all the Member States is required on decisions concerning taxation in the EU Council. As a result, it takes a considerably long time to form a consensus among the Member States, delaying the integration process. There is a concern that timely policy responses to deal with the fast changing economic situations will become even more difficult with the current decision making process within the EU as it expands in the future.

   The Convention on the Future of Europe is currently under progress. We consider that it is necessary to abolish the unanimity requirement for the legislation of tax policy. We would also like to see the realization of reforms in other areas that will enable the EU to speed up its decision-making and to reinforce the Single Market after enlargement.

2. There is a concern that the trading environment may regress including the areas of custom duties and bilateral preferential treatments during the period leading up to and following the next EU enlargement in May 2004. A possible confusion in operations during the transitional period is also another concern.

We call for sufficient preparatory works, publication of the roadmaps, timetables or progress, etc. for smooth system transfers of custom duties and value-added taxes particularly in the new Member States at the scheduled next EU expansion.

Relationship with previous progress reports:

There are no comments in the Progress Report as (1) and (2) are both new proposals.

1-E-4 Reasonable Settlement of Tariff Classification

(Japan-side recommendation)

Summary of recommendations:

1. Tariff classification based on ITA agreement should be applied to IT products designed utilizing digital or network technology. Especially, reconsideration should be made for products with multifunctional capabilities by IT technology, since unreasonably classified cases are observed.

2. We do recommend that multifunctional products based on IT technology be classified under the ITA products in tariff classification through reasonable discussions at the WCO conference to be held in the coming fall.

Background:

1. Progress in technology has brought about various issues in conjunction with tariff classification. Especially, IT products which have been expanding taking advantage of computing or digital technology are facing the classification problems.

2. The Information Technology Agreement with the purpose to eliminate tariffs on IT products enables consumers to enjoy digital economy through minimum investment in IT. On the other hand, certain products with multifunctional capabilities based on digital technology have been left outside of ITA coverage. For example, digital multifunctional products which have all functions of printer, scanner and facsimile, each of which has been recognized as ITA product, are not judged as covered by ITA by some countries including EU, even though such sophisticated multifunctional capabilities cannot be realized without IT technology. Such judgment is not in line with the spirit of ITA.

3. High tariff prevents innovative products from being introduced into the market at competitive prices, and consequently, obliges consumers to bear high cost, which would affect improvement of their lives.

Relationship with previous progress reports:

A recommendation on tariff classification for digital products was made under WP1 in July, 2001, to which a progress report by EU government was provided, explaining that it would

reconsider the issue in the process of HS2007. Although we no doubt desire that ITA products be reasonably classified in the process of HS2007 rework, our recommendation on this paper is regarding the HSC at WCO to be held this coming fall.

1-E-5 Proposed European Commission regulation on chemicals control

(Japan-side recommendation)

Summary of recommendations:

1. We support the objective of the regulation to protect human health and environment

2. The proposed Commission regulation on chemicals control should focus on risk assessment and risk control of chemicals base on scientific proof, and should be feasible with high cost-performance ratio.

3. Also, its consistency with the obligations under the TBT agreement and other WTO agreements should be fully taken into account.

4. We will comment on specific issues under the proposal during the public comments process, which started recently. We expect a careful consideration of our comments to finalize the proposal.

Background:

At present, the European Commission is considering a complete revision of the current regulation system on chemicals control and consolidates them into a unified European Commission Regulation.

Japanese industries support the objective of the regulation to protect human health and environment. While the draft regulation is not yet announced, the White Paper on Strategy for a future Chemicals Policy, the already-announced gist of proposals suggests that the regulation contain unprecedented details. They include mandatory registration of exhaustive data on the extensive number of chemicals by manufacturers and importers as well as data on the chemical substances used in products (such as automobiles, electric or electronics products) by manufacturers. In addition, the final products or components manufactured outside the EU may also be required to comply with the regulation as to the chemical substances used in their products.

As this regulation is expected to have a major impact not only on the EU economy but also on global trade, the European countries as well as the industries and governments of Japan and the United State have expressed concerns. The Japan Chemical Industry Association, representing Japanese industry, has expressed its opinion to the European Commission. The JBCE, a Japanese business organization in Europe, has submitted a position paper to suggest exclusion of products that use chemical substances from its application. The Japanese

government has also been expressing its concerns on multiple occasions, including at the Japan-EU Regulatory Reform Dialogue in December 2002.

Relationship with previous progress reports:

There is no direct mention in the Progress Report as this issue is a new proposal.

As for the improvements up to present, a comprehensive regulatory improvement policy was adopted in June 2002 and the progress on its action plans has been summarized. They are the follow-up measures to the conclusion of the Lisbon EU Council Meeting on regulatory simplification in March 2000 and the White Paper on European Governance in July 2001. At the same time, the EU is preparing a comprehensive mid-term strategy (2003 – 2006) to mitigate the existing gaps, etc. which are harming the effectiveness of the Internal Market. It is also preparing a new strategy based on a report on the current state of Internal Service Market (July 2002), etc.

1-E-6 Community patent

(Japan-side recommendation)

Summary of recommendations:

1. We welcome an agreement of the Member States (March 2003) to adopt the regulation on the Community patent and expect its early adoption and implementation.

Background:

1. A unified European system, which co-exists with the traditional ones at the national level, has been established with the Community trademark and Community designs.

   While the procedures from patent application to the granting have already been integrated under the European Patent System, the protection of patent rights is still under the jurisdiction of each Member State. Thus, no European-wide patent system in a true sense has been put in place, leaving patent protection matters, such as disputes over patent rights, under the jurisdiction of each Member State. In March 2003, the Council finally agreed upon the adoption of a regulation to establish a unified patent system (Community Patent), which will co-exist with national systems of patent protection, after a long co-ordination among the Member States.

   This draft Regulation includes a unified rule, which extends to patent protection against infringements, for example, establishment of a patent department within the European Court of Justice.

   We welcome the agreement on its adoption and call on early implementation of the Community patent since patent system since it will be effective in reducing application and renewal costs for businesses.

Relationship with previous progress reports:

There is no direct comment on this matter in the Progress Report since this is a new proposal.

As for business model patents, there is a comment that, “The current practice of the European Patent Office is that patents cannot be granted for business methods as such and the Commission decided that this basic situation should not be changed”

RECOMMENDATIONS TO JAPAN

1-J-1 Promoting economic growth

(Europe-side recommendation)

Summary of recommendations:

1. More effective use of monetary and fiscal policy should be made to combat price and asset deflation

2. More efforts should be made to re-capitalize the banking system and clean-up the bad loan situation

3. Public spending should be redirected into more productive areas of the economy

Background:

The current economic situation discourages investors from investing in Japan. Concerns include:

- Price and asset deflation (Stock markets are at their lowest levels in more than 20 years)
- High levels of government debt (highest in the G8 as a percentage of GDP)
- High levels of non-performing loans in the financial sector
- Slow pace of structural reforms

Rightly or wrongly, other economies in the region are seen as being more “dynamic” than Japan in attracting foreign investment.

We appreciate ongoing efforts by the Japanese Government to deal with these problems, such as the recent establishment of the Industrial Revitalization Corporation and increased pressure on the banking sector to clean up their balance sheets, and we encourage more efforts in this direction.

1-J-2 Championing business activity at the local level

(Europe-side recommendation)

Summary of recommendations:

1. More private sector involvement in the delivery of public services should be encouraged through the use of PFI/PPP schemes

2. Local governments should take a more proactive role in attracting investment beyond current promotion efforts; for example, by offering special tax and/or regulatory incentives to potential investors

Background:

European investors have been impressed by the increasingly positive attitude exhibited by the leaders of prefectures and localities towards FDI. There is a sense, however, that the local bureaucracy does not share this attitude.

Local investment promotion activities continue to focus almost exclusively on advertising (especially of government-affiliated industrial parks) and very few efforts are being made to "champion" new investment by offering business incentives such as breaks on tax or regulatory requirements.

The Government of Japan could also create a powerful new incentive for investment in Japan by further promoting the use of Private Finance Initiatives (PFI) and Public Private Partnerships (PPP). While the use of PFI is starting to gain more and more attention in Japan, the use of such tools to develop local infrastructure and deliver public services is still in its infancy.

1-J-3 Cross border stock-swaps (and related tax implications)

(Europe-side recommendation)

Summary of recommendations:

1. Reforms to corporate revitalization laws allowing for "triangular mergers" between Japanese and foreign corporations should be implemented as soon as possible.

2. Relevant tax laws should be amended to allow for the deferral of taxation on capital gains and related asset transfers as a result of share-exchanges that take advantage of this new "triangular merger" tool.

3. These reforms should be adopted into the Japanese Commercial Code (and relevant tax laws) in the next round of Commercial Code revisions.

Background:

Cross-border share-for-share transfers are not allowed under the Japanese Commercial Code. As an interim measure designed to promote increased foreign investment through M&A activity, Japanese corporate revitalization laws were amended recently to allow for a type of "triangular merger" share-exchange involving foreign corporations. Corporate reorganizations involving foreign firms that utilize this new tool will require permission from the Japanese Government and will not be able to make use of capital-gains deferral options currently available to wholly domestic reorganizations.

While we welcome revisions to corporate revitalization laws introducing "triangular merger" reorganizations in Japan and appreciate the positive shift in attitude within the Japanese Government towards M&A activity involving foreign firms that formed the basis for these reforms, we are disappointed that investors will not be able defer taxation of capital gains (or the transfer of assets) as in wholly domestic reorganizations.

1-J-4 Legal services

(Europe-side recommendation)

Summary of recommendations:

1. Legislation before the Diet allowing Japanese and foreign lawyers to form partnerships and allowing foreign lawyers to employ Japanese lawyers as associates should be implemented as soon as possible.

2. Follow-on legislation should allow foreign lawyers to incorporate their law offices in the same way as Japanese lawyers are currently allowed to do.

Background:

Legislation currently before the Diet removes prohibitions against foreign lawyers and Japanese lawyers forming partnerships and from foreign lawyers being able to employ Japanese lawyers as associates. The legislation is expected to pass the Diet in June. If implemented, these changes would drastically alter the way the foreign legal profession is organized in Japan.

We applaud the Japanese Government, in particular the Judicial Reform Promotion Headquarters and the Study Group on Internationalization, for their recent efforts to establish a truly international legal services sector in Japan.

The new legislation appears to satisfy calls for complete freedom of association and, to a lesser extent, equal treatment between Japanese and foreign lawyers, which has inhibited the development of the international legal services sector in Japan ever since the Foreign Lawyers Law went into effect in 1987.

1-J-5 Regulatory transparency

(Europe-side recommendation)

Summary of recommendations:

1. Japanese regulators should take a pro-active stance in promoting regulatory transparency and clarity. Requests for clarification (including requests for clarification outside of the "no-action letter system" should be dealt with swiftly and the findings quickly made public.

2. The current "No-Action Letter" system should be strengthened to make it legally binding and more widely used by regulators in Japan.

3. As a *matter of standard practice*, all requests for clarification (including request for clarification received outside of the "no-action letter system") should be answered *in writing*.

4. The scope of reform should be expanded for tax-related issues to include not only requests for clarification, but also explicit prior-clearance for specific transactions, including corporate restructuring.

5. Further consistency is requested from the National Tax Administration in the application of relevant tax laws.

Background:

It is difficult to receive binding, written clarification from authorities in Japan concerning issues of regulatory concern. A lack of transparency creates uncertainty, and this makes business planning difficult. This is one of the factors most frequently cited by European businesses as inhibiting the development of a truly open environment for trade and investment in Japan.

The GOJ implicitly acknowledged this problem with the introduction of the Japanese "No-Action Letter" system in March 2001. The "No-Action Letter" system was a welcome development, but has suffered from the following constraints: a) replies are not considered legally binding, b) oral replies are in some cases still allowed, c) the ministries have not actively encouraged its use, and d) as a result very few no-action letters have actually been issued.

More disturbing, however, is the general attitude of the regulatory authorities towards transparency and clarity in their respective regulatory jurisdictions. Regulators should be proactively seeking out areas that need clarification, and this is still not happening. Many firms continue to report receiving replies from regulators (especially concerning financial services and taxation) to the effect of "just try it and see what happens". This is unacceptable.

As a matter of standard practice, regulators should reply in writing to all requests for clarification from private firms, be it within the framework of the Japanese no-action letter system, or not. Despite numerous policy initiatives designed to eliminate the practice, oral replies remain the norm in Japan.

This has created somewhat of a double standard, especially in the financial services sector: on the one hand, the regulator requires firms to maintain a clear written relationship with their clients (in the interest of consumer protection), while on the other, they do not afford this same courtesy to the firms that they regulate.

1-J-6 Telecommunications

(Europe-side recommendation)

Summary of recommendations:

1. Interconnection charges should be lowered immediately to acceptable international benchmark levels

2. The new Telecommunications Business Law (TBL) and subsequent ministerial ordinances should contain the following:
   a) An internationally accepted methodology for competition analysis and review (the dominance of NTT companies should not be restricted to only where they have bottleneck facilities)
   b) Stronger regulatory accounting and information disclosure requirements on the NTT Group, and more investigative powers to the industry's prime regulator (the Home Affairs Ministry), as well as a legal requirement for the regulator to publish the results of its investigations
   c) Stronger "ring-fencing" rules to prevent NTT from leveraging its dominance in the local loop into new business areas
   d) An effective methodology to regulate all dominant carrier tariffs (similar in substance to OFTEL's "Stack Test")
   e) No tariff-filing requirements for non-dominant carriers, even for those designated as providing "universal services" (such as local call services) under the new law
   f) Establishment of a formal appeals mechanism on regulator decisions
   g) A requirement for the Home Affairs Ministry to publish an annual management plan to give consumers groups and industry advance notice of consultation on issues that may affect them
   h) A requirement that the Home Affairs Ministry issue consultation documents setting out preliminary proposals on particular issues to draw in the views of the industry and the public
   i) A requirement that the Home Affairs Ministry allow a minimum of 6 weeks for public consultations

3. In the long-term, an independent regulator with a pro-competitive mandate should be established to supervise the telecommunications sector in Japan

Background:

1. *Interconnection* – Current Japanese fixed line interconnection prices are unacceptably high by world standards. This distorts competition, keeps end-user prices artificially high, and imposes a substantial revenue drain on competitors. This situation is likely to deteriorate further under a new Long Run Incremental Cost (LRIC) model being developed by MPHPT. Under current proposals, local interconnection will *decrease* by 3% (to 4.37 yen per 3 minutes), but single tandem interconnection will *increase* by 12% (to 5.37 yen per 3 minutes), resulting in an overall *increase* in interconnection costs –

with the extent of the increase determined by a particular operator's ratio of local and tandem interconnection.

This is a perverse result given that:

- The use of a proper LRIC model should produce substantial price decreases – because the LRIC model should be constructed based on an efficient network without the legacies embedded in NTT's existing network and, consequently, the existing interconnection prices;
- It will force competing operators to absorb the price increase, reducing already slim margins, or pass them on to consumers in the form of higher retail prices and incoming settlement rates for international traffic, undermining their competitive position in the current deflationary environment. This creates the misleading impression that competition is resulting in increased prices when, in fact, price increases are due to the inappropriate calculation of interconnection charges; and
- It will force operators to incur the additional costs of rolling out infrastructure to interconnect at the local level in order to obtain the benefit of the lower price – even though single tandem (ZC) interconnection may be more efficient. Such expense is not viable in the current environment and will result in a wasteful duplication of facilities.

Interconnection benchmarking performed by European operators demonstrates that the revised charges are up to 50% above comparable rates, even allowing for local factors in Japan such as higher construction costs affecting the interconnection price.

These unjustifiably high prices result from a number of defects in the revised LRIC model. The key defects are:

- Reliance on the incumbent's existing inefficient network and costs – rather than those of a forward-looking efficient operator;
- Failure to optimize all elements of the model (including using lowest cost technology and dimensioning the model to process traffic volumes in the most efficient manner) – contrary to the principle of forward-looking efficiency;
- Failure to share common network costs over the expanding demand for broadband access, whilst instead loading these costs fully onto a declining volume of voice traffic; and
- Failure to exclude non-traffic sensitive (NTS) costs – contrary to the principle of cost causality and the accepted practice of other regulators.

Although all of these defects have a cumulative impact on price, the failure to exclude NTS costs has the single greatest impact, almost doubling the cost of interconnection. Exclusion of NTS costs would, in the MPHPT's own calculation, lower prices to within acceptable levels.

2. *Revisions to the TBL* – Legislation revising the Telecommunications Business Law (TBL) has been submitted to the Diet, which include provisions abolishing the distinction

between Type 1 and Type 2 carriers, the permission system for entry and exit, tariff regulations for non-dominant carriers, and ex-ante regulations with regard to interconnection, while at the same time maintaining asymmetrical regulations for dominant carriers.

It appears that changes to the TBL will likely result in considerable relaxation of regulatory requirements for all telecommunications firms in Japan. While competitors to the NTT Group are likely to welcome a reduction in the regulatory burden associated with doing business in the Japanese market, we are very concerned that the new laws and follow-on ordinances will not do enough to regulate the market power enjoyed by dominant carriers. These concerns include:

- How the regulator will ensure that the NTT Group does not abuse its market power without the maintenance of ex-ante provisions;
- How the regulator will ensure that the NTT Group does not abuse its market position without refocusing the definition of dominance on market power from the present notion of control over bottleneck facilities;
- How the regulator will ensure that the NTT Group does not use its market power to unfairly cross-subsidize different product lines without strengthening accounting transparency within the group;
- How competitors will be able to make a case of anti-competitive behavior in the new “ex-post” regime without help from the Government to force disclosure of materials relevant to suspected anti-competitive practices; and
- How new businesses areas will be regulated with respect to players with market power.

3. *Independent regulator* – Japan is unique amongst industrialized countries in that there is no stand-alone independent telecommunications regulator. The MPHPT is responsible for setting telecommunications policy (including promoting the industry), as well as regulating its implementation (including ensuring fair competition). Independent telecommunications regulators have been established in most other industrialized countries, including in countries throughout Asia, in order to:

   - Remove the perception and incentive for conflict of interest between any Government ownership of an incumbent operator, and its role as the regulator;
   - Insulate telecommunications from any political forces;
   - Increase the perceived levels of neutrality in a regulator and thereby establishing an expectation of impartial treatment of all operators; and
   - Improve market confidence, thereby encouraging investment and the entry of new operators into the market.

   We continue to be disappointed that the GOJ does not recognize the value of regulatory independence as an effective means with which to promote fairness, neutrality and competitive principles in the telecommunications sector. European experience clearly shows that independence has contributed to increased competition, market access opportunities for non-incumbent firms, and ultimately a better deal for consumers.

Regulatory independence would also make it easier to hire specialist staff (such as economists and anti-trust lawyers), which in turn would improve the quality of regulation.

1-J-7 Universal Banking

(Europe-side recommendation)

Summary of recommendations:

1. The Japanese Government should, in full respect of the spirit of the financial Big Bang, continue to work towards liberalizing all of the artificially barriers ("firewalls") separating banking, securities, asset management and insurance industries. It can do so while ensuring an appropriate product regulation and approval framework, protection of client information, and renewed emphasis on fiduciary duties of financial intermediaries.

2. Article 65 of the Banking Law, which prevents banking firms from conducting securities business and vice versa, should be abolished.

Background:

Firewall regulations artificially prevent an integrated financial industry in Japan. These barriers have been particularly detrimental to European financial services firms, as most are part of universal banking groups. Article 65 of the Securities and Exchange Law, for example, forbids banks from conducting securities business and vice versa. Not only are these barriers are out of step with the rest of the world, but they are also detrimental to Japanese consumers and institutions who pay for this artificial division through an increase in product cost and decrease in product choice and innovation.

The Financial Services Agency recently eased regulations on space sharing between banks and brokers for retail customers. This has created a situation where the firewalls in Japan between the banking and securities industries are in fact stronger for wholesale than for retail operations, which defies the original purpose of Article 65 – to protect individual investors.

"Double-hatting" of specified back-office operations have been allowed since 2001. While this was a welcome development, the underlying divisions remain.

1-J-8 Food additives

(Europe-side recommendation)

Summary of recommendations:

1. The 46 food additives submitted by the Ministry of Health Labor and Welfare (MHLW) to the Food and Sanitation Council on December 19th, 2002 should be reviewed and approved for use in Japan by the end of 2003.

Background:

Over 600 food additives in common use in Europe and around the world and recognized as being safe by international food safety bodies such as the Joint FAO/WHO Expert Committee on Food Additives (JECFA) are not allowed in Japan. This remains a major barrier to the import of food into Japan.

The GOJ recently changed its policy towards the approval of food additives in Japan, for the first time approving substances accepted by JECFA and in wide use in other parts of the world without waiting for companies to apply for approval. Ferro-cyanide (an anti-caking agent) was approved for use in salt in July 2002, and the Ministry submitted a list of 46 other candidates to the Food and Sanitation Council on December 19th, 2002 for priority review.

We welcome the GOJ decision to take a more proactive stance regarding the use of food additives in Japan. Having said this, we feel that the GOJ has not done enough to ensure complete and immediate compliance with accepted international standards. Many additives that been approved by JEFCA and are commonly used in Europe have not been included on the MHLW's priority list for review.

We are also concerned that the review process for the additives that did make it onto the MHLW's priority list will not be conducted in an expedient manner. It is our understanding that items will be reviewed one at a time, or at best in itemized "groups" (such as the polysorbate group – the first set of substances being reviewed). Each review expected to take at minimum 6 months to complete, which is much too slow.

1-J-9 Insurance

(Europe-side recommendation)

Summary of recommendations:

1. All requirements for prior product approval and pricing involvement by the FSA should be abolished in favor of a regulatory regime that focuses on macro-level supervision of solvency ratios, capital adequacy and modern accounting practices.

Background:

The Government of Japan's long term goal, as stated in its regulatory reform program, is to continue moving away from micro supervision of policies and pricing to macro-level supervision of solvency ratios, capital adequacy, and appropriate accounting practices.

The product approval process, especially for non-life products, is gradually being liberalized and the notification system has now been expanded to cover most commercial products. The Financial Council continues to debate the introduction of a "file-and-use" system for certain

non-life commercial product lines. A notification-in-principle system for personal lines is being studied, but the GOJ remains concerned about preserving consumer safety.

In general, we welcome the efforts the GOJ has made to deregulate the product approval process in the insurance sector over the past five years. The situation has improved remarkably, and the GOJ should be applauded for its efforts. We also welcome the Financial Council's on-going initiative to introduce a "file and use" system for commercial non-life products.

Having said this, there is really no need for the regulator to be involved at all in the approval of new products, as this only serves to stifle the introduction of innovative insurance products at competitive prices. Regulation should focus instead on the macro-level supervision of solvency margins and capital adequacy ratio in line with international best practice.

Companies also continue to report delays in the product approval process due to a lack of resources available to the regulator to process applications in an efficient manner.

1-J-10 In-vitro diagnostics

(Europe-side recommendation)

Summary of recommendations:

1. Reforms to regulations governing the approval of in-vitro diagnostic (IVDs) products in Japan initiated in August 2002 with changes to the Pharmaceutical Affairs Law (PAL) establishing a risk-classification mechanism should be completely compatible with international practice and result in meaningful deregulation of the product approval process.

2. Any new regulations governing quality systems should also be based on global standards.

Background:

Unlike in the US or in Europe, in-vitro diagnostics (IVDs) are treated as pharmaceuticals in Japan and must navigate a costly, time-consuming approval process particular to this categorization.

The Ministry of Health Labor and Welfare (MHLW) has worked hard over the past three years to reduce the amount of time that it takes to have IVDs approved under the current system for sale in Japan. The goal set by the Ministry in 1985 of processing product approval applications within 6 months is now being met 87% of the time, as compared with only 12% only three years ago. This is a very welcome development and the MHLW should be commended for its efforts.

The MHLW is also in the process of establishing a product approval process for in-vitro diagnostics based on risk classifications: high risk (ministry approval); low risk (3rd party

approval) and low risk standard substances (self-notification). Follow-on ordinances are currently being developed to implement amendments to the Pharmaceutical Affairs Law in 2002 establishing the risk-classification system.

Unfortunately, a number of regulations that are unique to Japan (such as the 3 lot / 3 time test data requirement) still inhibit the introduction of foreign IVDs in a timely and cost-effective manner.

We are also concerned that follow-on regulations announced by the MHLW on March 11th, 2003 will partially negate the potential benefits to be gained from the introduction of a risk-classification system. Many products that do not require approval in Europe are likely to be classified as high-risk in Japan, and thus require Ministerial approval (e.g. tumor markers and IDD related testing). As well, very little information has been made available concerning the structure and procedures for the 3rd-party approval for low risk products, which is completely new to Japan.

1-J-11 Animal health

(Europe-side recommendation)

Summary of recommendations:

1. The mandatory national assay for biological products should be replaced with a system that allows for speedy batch release with a simple notification report submitted by manufacturers based on in-house controls, as is common practice in Europe. The reliability of in-house testing can be confirmed by testing the first few production batches, followed by random sampling thereafter.

2. The mandatory national assay for all in-vitro diagnostic products should be eliminated immediately.

3. The national assay for manufactured/imported feed additives should be abolished after the introduction of Good Manufacturing Practice (GMP) on an industry-wide basis. In the mean time, producers that already employ GMP should be given an exemption from the national assay requirement. Sampling procedures should also be rationalized (e.g. by using attached samples) to eliminate the waste associated with current practices.

4. Reports prepared for New Animal Drug Application should be accepted in their original language with a summary in Japanese, as is currently the practice for pharmaceutical products intended for human use.

5. The acute toxicity study employing animals for mycelial (feed grade) products, a test unique to Japan, required for each batch to detect toxic substances should be eliminated.

Background:

We welcome recent developments on the establishment of Maximum Residue Levels (MRL), one of the items noted in last year's WG1 Report. The Ministry of Agriculture, Forests and Fisheries (MAFF) is reportedly in the process of revising its policy towards the introduction of Maximum Residue Levels in Japan, with the goal of introducing new MRL standards at the rate of approximately four compounds per year.

We are disappointed, however, that there has not been any significant movement regarding the other recommendations contained in last year's report, despite repeated requests from industry to improve regulatory efficiency in this area. As a result, the regulatory environment for animal health product approval lags far behind current practices in other parts of the world, including Europe, which inhibits the introduction of innovative products for use by the Japanese livestock industry, veterinarians and pet owners.

This has also resulted in the rather bizarre situation where it is in fact sometimes more difficult to receive approval for products intended for veterinary use in Japan than for human use. The requirement that all veterinary in-vitro diagnostics be assayed by a national assay institution, for example, does not exist for in-vitro diagnostics intended for human use in Japan – even for products used to diagnose major infectious diseases such as Hepatitis and AIDS.

1-J-12 Tax reform to facilitate investment in Japan

(Japan-side recommendation)

Summary of recommendations:

We recommend the Japanese Government review the following two points, which we have positioned as future issues in order to further revitalize the Japanese economy.

1. A new rule for participation exemption of dividends and capital gains from taxation

2. Improvement of the CFC tax system

Background:

1. Participation exemption, by which dividends and capital gains received from business investment are exempt from taxation, is one measure to encourage FDI.

   This rule is expected to promote direct investments into Japan in case that, for example, companies utilize Japan as an investment base for investments in Asia. Specific discussions should be put forward on the eligibility requirements for corporate tax exemption on the gains (from dividends received, etc.), including the percentage of share-holding and holding period.

2. Under the Japanese CFC rules, companies are required to review whether or not their affiliated companies are subject to the CFC taxation in Japan every year. Because of this requirement, for example, in the case of an affiliated company having both a share-holding function and a sales function and located in a country with a lower income tax rate, it is required to assess the percentage of results attributable to each function every year in order to determine whether or not it can be subject to the CFC taxation. This poses a disadvantage for businesses to set up parent companies/holding companies in Japan.

   In order to resolve this issue, it is necessary to consider building of a stable legal framework for the CFC rules, which is not to be affected from one year to another depending on the company's financial results through the application of predictable CFC rules.

Relationship with previous progress reports:

There is no comment on this matter in the Progress Report as (1) and (2) are both new recommendations at this time.