The EU-Japan Business Dialogue Round Table
Working Party 1

"Creating an open environment for trade and investment"

Working Party Leaders:

Mr. Katsuhiko Honda	Mr. Richard Collasse
Japan Tobacco Inc.	European Business Community (EBC)

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Recommendations to the EU and Japan

1-EJ-1 Concrete and focused actions to follow up the investment framework agreement to enhance foreign direct investment (Joint recommendation)

<Summary of the recommendation>

1. The heads of governments of the EU and Japan should follow up and expand the 'Cooperation Framework for Japan-EU Two-Way Investment Promotion' adapted at the EU-Japan Summit in Tokyo 2004. Concrete measures with substantial impact on investment between the EU and Japan should be elaborated.

2. Such measures should be assessable and clearly focused on the following four priorities: the optimisation of the returns on investment; supporting timely development of business; supporting timely and smooth business reorganisation; and promotion of regulatory reforms.

3. The results of the reviews of its progress should be communicated promptly to the BDRT as well as to the general public.

<Background>

An increase in mutual foreign direct investment will help contribute to the development of a knowledge-based economy in the EU and Japan. In order to make this goal a reality, it is important that the promotion of direct investment should be implemented in concrete policy measures.

At last year's BDRT, Working Party 1 recommended that the EU and Japan should make a Joint declaration on the direction to enhance foreign direct investment by the heads of the governments of the EU and Japan and that such a joint declaration should explicitly refer to the four priorities: the optimisation of the returns on investment; supporting timely development of business; supporting timely and smooth business reorganisation; and promotion of regulatory reforms.

At the 2004 EU-Japan Summit in Tokyo, the leaders of Japan and the EU adopted an investment framework agreement 'Cooperation Framework for Japan-EU Two-Way Investment Promotion'.

We welcome the adoption of the investment framework agreement as a first important step. We would, however, like to emphasise that the framework will have to be completed with concrete measures, with assessable impact on investment flows between Japan and the EU.

Progress should be reviewed and reported to an appropriate body, arguably the EJBRDT on a regular basis.

<Relation with the progress reports>

The Progress Report from the Government of Japan states:

On the occasion of the 13th Japan-EU Summit held in Tokyo on June 22, 2004, the leaders of Japan and the EU issued a joint press statement and a Cooperation Framework for Promotion of Japan-EU Two-way Investment.

Concrete measures related to the four areas designated as priorities in the BDRT recommendations, […] are explicitly referred to in the above Japan-EU Investment Framework.

Japan and the EU are to review the progress of the measures set out in the above Japan-EU Investment Framework at future Japan-EU Summits. Accordingly, the progress of the aforementioned measures is expected to be reviewed at this year's Japan-EU Summit.

The Commission Services Progress Report states:

At the 2004 EU-Japan Summit in Tokyo President Prodi, Prime Minister Ahern and Prime Minister Koizumi adopted an investment framework agreement ("Cooperation Framework for Japan-EU Two-Way Investment Promotion").

The investment framework agreement is a non-binding political framework that brings together various investment related aspects.

In general terms the Investment Framework brings together in a coherent form all investment-related aspects of the Action Plan that are currently dealt with in different fora, such as the summit statements and the Regulatory Reform Dialogue. In doing so it gives certain issues of interest for the business community more visibility, clearer government policy backing and their implementation an increased sense of urgency. The real measurement for the initiative is its value-added.

Both sides have decided against an overly ambitious and slow mechanism (such as a legally binding treaty) and opted instead to focus efforts on an instrument that provides practical solutions, is faster to implement and does not require new fora.

The European Commission and the Japanese Government have used the existing fora in particular high-level meetings between the Japanese Government and services concerned and the regulatory reform dialogue to implement the investment initiative.

1-EJ-2 The optimisation of returns on investment (Joint recommendation)

(1) Avoidance of double taxation

<Summary of recommendation>

1. The two authorities should exempt dividend payments from subsidiaries to parent companies and royalty and interest payments between related companies from withholding taxes. The Japanese government, in addition, should introduce measures to avoid the reduction of the ceiling of foreign tax credits as a result of such an exemption.

2. The European Commission should promote co-operation between Member States in their efforts to make bilateral tax treaties with third countries. The planned communication for next year on the subject may be an appropriate starting point.

<Background>

In order to enhance direct investment between the EU and Japan, measures to reward for taking risks associated with foreign investment are essential. In particular, the measures to avoid double taxation of the same profit should be regarded as sine qua non. Although there are various measures already in place such as bilateral treaties on the avoidance of double taxation (tax treaties) and foreign tax credit systems, there is room for improvement.

Japan and the Member States of the EU should make utmost efforts to improve these measures.

Japan and the EU should agree that withholding taxes should be exempted on dividends from subsidiaries to its parent company, and on royalty and interest payments between related companies.

As a guideline for the revision of bilateral tax treaties, such a framework agreement should lead to the revision of a tax treaty between each EU Member State and Japan that should reduce in practice withholding tax rates to zero.

The working party notes that the new US-Japan tax treaty provides a number of benefits to investment flows between the US and Japan through the reduction and/or elimination of withholding taxes on dividends, royalty and interest payments. It is important that such benefits are made available to investment flows between the EU and Japan.

Negotiations to revise tax treaties between Japan, and the UK and the Netherlands have started, which may result in the reduction or exemption from withholding taxes of dividend, royalty and/or interest payments received by parent companies. The working party welcomes these initiatives. The governments of Japan and the Member States of the EU should make further efforts to revise treaty provisions, and the European Commission should encourage the Member States to address this issue in an expedient manner.

The working party would like to draw attention to the Japanese foreign tax credit system that reduces the ceiling of deductible amounts by 2/3 if the rate of foreign withholding tax is zero. For companies with extensive overseas operations, this could lead to an increase in overall double taxation, which is contrary to the intention of a zero withholding tax rate. The Japanese government should introduce measures to avoid the reduction of the ceiling of foreign tax credits as a result of the introduction of a zero withholding tax rate.

<Relation with the progress reports>

The Progress Report from the Government of Japan states:

Japan will use the requests it deems appropriate as reference from the standpoint of improving the business environment.

Japanese government intends to continue negotiating with European countries […] with the new Japan-US Income Tax Convention as a basic model.

The Commission Services Progress Report states:

Only 17 EU Member States have signed a tax treaty with Japan and the most part of these treaties is really old. Significant differences between Member States' 'treatment of withholding taxes could damage the integrity of the EU single market. In this context, it has to be mentioned that the Commission intends to present in 2006 a Communication on the Member States' bilateral tax treaties – between Member States and with Third Countries – and their interaction with the EU legislation, and the possible implications for co-operation in this matter.

(2) Reducing compliance costs associated with transfer pricing

<Summary of recommendation>

A reduction of compliance costs of transfer pricing through simplification and rationalisation of transfer pricing regimes in a coordinated manner will increase international competitiveness of businesses in the EU and Japan. The two authorities should establish a joint forum, similar to the JTPF established between EU Member States, for the following purposes:

1. To harmonise and simplify interpretation and documentation requirements between the EU and Japan and among the EU Member States in order to reduce the costs of compliance to various transfer pricing taxation regimes.

2. To make the conclusion of bilateral and multilateral APAs (advance price agreements) between the EU Member States and Japan easier and cheaper by improving procedures.

<Background>

While there is a convergence of policies on transfer pricing taxation among major countries according to the OECD Guidelines, companies find it costly and complicated to comply with the transfer pricing requirements of various countries.

In addition, compliance costs associated with the transfer pricing taxation requirements in the EU are potentially far higher than such costs between the US and Japan when the market size is taken into account. This is due to the fact that there are 25 Member States in the EU with separate jurisdictions, each of which is smaller in terms of market size than the US or Japan. Multiple Member States are involved in European operations.

Although APAs are increasingly used in the EU Member States as well as in Japan, the conditions differ country by country and companies have to satisfy the requirements of each country. A transaction between the EU-Japan often involves three countries or more – i.e., Japan, an EU Member State where the market is located and an EU Member State where the European Headquarters with centralised European logistics and finance functions is located. For such businesses, multiple APAs are necessary to obtain sufficient assurance. However, multiple APAs are still in their infancy even within the EU, and the implications for costs and managerial resources are prohibitive. This is a unique situation between the EU and Japan, which could be better addressed by a bilateral forum between the EU and Japan rather than by a multilateral forum such as the OECD.

To improve these circumstances, the governments of the EU and Japan should establish a joint forum or a working group including private sector representatives in order to draw up guidelines in order to:

1. Harmonise and simplify interpretation and the documentary requirements between the EU and Japan and among the EU Member States in order to reduce the costs of compliance to various transfer pricing taxation regimes.

   The guidelines should aim to harmonise and, more importantly, simplify the interpretation and documentary requirements between the EU and Japan by establishing the best practice. Such best practice could then be applied by Japan and each Member State.

2. Make bilateral and multilateral APAs between the EU Member States and Japan easier and cheaper by improving their procedures.

   In order to reduce the costs of obtaining APAs, guidelines should be established on bilateral and, more importantly, multilateral APAs between the EU and Japan. Such guidelines, when applied by all the Member States and Japan, would enable a harmonised application of APAs between Japan and all the EU Member States.

< Relation with the progress reports >

The Report from the Government of Japan states:

(a) *Japan understands that taxpayers have been facing costly double administrative requirements to conform to the standards for transfer pricing documentation imposed by various taxation authorities. It also understands that through the standardisation of transfer pricing documentation, taxation authorities will be provided with the materials beneficial for the analysis of relevant overseas transactions and possible disputes arising from transfer pricing will be reduced.*

(b) *Japan recognises the effectiveness of bilateral APAs and it has been actively promoting them in order to ensure the smooth implementation of transfer pricing taxation regimes and to reduce the workload of businesses dealing with transfer pricing taxation regimes and to enhance the predictability of business management. In addition, mutual discussions concerning bilateral APAs have been progressing smoothly with the EU Member States, and no particular issues have arisen.*

With respect to transfer pricing taxation regimes including advance price agreements, the GOJ has engaged in discussions at the OECD jointly with the EU Member States. Therefore, it is considered that through these discussions, Japan and the EU Member States have reached a consensus.

If any guidelines between Japan and the EU are examined, they should be based on discussions at OECD.

The Commission Services Progress Report states:

In June 2005 the Forum is scheduled to start discussions on APAs and other procedures to avoid double taxation in the area of transfer pricing.

It has to be noted that 'EU Joint Transfer Pricing Forum' is not scheduled to address any possible co-operation between the EU and third countries, including Japan, in the field of transfer pricing.

(3) Participation exemption

<Summary of recommendation>

The governments of the EU, the EU Member States and Japan should, as a medium to long-term objective, consider the introduction and/or expansion of participation exemption regimes in order to promote direct investment between the EU and Japan.

<Background>

Participation exemption, by which dividends and capital gains received from business investment are exempted from further corporate taxation, is one measure to encourage mutual direct investment.

Participation exemption is also effective in encouraging direct investment in other countries from Japan and the EU, for example investment in wider Asia through Japan.

Participation exemption regimes are becoming more and more common in European tax jurisdictions. This working party recommends that the governments of the EU, each Member State and Japan consider the introduction and/or expansion of participation exemption as a medium- to long-term objective. Such an exemption could be granted to capital investment that qualifies certain conditions such as the minimum holding rate and period.

<Relation with the progress reports>

Report from the Government of Japan states:

Japan will use the requests it deems appropriate as reference from the standpoint of improving the business environment.

Commission Services Progress Report states:

The recent amendments (Council Directive 2003/123/EC) to the Parent-Subsidiary Directive have reduced, and will reduce further, the threshold requirements for benefiting from exemption from withholding tax on dividends.

As far as a possible participation exemption for capital investment is concerned, the Commission has not presented any proposal in this respect so far. The Commission does, however, note the recommendation that the introduction or expansion of the participation exemption should be considered as a medium- to long-term objective.

1-EJ-3 Supporting timely development of business (Joint recommendation)

(1) Smoother and swifter transfer of personnel

<Summary of recommendation>

1. Social security contributions

   The two authorities should introduce measures to avoid double contributions to the social security systems of both home and host countries by intra corporate transferees through the accelerated introduction of social security agreements. In addition, they should introduce an interim measure since it is likely to take a long time to conclude bilateral agreements between all the Member States and Japan. Such an interim measure could be either unilateral exemption by the host country or refund of contributions to pension funds by the host country when such expatriates return to the home country.

   Research work should be outsourced to external think tanks.

To faciliate the negotiations on Social Security agreements, external think tanks should be contracted to do the basic research and provide adaptable agreement texts to be adopted by governments within a period of five years.

2. Work and residence permits

The two authorities should simplify and accelerate the procedure to obtain a work and residence permit – or a residence permit for self-employed statutory directors – for intra-corporate transferees between the EU and Japan. The procedure should include the possibility to submit an application for a work-residence permit or a residence permit for self-employment after entering the assigned country. Furthermore, spouses should be automatically granted the same rights as the holder of the permit, such as a work-resident permit and a residence permit for self-employment, upon their arrival.

<Background>

1. Social security contributions

Double payments of social security contributions by and for their personnel dispatched between the EU and Japan discourage investment by businesses.

When a company sends its employee to an overseas assignment for a limited period – typically 3 to 5 years – usually the employee concerned and his/her employer keep on contributing to the social security system, particularly pension funds, of the dispatching country. If contribution to the social security system of the hosting country is obligatory, contributions will be paid in both countries. This double payment is a heavy and unnecessary burden for a company and its employee. A social security agreement solves this problem by typically exempting intra-corporate transferees from contributing to the social security system of the hosting country for a limited period.

Research work should be outsourced to external think tanks.

So far Germany, the United Kingdom, Belgium and France have concluded bilateral social security agreements with Japan. The agreements between Japan, and France and Belgium are not yet put into effect.

We want to see swift negotiations and conclusions of agreements between all EU Member States and Japan but do acknowledge that it requires a heavy workload and inevitably surpasses current administrative capacities. At this pace, it takes a few years at least to negotiate, conclude and ratify a social security agreement. It could take more than 30 years to conclude such agreements with the rest of the Member States. In addition, such an agreement may never be introduced between Japan and a Member State that hosts a small number of Japanese expatriates and vice versa.

Given the capacity problem of dealing with several negotiations concurrently, the parties suggest that external think tanks should be contracted to lay the foundation

for agreements by doing the basic research and provide adaptable agreement texts to be adopted by governments within a period of five years.

Furthermore, both authorities should introduce an interim measure. Such an interim measure could be either unilateral exemption by the host country or refund of contributions to pension funds by the host country when such expatriates return to the home country.

2. Work and residence permits

For the smooth and efficient running of international businesses, it is essential that companies are able to dispatch key personnel including directors. Such transfers do not have any negative impact on the labour market in the host country. On the contrary, it will expand employment in the host country through the development of business, and expatriates themselves tend to pay high income tax to the host country. The requirement to obtain work and residence permits for intra-corporate transferees between the EU Member States and Japan is usually a formality, and it is rare that the application of an intra-corporate transferee is questioned with substantial reasons. However, the burden on companies as well as employees and their families is substantial, and does constitute an obstacle to swift development of business.

The two authorities should simplify and accelerate the procedure to obtain work and residence permits for intra-corporate transferees between the EU and Japan. The procedure should include a possibility to submit an application for work and resident permits after entering the assigned country. The Working Party notes that, in Japan, this is already possible.

Furthermore, to facilitate swift deployment of personnel, spouses should be allowed to engage in economic activities in the host country. They should be granted, upon their arrival, the same rights as the holder of the permit without filing a separate application. The Working Party notes that, in the UK, this has been already implemented.

<Relation with the progress reports>

1. Social security contributions

The Progress Report from the Government of Japan states:

[T]he GOJ intends to conduct negotiations with countries in order of priority upon giving comprehensive consideration to the scale of insurance premiums levied under the social insurance systems of partner countries, the situation of Japanese nationals and companies based in those countries, demands from the business community, and bilateral relations, among others. With regard to agreements with each EU Member State, Japan will proceed with the negotiations based on such comprehensive considerations.

The GOJ recognises the importance of concluding agreements with EU Member States, and given the requests received from the business community, among others, the GOJ intends to make efforts to conclude agreements with each Member State as far as possible.

The Commission Services Progress Report states:

The problem of double-contributions can only be addressed by concluding bilateral social security agreements with the Member States concerned. The Commission welcomes the progress of negotiations on the conclusion of such agreements between Japan and certain Member States.

Given the competencies in this area, the conclusion of social security treaties between Member States and Japan has to be discussed on a bilateral basis.

2. Work and residence permits

   The Report from the Government of Japan states:

   It has been decided that applications submitted by foreigners who are employed under contracts with agencies deemed to be of "good standing," [...] would be processed within approximately two weeks from the date of the applications were received.

   In terms of determining the qualifications of intra-company transferees, they may apply to change their status of residence regardless of whether they entered Japan for a different purpose, and the GOJ is making efforts to process such applications in a swift manner.

   A spouse may acquire the status of residence permitting work and will therefore be able to work.

   The Commission Services Progress Report does not respond to this point.

(2) Data Protection: International Data Transfer

<Recommendations>

1. Japan's Data Protection Law should be amended in a way that it could satisfy the level of protection required by the EU's Data Protection Law to permit the transfer of personal data from the Member States to Japan.

2. The EU should re-examine the current standard contractual clauses between a data controller and a data processor whether they are workable and sufficiently flexible in the light of modern business practice and experience.

<Background>

Directive 95/46/EC, on the protection of individuals with regard to the processing of personal data and on the free movement of such data, requires Member States to permit transfer of personal data to countries outside the European Union only where there is adequate level of protection of such data as the Directive could provide, unless one of specific exemptions applies.

Japan's Data Protection Law is not deemed to provide the adequate level of protection. The main reasons are in the fact that the Japan's law lacks clauses on transfer to third countries, the distinctive treatment of sensitive data and the data subject's 'right' of access to its data. The lack of the adequate level of protection has resulted in the prohibition of transfer of personal data, for example, from subsidiaries of Japanese companies to their headquarters.

On 27 December 2004, the European Commission approved a new set of the standard contractual clauses for data transfers proposed by seven international business associations, including the Japan Business Council in Europe (JBCE), as offering an "adequate level of data protection" under the EU's Data Protection Law. Companies have been allowed to use the clauses to provide a legal basis for data transfers to the controllers (as importers) outside Europe since 1 April 2005. The standard contractual clauses previously approved by the European Commission in 2001 were less practical and flexible for business use.

On 14 April 2005, Article 29 Data Protection Working Party, an independent European advisory body on data protection and privacy set up under Article 29 of Directive 95/46/EC, adopted Working Document Setting Forth a Co-Operation Procedure for Issuing Common Opinions on Adequate Safeguards Resulting From "Binding Corporate Rules". As the result, a corporate group could now submit draft binding corporate rules (BCRs) including the data transfer outside Europe for the approval of relevant data protection authorities through 'one' Data Protection Authority (DPA) acting as the leading DPA. Previously, not all Member States approved Binding Corporate Rules. Although the participation of DPAs in the approval of binding corporate rules is voluntary, it is a significantly positive step.

The Working Party welcomes the above two developments.

The above-mentioned new set of standard contractual clauses, however, covers only contractual relations between data controllers and does not cover those between a data controller and a data processor. To cope with a fast-moving business environment, the current standard contractual clauses should also be examined in the light of business practices and experiences for the possibility of modifications in order to enable subcontracting and outsourcing of data processing in a third country in the process of international business.

Furthermore, the Government of Japan should amend Japan's Data Protection Law in order to satisfy the adequate level of protection in the light of the EU law to permit the transfer of personal data from the Member States to Japan. The Working Party is of the

opinion that the adequacy decision by the European Commission on Japan's Law would establish more internationally equal, transparent and secured data protection regimes between the EU and Japan to support international business development.

<Relation with the progress reports>

In the recommendations of 2004, we recommended to the EU that there should be a legal framework that allows subsidiaries of Japanese companies in Member States to transfer personal data to Japan or a third country where such data is handled without additional guarantees being necessary. (1-E-4).

The Commission Services Progress Report states:

The European Commission adopted the "alternative standard contractual clauses" submitted by a coalition of business associations, including the Japan Business Council of Europe on 27 December 2004.

1-EJ-4 Guaranteeing stable rules for choice of legal presence and facilitating business reorganisation from a legal and tax point of view

(Joint recommendation)

<Summary of recommendation>

1. Improvements of Company Laws under way in the EU and Japan should be carried out in full to facilitate smooth cross-border reorganisations between the EU and Japan that involve exchange of shares and transfer of assets. Companies investing in Japan and the EU should be protected from sudden changes in rules governing the forms of legal presence acceptable for conducting business.

2. Tax law should be improved in order to expand the scope of tax deferral on unrealised profits resulting from business reorganisations including those involving exchange of shares and transfer of assets.

<Background>

1. Facilitate Smooth Cross-border reorganisations

In order to cope with rapidly changing markets and business environments, timely reorganisation of group businesses across national borders is essential for all global businesses.

Japanese company law and tax law have improved considerably over the past five years and now enable companies to carry out a wide range of business reorganisations on a tax neutral basis. We are pleased that many of these issues are addressed in the new Corporation Law, which will introduce a wider variety of modern restructuring methods. The introduction of the new Corporation Law will

provide further flexibility. However, direct cross-border exchange of shares will still not be possible, and the introduction of an intermediate measure in the right direction, the triangular merger scheme, has unfortunately been delayed for one year.

Furthermore for global companies, flexibility in choosing the jurisdiction of incorporation is essential. Rules governing acceptable forms of legal presence in the host country must be clear and consistent with authorisation practices.

On the European side, the proposal for a Directive of the European Parliament and of the Council on cross-border mergers of companies with share capital (a 10th Company Law Directive) should be adopted and implemented with no delay. The proposed cross-border transfer of registered office of limited companies without liquidation and incorporation should be adopted and implemented as soon as possible. A Statute for European Private Company should, furthermore, be introduced as soon as possible.

Rules on forms of legal presence allowed for conducting business in the host country are extremely important for foreign investors. Sudden changes of such rules cause economic loss, uncertainty and deep distrust. Article 821 of the new Corporation Law in Japan challenges the legal framework within which foreign companies have been acting in Japan for over 50 years. Yet the introduction of the Article was insufficiently communicated publicly. The lack of notice and understanding of the law has placed many foreign firms in the difficult position of great regulatory uncertainty.

It is crucial that the government delivers on its guarantees that the introduction of the article implies no change in regulatory practices. The working party welcomes the understanding of these serious concerns on the part of the Japanese Government. Given the strict language and apparent risk of a different interpretation by a third party in court, however, the GOJ should work towards a revision of the text itself before the law is implemented.

The two authorities should improve respective company laws and related provisions swiftly in order to facilitate cross-border business reorganisations.

2. Taxation

In a cross-border merger, when the merging company issues shares in exchange for shares in the merged company, the recipient of new shares may be taxed for unrealised gains. In order to facilitate cross-border business reorganisation, it is necessary to modernise tax laws and enable tax-neutral cross-border exchange of shares.

In Japan, tax deferral is currently only available for share exchanges involving Japanese-only companies, and only then in qualifying circumstances.

When a company carries out cross-border reorganisation in the EU that does not qualify within the scope of the Merger Directive, unrealised gains may be taxed. Taxation on unrealised gains at a time of reorganisation could be a considerable

amount and could deter companies from reorganisation, which would reduce the international competitiveness of the company and consequently the international competitiveness of the EU economy.

The two authorities should improve respective tax laws in order to widen the scope of tax-neutral reorganisation.

<Relation with the progress reports>

The Progress Report from the Government of Japan states:

The Legislative Council of the Ministry of Justice finalised the outline of the Bill on the modernisation of Japanese corporate law on February 9, 2005 and submitted it to the Minister of Justice. This outline includes provisions that would introduce flexibility in merger currency for use in mergers and exchange of shares and approves the use of foreign shares as merger currency. For all aspects of the tax reform, see the attached appendix.

The Commission Services Progress Report states:

On 17 February 2005, on the basis of a proposal from the Commission (COM(2003) 613 final), the Council adopted Directive 2005/19/EC amending Council Directive 90/434/EEC ('the Merger Directive').
Directive 2005/19/EC, which follows the Commission's proposal in most respects, updates, clarifies and broadens the scope of the Merger Directive, in that it updates the list of companies to which the Directive applies to cover new legal entities, including certain co-operatives, non-capital-based companies, mutual companies, savings banks, funds and associations with commercial activity; it also includes companies formed under the European Company and European Co-operative Society statutes; extends the application of tax deferrals to a new form of business reorganisation – the 'partial division', which occurs when a company, without being dissolved, transfers one or more branches of activity to an existing or newly created receiving company in exchange for the issue of shares in the receiving company to the shareholders of the transferring company; ensures that when the registered office of a European Company ('SE') or of a European Co-operative Society ('SCE') is transferred from one Member State to another deferral of tax applies to capital gains on assets which remain connected to a permanent establishment of the SE or SCE in the first Member State; clarifies that the tax deferral regime applies also when a company decides to convert its foreign branch into a subsidiary.

1-EJ-5 Promotion of regulatory reforms

(Joint recommendation)

<Summary of recommendation>

1. The EU and Japan should continue to cooperate with each other through their ongoing regulatory reform dialogue with the goal of creating an open environment for trade and investment.

2. The EU and Japan should abolish unreasonable authorisation procedures related to products and services, and continue to pursue mutual recognition of product standards, certification and notification. It is equally important that both authorities cooperate when introducing new standards to assure standard convergence and avoid the creation of future barriers to trade.

<Background>

We appreciate the commitment of the authorities of the EU and Japan to regulatory reform, as demonstrated in the annual EU-Japan regulatory reform dialogue. Cumbersome regulatory requirements represent a large barrier to increased trade and investment. Mutual recognition of divergent regulatory requirements and compliance procedures should be pursued as much as possible. It is important that also new standards in areas such as restriction on usage chemical emissions are developed in convergence with each other.

Within the field of consumer electronics, Japan Green Procurement Survey Standardization Initiative (JGPSSI) and the 2002/95/CE, 2002/96/CE is coming in to full effect this year. Within the field of building products, the Ministry of Land Infrastructure and Transport (MLIT) introduced restrictions on Formaldehyde emitting building materials 2003 and is working with more comprehensive policies regulating all Volatile Organic Compound (VOC) emitting materials. In Europe、prEN 15052 a standard for VOC-emitting resilient textile and laminate floor coverings is being developed along with many national schemes, the German AgBB assessment scheme for construction products being arguably the most comprehensive.

We support all efforts to protect consumer from the emission of harmful chemical emissions but are concerned that not enough is done to co-ordinate regulatory initiatives. Consumer electronics and Building Materials represent a substantial part of the EU-Japan trade and should not be disrupted by expensive adaptation to and certification for differing standard schemes.

<Relation with the progress reports>

Both the EU and the Japanese reports refer to improvements in the regulatory environment as a result of the two High Level Meetings on Regulatory Reform in November 2003 and February 2004.

Furthermore, the Japanese report states that, following the policy speech by Prime Minister Koizumi in January 2003, a programme of promoting inward investment in Japan that cover 5 areas and 74 items was agreed in an Invest in Japan meeting and

that various measures have been implemented. In addition, the report refers to reforms in certification based on the re-amended 3-year plan to promote regulatory reforms.

Recommendations to the EU

1-E-1 The policy of the EU on taxation

(Japan-side recommendation)

<Summary of recommendation>

1. The European Commission and the Member States should realise a common consolidated corporate tax base as soon as possible.

2. Merger Directive (90/434/EEC)

   (a) Its scope should be extended to include the deferral of taxation on unrealised gains on goodwill.

   (b) Its scope should be extended to include deferral of taxation on the transfer of real estates and other intangible assets.

   (c) The requirements in certain Member States to maintain the holding of shares for a number of years should be abolished.

3. Concerning the EU Transfer Pricing Documentation - the EU TPD - proposed by the Joint Transfer Pricing Forum, the EU and the Member States should commit themselves to exemption from penalties (i.e. penalties related to non-compliance with documentation requirements, penalties related to transfer pricing adjustments and interest related to adjustments) if a company submits an EU TPD acting in good faith and in a timely manner.

4. Although VAT is a common taxation system in the EU, difference among Member States is so large that companies find it very difficult to centralise VAT administration. The EU and the Member States should simplify and harmonise it to the extent that companies can centralise VAT administration easily without employing people with expert knowledge of the VAT regime in each country in which it is operating.

5. The European Commission and the Member States should make swift progress in realising the cross-border offset of losses against profits.

<Background>

1. Common consolidated corporate tax base

   Many Japanese companies are implementing integration and rationalisation of their European business organisation in order to remain competitive in the Single Market. Examples are the centralisation of such functions as sales support and accounting. The relation between intra-group transactions and taxation is an important element in decision making in a business. It is highly desirable that companies with international business should be allowed to compute the income of the entire group

according to one set of rules and establish consolidated accounts for tax purposes in the EU, as the European Commission stated in its Communication in October 2001.

The European Commission and the Member States should continue to make efforts, despite various obstacles, to realise a common consolidated corporate tax base as soon as possible.

2. Merger Directive

(a) Deferral of taxation on unrealised gains on goodwill

In business restructuring, if goodwill is transferred from one Member State to the other, it could trigger taxation in the former state. The cross-border reorganisation of sales networks is often necessary to increase economic efficiency in the Single Market. In such a reorganisation, the transfer of goodwill is often unavoidable. However, goodwill transfers could trigger a very high amount of taxation. As a result, companies could be forced to leave an economically sub-optimal structure untouched.

In the annex of the communication COM (2001)582, the European Commission recognised this as an issue and suggested that Directive 90/434/EEC could extend its scope so as to defer the taxation of unrealised gains on goodwill where it is moved to another Member State while preserving the tax claims of the Member State from which goodwill was moved.

The recently adopted amendments to the Directive (2005/19/EC), however, do not include provisions related to this issue.

The European Commission and the Member States should recognise the benefit of profound business reorganisation to the competitiveness of the European economy and should facilitate it through the introduction of the deferral of taxation on unrealised gains on goodwill.

(b) Deferral of taxation on the transfer of real estates and other intangible assets

With the same reasons as for item (a), by extending the scope of the Directive to the transfer of real estates and other intangible assets in reorganisation, companies could reduce the cost of reorganisation and increase competitiveness.

(c) Shareholding requirements

Merger Directive (90/434/EEC) provides for the deferral of corporate tax in the qualified cross-border restructuring of business. In certain Member States, companies are required to hold shares that they have received in exchange for contributed assets for a number of years even if those holding companies cease to function as an operating company. There appears to be no ground in the Directive to support such measures.

In addition to the cost of maintaining these empty companies, it will increase the risk of double taxation. Corporate taxes paid by the subsidiaries of the new holding company will not qualify for Japanese foreign tax credit for the portion distributed through the empty company, because the scope of Japanese foreign tax credit is limited to the second tier companies.

Therefore, the requirements in certain Member States to maintain the holding of shares for a number of years should be abolished.

3. Transfer Pricing

The Joint Transfer Pricing Forum set up by the EU is proposing the EU Transfer Pricing Documentation – the EU TPD. The EU TPD could enable companies to centralise and simplify the preparation of TP-related documentation in the EU. Therefore the EU TPD could reduce the compliance costs related to transfer pricing taxation. It should benefit not only companies operating in several Member States but also the tax authorities by allowing them to have access to a set of harmonised documentation.

To provide sufficient incentive for compliance with the EU TPD, the EU and the Member States should commit themselves to exemption from penalties (i.e. penalties related to non-compliance with documentation requirements, penalties related to transfer pricing adjustments and interest related to adjustments) if a company submits an EU TPD acting in good faith and in a timely manner.

4. VAT

Many Japanese companies are implementing integration and rationalisation of their European business organisation in order to remain competitive in the Single Market. Accounting functions including VAT administration are often targeted for centralisation with the aim of reducing overall costs and increasing efficiency.

Although the VAT system in the EU is a common system, in reality, differences among Member States are significant mainly due to derogations. Presently, therefore, the centralisation of VAT administration carries a high financial risk.

For example, if centralised accounting staff with limited country-specific knowledge make a mistake in a repetitive transaction, the accumulated amount that should be rectified could become high over a relatively short period. In addition, a penalty may be imposed. To avoid such a high risk, businesses have to either leave accounting staff in local operations or employ a number of accounting staff with country-specific knowledge in a central location. In either case, cost-effective centralisation of accounting functions is unlikely to be realised.

The EU is proposing one-stop shopping to facilitate and simplify VAT administration (COM 2004/728). It is mainly for taxable persons carrying out taxable activities aimed at consumers in Member States where they are not established.

The EU should go further in its VAT policy and extend the benefits of simplification to the centralisation of VAT administration in general.

For reference we would appreciate the comments made by Commissioner Kovacs in his recent speech ("Simplifying VAT Obligations - towards a one-stop scheme" Berlin 31 May 2005*).

5. Cross-border offset of profits and losses

A proposal for a Directive for cross-border offset of the losses of permanent establishments and subsidiaries against the profits of the parent company was issued in 1990. The European Commission withdrew the proposal in December 2001. The European Commission announced the intention to initiate a new round of technical preparatory meetings with Member States in 2002 before issuing a new proposal. Such technical preparatory meetings have not been initiated due to opposition by the Member States.

The cross-border offset of profits and losses is a very important issue for businesses operating in the EU. The European Commission and the Member States should make swift progress in this area and realise an EU framework for the cross-border offset of profits and losses.

<Relation with the progress report>

1. Common consolidated corporate tax base

The Commission Services Progress Report states:

The Commission established a Working Group in November 2004 composed of experts from Member State administrations to discuss progress on developing a common consolidated corporate tax base. [...] Although all twenty-five Member States participate in the technical work, two have stated they do not support the introduction of a common consolidated tax base as a matter of principle.

Central to the establishment of a consolidated tax base (taxable profits) would be the arrangements for sharing tax base (taxable profits) between Member States. The Commission is continuing research into the issues that would be relevant to tax base (taxable profits) sharing, such as definitions of groups of companies and of income, formulae and weightings.

2. Merger Directive

(a) Deferral of taxation on unrealised gains on goodwill

The Commission Services Progress Report does not refer to this point.

(b) Deferral of taxation on the transfer of real estates and other intangible assets

The Commission Services Progress Report states:

As already mentioned in the 2004 Progress Report, the Commission consulted Member States on the possibility of extending the scope of the merger Directive to cover tax deferral on real estate transactions and the transfer of intangible assets, but decided to limit its amendment proposal to those elements on which there appeared to be the prospect of reaching final agreement.

In view of the fact that agreement on even those elements proved difficult to reach, it may, at present be unrealistic to assume that the prospect of reaching agreement on real estate transactions and intangibles has improved.

(c) Shareholding requirements

The Commission Services Progress Report states:

The Commission has already noted that several Member States have imposed holding requirements that do not appear to have support in the Merger Directive.

The Commission is continuing to monitor the situation closely.

3. Transfer Pricing

This is a new recommendation.

4. VAT

This is a new recommendation.

5. Cross-border offset of profits and losses

The Commission Services Progress Report states:

In its November 2003 Communication "An Internal market without company tax obstacles: achievements, ongoing initiatives and remaining challenges" (COM (2003)726 final), the Commission announced that it would consult with Member States with a view to presenting a more comprehensive initiative in this area in late 2004/early 2005. Such consultation may be expected to take place in the first semester of 2005.

1-E-2 The policy of the EU on company law

(Japan-side recommendation)

<Summary of recommendation>

1. The proposal for a Directive of the European Parliament and of the Council on cross-border mergers of companies with share capital (a 10th Company Law Directive) should be adopted and implemented without delay.

2. A 14th Company Law Directive on the cross-border transfer of the registered office of limited companies without liquidation and incorporation should be proposed, adopted and implemented as soon as possible.

3. A Statute for a European Private Company should be introduced as a short-term priority.

<Background>

1. Proposed Directive on cross-border mergers

   The taxation regimes for cross-border mergers in the EU have been harmonised by Council Directive 90/434/EEC. Council Regulation EC/2157/2001 has introduced the EU company law framework for cross-border mergers for the SE since October 2004. For the other forms of companies, a 10th Company Law Directive would create the EU company law framework for cross-border mergers.

   A proposal for a Directive of the European Parliament and of the Council on cross-border mergers of companies with share capital (a 10th Company Law Directive) was issued in November 2003 and approved by the European Parliament with amendments in its first reading in May 2005. It should be adopted and implemented without delay.

2. A 14th Company Law Directive

   The cross-border transfer of a registered office currently involves liquidation and incorporation of companies, which could trigger exit taxation even if underlying business does not change.

   A 14th Company Law Directive, which would provide the EU company law framework for the cross-border transfer of the registered office of limited companies, should be proposed, adopted and implemented as soon as possible.

3. Statute for a European Private Company

   The European Company Statute has enabled the establishment of a European Company (SE) since October 2004. The European Company Statute is for public companies. It has been criticised as cumbersome and complex, unsuited to the needs of SMEs, which are 90% of companies in the EU.

   The European Commission published a Communication to the Council and the European Parliament, 'Modernising Company Law and Enhancing Corporate

Governance in the European Union – A Plan to Move Forward' in May 2003. In the Communication, the European Commission states that it will launch a feasibility study in order to assess the practical needs for – and problems of – a European Private Company Statute by 2005 and that, if the outcome is positive, it will propose a Statute for European Private Company between 2006 and 2008.
The introduction of a Statute for a European Private Company should be a short-term objective in order to meet the needs of private companies in the EU.

<Relation with the progress report>

1. Directive on cross-border mergers

   The Commission Services Progress Report states:

   There are good chances that the Directive will be adopted in 2005, possibly, even in the first half of 2005, depending on the EP's opinion and the speed of translation works.

2. A 14th Company Law Directive

   The Commission Services Progress Report states:

   The elements that could be part of the 14th Company Law Directive are currently being discussed internally by the Commission services. No firm decision has yet been taken on such a proposal.

3. Statute for a European Private Company

   The Commission Services Progress Report states:

   On 14 January 2005 external consultants carrying out a feasibility study on a statute for a European Private Company have presented their first findings in the workshop where interested parties and organisations took part. The finalisation of the study is foreseen for the end of 2005. Depending on the outcome of the study, pertinent legislation activity may be undertaken subsequently.

1-E-3 The policy of the EU on corporate governance

(Japan-side recommendation)

<Summary of recommendation>

Corporate governance and its disclosure make sense only if it is applied to the entire group companies in a consistent way. Corporate governance and its disclosure, therefore, should be regulated at the level of listed companies where disclosure to shareholders is crucial.

The European Commission should coordinate Member States and introduce a guideline in order to make sure that corporate governance and its disclosure is regulated at the level of listed companies.

Adoption of a code should be voluntary and companies should comply with the adopted code based on the principle of 'comply or explain'.

<Background>

Currently, the ways in which regulations on corporate governance are implemented are left to the discretion of the Member States.

Corporate governance and its disclosure make sense only if applied to the entire group of companies in a consistent way. If corporate governance and its disclosure are regulated at each legal entity level by binding national measures, each entity of a group has to cope with different national laws in addition to the corporate governance of the group. This is likely to lead to an unnecessary burden on companies without reinforcing the corporate governance of the group.

Therefore, corporate governance and its disclosure should be regulated at the level of listed companies where disclosure to shareholders is crucial.

Corporate governance code should allow sufficient flexibility according to the difference and necessity of individual companies. Adoption of a code should be voluntary and companies should comply with the adopted code based on the principle of 'comply or explain'.

<Relation with the progress report>

The Commission Services Progress Report states:

In principle, the European Commission agrees with the idea that corporate governance rules and adjacent disclosure rules should be implemented throughout a group of companies in a consistent way.

Taking into account the very nature of corporate governance rules and the "soft law approach" chosen by the Commission and supported by Member States, it does neither seem feasible nor appropriate to mandate at the EU level "home-country" principle.

Nevertheless the issue of the consistency of corporate governance rules throughout the groups of companies could be a good topic for a discussion and research by the recently established European Corporate Governance Forum.

The Forum can also provide strategic advice to the Commission – including areas of priority, concerns, etc. – taking into account the global dimension.

1-E-4 Japanese expatriates

(Japan-side recommendation)

<Summary of recommendation>

The EU should introduce a fast track procedure for Japanese nationals who are already legally resident in a Member State when he or she moves to another Member State for economic activities or other reasons.

<Background>

Companies transfer more and more employees across the EU. They could be EU nationals as well as Japanese nationals. Japanese nationals are sometimes subject to a fast track procedure for work and residence permits if they come directly from Japan to a Member State. When they move between Member States, they often have to go through a slower procedure. Facilitating the mobility of workers from one Member State to another would enable companies to adapt themselves to the development in the Single Market more quickly and more effectively.

There should be a European fast track treatment for Japanese nationals who are already legally resident in a Member States when he or she moves to another Member State for economic activities or other reasons.

<Relation with the progress report>

This is a new recommendation.

1-E-5 Pension

(Japan-side recommendation)

<Summary of recommendation>

The European Commission and the Member States should eliminate double taxation related to occupational and supplementary pensions as soon as possible.

<Background>

As companies transfer more and more employees across the EU, the costs arising from double taxation on contributions and payouts become significant. The problem is that the tax deductibility of pension funds is often limited to the country in which they are set up and that contributions to funds based in other Member States are not necessarily tax deductible. When payouts are taxed as income while contributions are not tax deductible, there will be double taxation.

The Directive on the activities of institutions for occupational pension, which enables the creation of an EU-wide pension fund, was adopted in June 2003. Furthermore, the European Commission has opened infringement proceedings against several Member States that appear to apply discriminatory tax rules to contributions to pension funds based in other Member States.

The European Commission and the Member States should continue to make efforts in order to eliminate double taxation related to occupational and supplementary pensions as soon as possible.

<Relation with the progress report>

The Commission Services Progress Report states:

The Commission services are currently working on a proposal for a directive establishing minimum requirements at European level to improve the portability of supplementary pension rights. The proposal is due to be adopted by the Commission in the first half of 2005.

The Commission also launched infringement procedures against ten Member States in order to eliminate tax discrimination with regard to pension funds established in other Member States. In addition, Directive 2004/41/EC on the activities and supervision of institutions for occupational retirement provision will facilitate the mutual recognition of pension funds and will widen the scope for the cross-border management of professional pension schemes.

1-E-6 Community Patent

(Japan-side recommendation)

<Summary of recommendation>

The proposal for a Council Regulation on the Community patent should be adopted and implemented as soon as possible.

<Background>

Intellectual and industrial property rights in the EU have been protected by national systems of law. Unified European systems, which co-exist with the traditional ones at the national level, have been established with the Community trademark and Community designs. An agreement to adopt the Regulation on the Community patent was reached in a Council meeting in March 2003.

After more than two years, however, the proposal has not been adopted. In addition, there is a possibility that it may have to be withdrawn. We would like to urge the EU and the Member States to adopt the proposal and implement it as soon as possible.

<Relation with the progress report>

The Commission Services Progress Report does not respond to this point.

1-E-7 Fight against counterfeited, pirated and contraband goods

(Japan-side recommendation)

<Summary of recommendation>

Fight against counterfeited, pirated and contraband goods should be reinforced at the new and extended border of the EU.

<Background>

With 10 new Member States, the border of the EU has been moved and extended since May last year. At the new border of the EU, the authorities may be less effective against counterfeited, pirated and contraband goods than at the old border where officials are more experienced.

The EU and its Member States should make utmost efforts to prevent an increase in goods infringing an intellectual property right entering the EU after the enlargement. Furthermore, the EU should exert every effort to support and train the personnel of the new Member States.

<Relation with the progress report>

The Commission Services Progress Report does not respond to this point.

1-E-8 Tariffs and tariff classification

(Japan-side recommendation)

<Summary of recommendation>

1. Compared with other developed nations, the European Union (EU) imposes high tariffs on certain manufactured goods (for example, duties on audiovisual electrical appliances: EU 14%, Japan almost 0%; duties for automobiles: EU 10%, Japan 0%, United States 2.5%). These should be eliminated or reduced.

2. Tariff classifications must be appropriate, timely and transparent, based on the primary function of the manufactured good at the time of import. Importers find that classification remains unpredictable because of inconsistencies in the interpretation of the tariff schedule by the EU.

<Background>

1. The EU continues to levy high tariffs on certain manufactured goods. These are high compared with other developed countries. Advanced nations should advocate free trade by resolving tariff peak issues and assessing the quantitative impact high tariff goods have on economic development. In addition to the comprehensive and general World Trade Organization (WTO) and non-agricultural market access (NAMA) tariff reduction talks, Japan would like to see the EU, in a position to spearhead market liberalisation, take the initiative to lead sectoral tariff negotiations that include high duty products. In addition, offering EU consumers digital household electrical appliances and other IT-related goods at prices incorporating tariff costs in line with other developed countries will ultimately contribute to the region's economic development based on information and communication technologies (ICT) that the EU espouses.

2. Rapid advances to digital technology have led to the development of an increasing number of multifunctional products that are becoming difficult to categorise under the conventional EU tariff classification system. Inconsistencies or sudden changes to the way the functions of these goods are interpreted during the classification process can undermine predictability for businesses, and adversely affect free trade. In terms of the way in which the EU determines classification of goods for tariff purposes, critics point out the interpretation of the tariff schedule does not take into account the primary function of the product at the time of import and lacks transparency, timeliness and predictability. Concerns remain that the EU tariff classification is conducted deliberately and arbitrarily.

<Relation with the progress report>

EU tariffs for manufactured products are comparable to those of other industrialised countries. According to 2001 WTO statistics, the average concessionary tariff levied by the EU on industrial goods is 4.1%, compared with 3.9% imposed by the United States, and 3.5% by Japan. Tariffs above a certain high level (over 15%) are imposed on 1.5% of all manufactured goods in the EU, 3.5% for the United States, and 1.8% for Japan.

For some products, the EU does impose higher tariffs relative to other developed countries. However, these are the results of WTO negotiations that followed the General Agreement on Trade and Tariffs (GATT) and past Uruguay Round talks aimed at concluding the Trade on International Technology Products (ITA) agreement for information technology (IT). Compromises made by the EU and concessions made to the EU for market liberalization are balanced.

Tariff barriers for non-agricultural products and non-tariff barriers continue to be priority issues for the EU within the framework of the current WTO rounds. Non-agricultural products account for over 80% of international trade in goods. A substantial cut in tariffs for industrial goods will provide significant trade opportunities for both developed and developing countries. All WTO member nations should continue to contribute towards this process in a way that is appropriate to each country's economic development and capability.

1-E-9 The decision-making system of the EU

(Japan-side recommendation)

<Summary of the recommendation>

The EU and its Member States should pursue institutional reforms so that the EU could speed up its decision-making. In the corporate taxation area, in particular, unanimity requirements in the Council should be abolished in the area where uncoordinated taxation policies of Member States could become obstacles to cross-border business activities.

<Background>

It appears that institutional reforms of the EU, including the reforms of its decision-making system that is crucial after the enlargement, are not going smoothly.

The EU and its Member States should pursue institutional reforms nevertheless so that its decision-making will function effectively and efficiently. Furthermore, they should make every effort to improve the Single Market-related legislation even during the period of political uncertainty.

In the area of corporate taxation policy where businesses expect further development, the current decision-making requires the unanimous agreement of the Member States in the Council, which hampers progress in this area.

In our opinion, although the Member States should retain competence over their taxation policy, it is necessary to have EU rules in areas where uncoordinated taxation policy constitutes obstacles to cross-border business activities. The unanimity requirements in the Council should therefore be removed under certain conditions in order to speed up decision-making in the area of taxation policy.

Recommendations to Japan

1-J-1 Maintaining stable rules for legal presence of foreign companies

(Europe-side recommendation)

<Summary of recommendation>

The Government of Japan should use all means available, including revision, to ensure that Article 821 introduced recently without adequate public notice into the Japanese Corporation Law does not constrain forms of legal presence available for foreign companies in Japan. Forcing foreign companies into detrimental reincorporation by suddenly changing the legal framework governing forms of legal presence substantially damages investor confidence in Japan.

< Background >

Article 821, of the new Corporate Law with, the heading "pseudo-foreign companies", maintains that "*No foreign company having its principal place of business in Japan or primary purpose of which is to carry on business in Japan may engage in transactions on a continuous basis in Japan …..Any person who engaged in the transactions shall be jointly and severally liable to any counterparty for such transactions*."

The introduction of Article 821 was not sufficiently communicated publicly. It was discovered by many firms long after the legislation was passed by the House of Representatives of the Diet, and only days before it was expected to be submitted to a vote in the House of Councillors. The lack of notice and understanding of the law has placed many foreign firms in the difficult position of regulatory uncertainty.

Not only financial services firms (especially securities and asset management firms), but also law firms, project management firms, pharmaceutical companies, trading companies and a wide range of companies owning property in Japan are established in Japan as branches of special purpose offshore companies and are, thereby, potentially affected by Article 821.

The form of incorporation of most affected companies has been tailored to meet the demands of the Japanese regulatory environment in the first place. When doing business in Japan, European Banks have, for instance, to separate their business entities in Japan as Article 65 of the Securities and Exchange Law prohibits banks from conducting securities business and vice-versa. Given the difficulty of registering two branches of one head office, a special head office is usually set up in Europe for the purpose of heading the Japan branch of the security operations. This setup has been chosen with the full knowledge and consent of the Ministry of Finance（MOF）and also by the financial services agency（FSA）.

With the law having passed the Diet, it is crucial that the government delivers on its guarantees that the introduction of the article implies no change in regulatory practices. We welcome the understanding of our serious concerns about this issue on the part of the Japanese government as expressed in the bill rider, which unfortunately is not a legally binding document. Given the strict language and apparent risk of a different interpretation

by a third party in court, however, the GOJ should work towards a revision of the text itself before the law is implemented.

<Relation to progress report>

New issue

1-J-2 Promoting economic growth through decisive reform

(Europe-side recommendation)

<Summary of recommendation>

It is important that the Japanese Government continue pursuing its structural reform agenda so that the current economic recovery can be maintained.

< Background >

Although the economic recovery has decelerated slightly this year, corporate sentiment remains strong. Many factors contribute to the positive development - corporate restructuring, a slow but steady increase in consumer confidence, new capital investments and a stabilisation of the financial system and an expanding monetary policy. Especially encouraging is the progress in dealing with the non- performing loan problem by banks and authorities.

The recovery is, however, still fragile. It is essential that while continuing with expansive monetary and fiscal policies, the Japanese Government should resolutely implement the structural reform efforts initiated by the Koizumi Cabinet in areas such as privatisation, financial system reform, public finance, and decentralisation.

Certain progress can be seen in a range of policy areas, but still much effort is needed to rapidly translate this into action at all levels of government.

<Relation to progress report>

The GOJ has heretofore been engaged in measures that encourage new businesses, measures that aim to revitalise regional economies whereby local interests and endeavours such as the Special Zones for Structural Reform Programme and urban renaissance programmes are respected, as well as social security systems that aim to create a sustainable social structure, while taking all necessary measures to secure the safety net for employment and for small- and medium-sized enterprises (SMEs).

1-J-3 Modernising legal and tax systems to support foreign investment

(Europe-side recommendation)

<Summary of recommendation>

The Company Law and relevant corporate tax laws should be revised to allow for cross-border share exchanges on a tax-neutral basis. Swift introduction of the triangular merger scheme into the new Corporation Law is of the highest importance.

< Background >

Merger and acquisitions represent the largest portion of foreign investment into Japan. This form of investment would certainly increase if corporate and tax laws made it easier for foreign companies to use their own shares as consideration in an acquisition on a tax-neutral basis.

Unlike in most tax jurisdictions in Europe, however, Japan does not allow for tax on unrealised capital gains to be deferred on share exchanges involving foreign firms.

We had welcomed the cross-border triangular merger scheme that was slated for inclusion in the new Corporation Law as a cautious, yet important step to introduce modern modalities of organisational restructuring. The decision to delay its introduction by one year was a disappointment as it has damaged the credibility of all investment promotion policies.

If Japan is to prove the sceptics wrong, the most critically important measure is to amend Japan's Corporate Tax Law in concert with the introduction of the new Corporation Law to allow for tax-neutral corporate restructurings and restructurings involving foreign companies.

<Relation to progress report>

The Legislative Council of the Ministry of Justice finalised the outline of the Bill on the modernisation of Japanese corporate law on February 9, 2005 and submitted it to the Minister of Justice. This outline includes provisions that would introduce flexibility in merger currency for use in mergers and exchange of shares and approves the use of foreign shares as merger currency.

1-J-4 Take-over defences should be introduced with caution

(Europe-side recommendation)

<Summary of recommendation>

Take-over defences outlined in the new Corporation Law shall be introduced only with proper shareholders' rights protection in place. We support the Guidelines outlined by the Ministry of Economy, Trade and Industry first and then also the Ministry of Justice but are concerned that these are not yet legally binding.

< Background >

The new corporate code opens the door to an array of defensive measures against hostile take-overs. While understanding the desire to have such mechanisms available, we are concerned that some of the proposed poison pills will be introduced without proper protection of shareholders' rights. For the most part, we believe that METI's various materials and reports set forth sensible guidelines and excellent general principles for Japanese boards to follow when adopting defence plans. However, there is a limit to what can be accomplished by means of "guidelines," which usually are not compulsory, sufficiently detailed, or fully integrated with other laws. At the same time, the takeover defences that will be enabled by the new Corporation Law will operate as *legal* devices, with mandatory effect.

A formal board decision with proper minutes should be required before launching a defensive measure and a trigger should always be reversible within a certain period of time. A clear formula for calculating appraisal rights should be provided as well.

It is, furthermore, essential that the GOJ does not give in to pressure to include comprehensive defensive measures of the Delaware type to prevent greenmailing. Within the Japanese context, these measures would risk a virtual stranglehold on the M&A Market and, therefore, on FDI.

<Relation to progress report>

New issue

1-J-5 Championing business activity at the local level

(Europe-side recommendation)

<Summary of recommendation>

More private sector involvement in the delivery of public services should be encouraged through the use of PFI/PPP schemes. Local governments should also take a more proactive role in attracting investment beyond their current promotion efforts, for example, by offering special tax and/or regulatory incentives to potential investors. Cities and prefectures should be better co-ordinated in their incentive packages and existing regulatory incentives should be made easier to understand for potential investors.

< Background >

Europe firms are reporting increasingly proactive efforts by local authorities to attract foreign investment, including offering monetary incentives such as subsidies. This is a positive development and should be maintained. It is hoped that with further decentralisation (especially the transfer of more taxation authority), local authorities will

have even more tools at their disposal to help attract business from overseas. We also see much potential in the use of "special de-regulation zones" to help attract investment.

With regard to the use of PFI/PPP, we note a report published by JETRO in July 2003 entitled "The Survey on Actual Conditions Regarding Access to Japan – Partnership between Public and Private Sectors in Public Works and Services" which highlights the numerous barriers that exist for foreign firms trying to access Japan's public works market. We await the final report of the Cabinet Office's PFI Promotion Committee. The interim report (June 1, 2004) is outlining barriers to the further development of the PFI market in Japan and we, in large, support the suggestions to improve the situation. We ask that the Japanese Government implement concrete measures to ensure that private capital and expertise can contribute more to the development of public facilities and services in Japan.

<Relation to progress report>

"The GOJ carries out procurement in a fair, transparent manner that does not discriminate domestically or internationally in accordance with the World Trade Organization (WTO) Agreement on Government Procurement and the Action Plan on Reform of the Bidding and Contracting Procedures for Public Works (approved by the Cabinet on January 18, 1994), which the GOJ formulated on its own initiative.

As of the end of December 2004, guidelines were established to implement 180 PFI projects throughout Japan and these projects are under way.

<PFI projects in progress (cumulative total)>

End of FY1999	*End of FY2000*	*End of FY2001*	*End of FY2002*	*End of FY2003*	*End of FY2004*
3	*15*	*43*	*90*	*137*	*180*

<Number of projects by area>

Compiled by the Cabinet Office

Area	*No. of projects*
Education and culture (elementary and junior high school, universities, libraries, etc.)	*57*
Living and welfare (welfare facilities for the elderly, etc.)	*11*
Health and environment (hospitals, waste disposal facilities, water supply facilities, etc.)	*34*
Industry (wholesale market, tourist facilities, etc.)	*8*
Urban development (parks, sewer facilities, port facilities, etc.)	*22*
Safety (police facilities, prison facilities, etc.)	*5*
Government offices and housing (housing for civil servants, etc.)	*21*
Other	*22*
Total	*180*

At the Japan-EU Summit in 2003 and 2004, the two sides agreed that they would further enhance exchanges of information on PFI/PPP as well as exchanges of views on good practices of PFI/PPP. As a result, information exchange meetings were held between Japan and the EU in November 2003 and November 2004. A number of local governments and the Nippon Keidanren, which dispatched a PFI investigation team to Europe, participated in the meeting held in November 2004. At this meeting, the EU side explained the results of the public comments on the new Directive on public procurement and a question and answer session was held on the articles of the new Directive such as those concerning the "competitive dialogue" (a method of forming a PPP through dialogue and negotiation between the procuring entity and bidders, which have been narrowed down to a number of companies, without determining the specifications and service content in detail at the beginning of the process).

Japan and the EU cooperated to make a Japanese translation of the Guidelines for Successful PPPs, compiled by the European Commission. This translation was distributed at venues such as the PPP Seminar held in Tokyo in May 2004 (sponsored by the Ministry of Economy, Trade and Industry (METI), Government of France and others; attended by approximately 200 people from local governments and companies).

In the summer of 2004, the European Commission published a compilation of cases of PPP in Europe ("Resource Book on PPP Case Studies"). The Ministry of Foreign Affairs (MOFA) has commissioned the making of an explanatory book on the case studies in Japanese language.

The GOJ established the Programme for the Promotion of Foreign Direct Investment in Japan to support the voluntary efforts made by local governments. The GOJ is reviewing aspects including the administrative procedure so that local governments can present conditions in a flexible and prompt manner and based on their own originality and ingenuity, to attract investment. The GOJ is following up on the status of progress accordingly.

As for efforts regarding Special Zones, 506 cases of regulatory reform have been realised in agriculture, education, medical care, welfare and other areas previously deemed difficult to tackle, bearing in mind proposals submitted by local governments and private businesses. Approval has been given for 475 plans for Special Zones, which make use of such regulatory reform.

Future outlook

The GOJ will continue to vigorously promote the use of PFI. It will also spread knowledge on PFI/PPP through efforts such as holding seminars to share European countries' experience with PPP.

The GOJ will continue to steadily implement the Program for the Promotion of Foreign Direct Investment in Japan. It will regularly follow up on its status of progress, make efforts to appropriately review this programme as necessary and strive to effectively implement policies.

The GOJ will also seek proposals on Special Zones from local governments and private businesses including foreign companies, among others. Once the proposals are received, it will seriously consider the proposals in a forward-looking manner to find out what steps are necessary in order to realise these proposals."

1-J-6 Privatisation of Japan Post

(Europe-side recommendation)

The privatisation of Japan Post is an important element of the Japanese Government's ongoing structural reform efforts and, if implemented effectively, will contribute to the reinvigoration of the Japanese economy. It is imperative, however, that the framework for privatisation ensures a level playing field for private sector competitors in Japan Post's three core business lines: insurance, banking and delivery services. The privatisation scheme as presented in the package of bills submitted to the parliament in April 2004 does not go far enough in separating the branches of operation. Cross-shareholding between the holding company and the entities (mail services, postal savings, postal life insurance and the branch network) should not be accepted as it will enable centralised group management after full privatisation in 2017 with the risk of cross-subsidised financial products on the market.

< Background >

In principle, we support the privatisation of Japan Post and its three core businesses: postal services, savings, and insurance. The benefits of privatisation will only be realised, however, if the Government of Japan establishes a framework for privatisation that ensures a level playing field in the market. In the case of Japan Post, this will not be easy considering the sheer size of its current operations
The Japanese government is proposing the creation of a panel to ensure that the privatised postal firms will compete with the existing businesses on an equal footing. Details on what the government includes within the concept of equal footing and how such a panel will be set up and run should immediately be elaborated and communicated publicly. Market expansion with subsidised financial products on the part of Japan Post should be prevented.

Strict limits should be placed on the ability of Japan Post to expand its business in insurance, banking and other areas until appropriate competitive safeguards are in place to prevent Japan Post from using its dominant position in existing markets to cross-subsidise loss-making business, as well as entry into new business areas. Allowing cross-shareholding between the branches in the bills submitted to the parliament (the holding company mail services, postal savings, postal life insurance and the branch network) is not helpful.

As such, we support the complete separation of Japan Post's insurance, savings and postal services business.

With regard to Japan Post's *Kampo* insurance business, at a very minimum a privatised Japan Post should be subject to the same capital, solvency margin, tax and policy-holder protection funding requirements as other private insurers in order to create a level playing field in the life-insurance market. Since *Kampo* provides the same services as their private-sector competitors, all should be subject to the same legal and regulatory requirements.

With regard to Japan Post's savings business, at the very minimum, a privatised Japan Post should be subject to the same regulations and supervision as private financial institutions and all privileges accorded to the current entity as a governmental institution should be completely abolished.

<Relation to progress report>

"In terms of the privatisation of the Japan Post, the Cabinet decided the "Basic Policy on the Privatisation of the Japan Post" on September 10, 2004, after considering such aspects as ensuring Japan Post's equal footing with the private sector.
The "Basic Policy on the Privatisation of the Japan Post" stipulates as follows with regard to ensuring Japan Post's equal footing with the private sector.

- *The competitive conditions will be equalised with other private companies.*
- *Each of the companies established through privatisation will be subject to tax obligations, just like any other private company.*
- *Contracts for postal savings and postal life insurance will be differentiated between those concluded before (hereinafter referred to as "old contracts") and those concluded after (hereinafter referred to as "new contracts") privatisation. As such, new contracts will be subject to the Deposit Insurance Corporation of Japan or the Life Insurance Policyholders Protection Corporation of Japan, while government guarantees will be abolished. (Ordinary savings will be classified as new contracts.)"*

1-J-7 Facilitating business development through regulatory reform

(Europe-side recommendation)

<Summary of recommendation>

The Japanese Government's regulatory reform programme should be strengthened by giving the new Regulatory Reform and Privatisation Promotion Council extra powers to implement the Government's "3-year Regulatory Reform Programme" and by expanding the special deregulation zone initiative. Special attention should be paid to regulatory reform recommendations made in the context of the EU-Japan bilateral regulatory reform dialogue and recommendations submitted by European business organisations such as the Council of the European Business Council in Japan.

< Background >

We welcome the current Government's ongoing commitment to regulatory reform, including the recent release of a new "3-Year Regulatory Reform Programme" and the creation of a new body under the Cabinet Office tasked with promoting regulatory reform. The proposals contained in the "3-Year Regulatory Reform Programme" should be implemented as soon as possible.

We note a number of positive developments in Japan's regulatory reform efforts, including in issue areas previously monitored by the BDRT, including the liberalisation of partnerships between Japanese and foreign lawyers and testing requirements for animal health products, passing an important revision of the anti-monopoly act in the diet in April 2005. We are disappointed, however, that many regulatory issues of long-standing concern to businesses in Japan continue to be ignored by the authorities, and we ask that more effort is made to resolve these issues as soon as possible. Please refer to the "EBC Report on the Japanese Business Environment" for more details.

<Relation to progress report>

"The Three-Year Programme for Promoting Regulatory Reform and Opening up to the Private Sector was approved by the Cabinet on March 19, 2004 and regulatory reform and opening-up to the private sector is in progress in accordance with the Programme. The Council for Regulatory Reform and Opening-up to the Private Sector was established on April 1, 2004 as an advisory body to the Prime Minister. This Council submitted the First Report on Promoting Regulatory Reform and Opening-up to the Private Sector to the Prime Minister on December 24, 2004 (a Cabinet decision was made on December 28, 2003 to respect the Concrete Measures in the Report to the utmost extent). The Council is also monitoring the status of progress of regulatory reform based on the Three-Year Programme for Promoting Regulatory Reform and the Three-Year Programme for Promoting Regulatory Reform and Opening-up to the Private Sector.

As part of this process, the GOJ takes into consideration recommendations on regulatory reform submitted by the EU at the Japan-EU Regulatory Reform Dialogue as well as opinions from within Japan and overseas, including those of the European Business Council (EBC).

1-J-8 Ensuring transparency and consistency in the regulatory process

(Europe-side recommendation)

<Summary of recommendation>

Japanese regulators should make more efforts to improve the transparency and consistency of regulation, including for tax-related matters. When new laws are formulated they should with no delay be accompanied with clarifying orders.

< Background >

A lack of transparency and consistency in the application of regulations continues to be 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, especially in areas with complex regulatory environments such as financial services and taxation.

It is still common for rule interpretation and enforcement to vary substantially depending on the officer in charge and the current political situation. It is difficult in many cases to challenge decisions of the regulator for fear of negative treatment from the authorities in the future. Judicial recourse is often not a realistic option, especially for tax-related matters, as the overwhelming majority of rulings favour the regulators. Moreover, disputes between taxpayers and Japanese tax authorities continue to be published regularly in the media, despite the supposed confidentiality of such matters.

When new laws are formulated or old laws revised, guidelines and cabinet orders should be swiftly formulated as the law itself seldom gives practical guidance. The revision of the Pharmaceutical Affairs Law implemented in April 2005, for instance, still needs to be complemented with clarifying guidelines on approval procedures for in-vitro medical diagnostics products.

A lack of transparency creates uncertainty, and this makes business planning difficult.

Having said this, we are encouraged that the public comment system and the no-action letter system will be reviewed under the Government's new "3-Year Regulatory Reform Programme". We also welcome the increased scope of the written reply procedure to cover tax-related issues and hope that the somewhat vague exceptions will not prevent sound utilisation.

All too often, however, these positive policy initiatives do not filter down to front-line administrators and it is still common to hear replies to requests for clarification to the effect of "just try it and see what happens".

<Relation to progress report>

"The Council for the Promotion of Regulatory Reform and Opening-up to the Private Sector has been discussing and examining on the theme of "Establishing standards for reviewing regulations, etc." The Council submitted the First Report on Promoting Regulatory Reform and Opening-up to the Private Sector to the Prime Minister on December 24, 2004.

Since September 2001, the GOJ has implemented the procedure of providing written replies to inquiries submitted before the tax filing deadline (pre-declaration inquiries) concerning tax treatment of individual transactions and other issues and publicising the content. The GOJ later prepared abuse prevention measures, among others, and conducted a review to expand the scope of these measures. These measures have been applied to inquiries beginning with those received on March 29, 2004.

Major changes are as follows.

1."Transactions involving individual circumstances of specific taxpayers, etc." were previously not covered under the scope of the written reply procedure. They are now covered under this procedure as long as they do not fall under certain conditions that have been introduced to prevent abuse of measures, among others.

2.Regarding general inquiries common to parties belonging to the same industry or business category, a separate procedure was established to provide general replies to inquiries submitted by these parties based on certain conditions.

1-J-9 Modernising Japan's food additives list

(Europe-side recommendation)

<Summary of recommendation>

The remaining 43 as yet unapproved food additives in the list of 46 submitted by the Ministry of Health, Labour and Welfare (MHLW) to the Food and Sanitation Control Council on December 19, 2002 should be reviewed and approved for use in Japan without delay. The time schedule for approval should be made public by the Food Safety Commission.

< Background >

All of the food additives submitted by the MHLW to the Food and Sanitation Control Council on December 19, 2002 have been approved by the Joint FAO/WHO Expert Committee on Food Additives (JECFA) and are in wide use in both the US the EU. We welcome the initiative by MHLW to make public a time schedule to review the additives and encourage the Food Safety Commission to do the same. Notwithstanding the efforts on the part of the MHLW to clarify and expedite the process, to date, only three of 46 additives have received approval for use in Japan.

The lack of conformity between Japan's food additive list and international standards remains a major barrier to the import of food into Japan. We ask that the Japanese Government expedite the approval process for additives that are in common use throughout the world.

<Relation to progress report>

1) In Japan, food additives, including flavouring agents, are permitted for use only when they are designated by the Minister of Health, Labour and Welfare under the Food Sanitation Law as substances that are unlikely to cause health hazards.
Also, the Food Safety Basic Law requires that the opinions of the Food Safety Commission and the Pharmaceutical Affairs and Food Sanitation Council be heard when the Minister permits the use of new substances as food additives.
(2) The GOJ gives priority to evaluation for the authorisation of certain food additives and flavouring agents including those proposed by the EU, which have been proven safe internationally and widely used. The Minister already took necessary procedures to hear

the opinions of the Food Safety Commission on the twenty food additives for which full documents had been prepared. This means procedures for designation such as risk assessment have been initiated for more than 40 per cent of the 46 food additives.
Of the above-mentioned substances, two have already been assessed by the Food Safety Commission. Considerations for one of these, calcium stearate, have been completed in the Pharmaceutical Affairs and Food Sanitation Council and approval for use in Japan was granted in December 2004. Nitrous oxide is also scheduled to be approved for use in Japan at the end of March 2005.
(3) In addition, three flavouring agents were permitted for use in December 2004.

1-J-10 Protecting test data in new drug applications

(Europe-side recommendation)

<Summary of recommendation>

Protection for data submitted as part of a new drug application should be made equivalent to the protection currently provided for in Europe. We support the Federation of Pharmaceutical Manufacturers' Association of Japan (FPMAJ) call for an eight-year protection period, noting that a similar period of protection was approved by the EU Council on March 11, 2004.

< Background >

The cost of developing innovative new drugs and obtaining regulatory approval is substantial. Pharmaceutical companies spend on average 10 years and several billion yen to bring a new drug to market. Data submitted along with new drug applications is therefore valuable intellectual property and should be protected. Without protection of intellectual property rights in the field of pharmaceuticals, Japanese consumers will not be able to have access to new, often life-saving, drugs.

<Relation to progress report>

FPMAJ submitted a request dated April 14, 2004 to set the period of protection for data on new drugs at eight years. With this in mind, the GOJ is considering improving protection of test data submitted for new drug application, to ensure the protection of intellectual property rights and to increase incentives for new drug development.

1-J-11 Strengthening market mechanisms in the telecommunications sector

(Europe-side recommendation)

<Summary of recommendation>

1. Japan should not introduce universal service funding obligations. Non-traffic-sensitive (NTS) costs should not be transferred from the interconnection charge into a universal service funding scheme.

2. Japan should maintain its current policy approach of non-intervention in the mobile market, as this strikes the right balance between vigorous price competition and sustainable investment in innovative products and services.

3. Japan should ensure that the criteria for allocating growth spectrum do not entrench dominance and unfairly disadvantage competitors by starving them of spectrum and frustrating their growth.

4. There should be a legislative requirement that the regulator make decisions based on objective economic factors, with specific references to internationally accepted tests, such as "the long-term interests of end-users", "efficiency", "innovation", "investment", and "effectively competitive outcomes".

5. The existing obligations on bottleneck facilities do not adequately safeguard abuse of dominance. They need to be strengthened by:
   A) Requiring NTT to notify and price on tariff in market segments where it is dominant;
   B) Requiring NTT to publish regulatory accounts horizontally across its different businesses and vertically between the network and retail parts of its horizontal business; and
   C) Strengthening firewalls to prevent NTT from leveraging its dominant position in the local loop into new business areas.

< Background >

1. Japan does not need universal service obligations because competition and technology have made them obsolete. Overseas experience has shown that the administrative costs of universal service funds outweigh the benefits. NTT should absorb NTS costs itself. International regulators prohibit the use of universal service funds to recover NTS costs as this would be a tax on competition.

2. The MIC is currently completing the first Effective Competition Review (ECR) of the mobile industry and has correctly acknowledged that regulatory policies should not be decided by the ECR process. Regulatory intervention in mobile is not necessary or justified because strong competitive pressures are producing effectively competitive outcomes at all functional levels of the Japanese mobile market.

3. On 3 June 2005, the MIC released draft guidelines for the allocation of 1.7GHz and 2.0GHz spectrum, and invited the public to submit comments by 4 July 2005. The proposed criteria require operators to have a minimum number of subscribers per Megahertz before becoming eligible for growth spectrum. If more than one operator is eligible for spectrum, then the operator with the highest number of subscribers per

Megahertz will win the spectrum allocation. These proposed criteria unfairly favour the dominant operator and disadvantage competitors. Awarding spectrum on the basis of subscriber numbers entrenches dominance and symmetric treatment of dominant and non-dominant operators reinforces dominance. The criteria need to be adjusted to prevent the concentration of spectrum in the dominant operator and ensure competing operators have a fair opportunity to obtain growth spectrum.

4. The current references in the Telecommunications Business Law to concepts of "fair competition", "users' benefit…and…convenience", and "proper and reasonable operations" are inadequate, because they are subjective and too ambiguous to have any practical relevance. This results in a high degree of uncertainty and unpredictability in the regulatory process.

5. The newly amended Telecommunications Business Law does not adequately constrain, or allow the regulator to monitor and detect anti-competitive behaviour by the incumbent. Stronger and more specific tariffing and information disclosure obligations are required to prevent, detect and respond to anti-competitive behaviour by the incumbent.

For a more detailed overview of these and other challenges, please refer to the European Business Council's position paper "Telecommunications Reform in Japan" (June, 2005).

<Relation to progress report>

(1) Japan has included NTS costs in costs for interconnection charges from a viewpoint of tariff policy. In October 2004, the Ministry of Internal Affairs and Communications (MIC) received a report from the Information and Communications Council stating that it would be appropriate to phase out NTS costs from the costs for interconnection charges over a five-year period, regarding the calculation of interconnection charges that will be applied in FY2005 and thereafter. Bearing this report in mind, the MIC submitted a draft ministerial ordinance for the partial amendment of regulations for interconnection charges to the Information and Communications Council. On January 31, 2005, the GOJ received a report from the Council stating that it would be appropriate to amend the regulations in line with the draft.

(2) Article 1 of the Telecommunications Business Law provides that the purpose of this law is to "promote fair competition" and "protect the users' [of telecommunications service] benefit and thereby to ensure the convenience of the people." In this way, legal stipulations for promotion of competitive market environment and the interests of consumers already exist. Article 1 also stipulates that "the proper and reasonable operations [of telecommunications business] shall be ensured." Thus, considerations on economic factors in decision-making are already included in the legal stipulations.

(3) Even after the amended Telecommunications Business Law went into effect in April 2004, telecommunications carriers which establish so-called bottleneck facilities are obliged to carry out the following tasks. The MIC can thus sufficiently monitor potential abuse of market power.

(i) The accounting for the bottleneck facility management division and bottleneck facility use division shall be kept separate and the accounting results should be publicly released.

(ii) Interconnection tariffs shall be established and authorisation from the Minister for Internal Affairs and Communications shall be obtained.

(iii) In order to appropriately calculate charges, accounting shall be maintained for each service and publicly disclosed in accordance with the procedures established by the ministerial ordinance of the MIC.

(iv) Tariffs shall be established and filed for universal telecommunications services and designated telecommunications services (services that are established considering that alternative services are not fully provided by other carriers, among other factors).

If telecommunications carriers establish inappropriate charges or conditions of provision for services for which tariffs are not required to be filed, the Minister for Internal Affairs and Communications can issue an order to improve business activities to rectify the situation.

(4) As regards frequencies for mobile phones, the "Guidelines for frequency refarming," which were released in October 2003, proposed consideration of frequency refarming to ensure frequency bandwidth of, for mobile communications system use, 330 to 340MHz over the medium term and up to 1.38GHz over the long term.

With respect to spectrum user fees, the MIC established the Sub-Group on Spectrum User Fees under the Study Group on Policies Concerning the Effective Radio Spectrum Use in January 2003. This Group has been investigating a framework for a new spectrum use fee system. As a result, the Final Report from the Study Group on Policies Concerning the Effective Radio Spectrum Use (the basic approach concerning the revision of spectrum user fees) was compiled and publicly released in October 2004. This final report includes recommendations to take into account the degree of congestion of frequencies and quantitative factors (bandwidth, antenna power) in calculating spectrum use fees with the aim of promoting the effective utilisation of radio spectrum.

1-J-12 Promoting EU-Japan cooperation in commercial aircraft development, production and procurement

(Europe-side recommendation)

<Summary of recommendation>

Competition in the procurement of commercial aircraft will benefit all airline companies and passengers, and could contribute to promoting the Japanese government's plan to double the number of foreign tourists to Japan within five years.

By buying large aircraft for official government use from various suppliers, the Japanese government would follow the positive example of the private sector which has recognised the advantages of multiple-sourcing.

< Background >

Despite numerous efforts over many years to engage in greater industrial cooperation with Japanese manufacturing companies, European aircraft and aerospace manufacturers have had only limited success in working with their Japanese counterparts as true partners.

Given the competitiveness and growing presence of European aircraft and aerospace companies around the world, it is in Japan's strategic interest that the Japanese industry diversity its portfolio to work more actively than in the recent past with European companies.
By limiting its cooperation primarily to a number of limited suppliers, the Japanese industry risks closing itself off from potential business opportunities with European companies as well as depriving itself of access to leading-edge technology, know-how, and production and management techniques.

Another consequence of Japanese manufacturers refusing to work with European companies is that these companies, when faced with an unreceptive or unenthusiastic environment in Japan, are likely to go to other markets, including China, to find (and sometimes develop) industrial partners. In the long run, this could potentially lead to the development of Asian companies that will increasingly compete with Japanese companies for the design and production of aircraft and aerospace parts, equipment and systems.

The Frame Agreement on "Japanese-French Cooperation on Supersonic Technologies," signed on June 14, 2005 at the Paris Air Show between the Groupement des Industries Françaises Aeronautiques et Spatiales (GIFAS) and the Society of Japanese Aerospace Companies (SJAC), is a good first step to foster and enrich the relationships between the aerospace industries of Japan and France.

Such broad agreements are helpful to create a more open environment for EU-Japan industrial cooperation, but more active efforts should be encouraged on the level of individual Japanese companies to work cooperatively with European aircraft and aerospace companies, for the mutual benefit of Japan and the EU.

Despite the demonstrated competitiveness of European commercial aircraft around the world (last year, they led competition by 57% to 43% in worldwide sales), Japan's major airline companies continue to buy almost exclusively their aircrafts from one single supplier.

Japan's largest airline company, with a fleet of 284 airplanes, has only 28 large aircraft from a European supplier versus 224 large aircraft from a privileged supplier. These 28 aircraft were not bought by the airline company but rather were inherited by the company when it acquired a smaller Japanese airline company. Japan's other large airline company has 35 large aircraft from a European supplier versus 138 large aircraft from the same single supplier.

Because the two largest Japanese airline companies have chosen to buy their next generation passenger aircraft from that company, the share of European participation in Japan's large passenger aircraft market will almost certainly diminish over time. This is counter to the global trend and deprives Japanese airline companies and passengers of the opportunity to enjoy the most technologically advanced and competitive passenger aircraft in the world.

Although the Japanese government has stated its desire that the Japanese commercial aircraft market be open and competitive, its own procurement of large aircraft for official government use has been limited to the very same single supplier. The Japanese government could follow the positive example of the private sector which has recognised the advantage of multiple-sourcing.

<Relation to progress report>

New Issue

1-J-13 Foreign tax credit

(Japan-side recommendation)

<Summary of recommendation>

The Japanese government should expand the number of tiers covered by its foreign tax credit system considerably. Furthermore, the minimum shareholding requirement should be reduced from the current 25% to 5 or 10%.

< Background >

Japanese companies are entitled to the indirect foreign tax credit only up to the second tier subsidiaries under the Japanese tax law. To qualify, Japanese parent companies must own, directly or indirectly, 25% or more of the capital or shares in a subsidiary.

In contrast, indirect foreign tax credit under the US tax law is applicable up to the sixth tier subsidiaries. Therefore, a US corporation is able to establish several holding companies at different tier levels with less concern regarding the limitation on the foreign tax credit. The EU has abolished restrictions on tiers in the EU from January 2005 and will gradually reduce the shareholding requirements to 10% by 2009 under Council Directive 2003/123/EC.

These restrictions on tiers could reduce international competitiveness of Japanese companies by double taxation.

The selection of an organisational structure of international business should be based purely on business reasons. The tax system applicable to the parent company should not interfere with these business decisions. There is a serious concern that double taxation

resulting from the tier limitation on the applicability of indirect foreign tax credit would deprive Japanese companies of competitiveness in conducting global business when compared with other foreign multinational companies in international markets.

We recommend that the Japanese government should expand the number of tiers subject to foreign tax credit. Furthermore, given the expected increase of strategic alliances, the minimum shareholding requirement should be reduced to 5 to 10%.

<Relation to progress report>

Report from the Government of Japan states:

Japan will use the requests it deems appropriate as reference from the standpoint of improving the business environment.

1-J-14 CFC rules

(Japan-side recommendation)

<Summary of recommendation>

We recommend the following three points concerning Japanese CFC rules.

1. To exempt profits for re-investment
2. To increase certainty in their application
3. To reconsider of Exception

< Background >

1. Corporate income tax rates in the EU Member States have recently decreased. In some countries, it has dropped to below 25%, which triggers the application of Japanese CFC rules. As Japanese multinational companies expand in cross-border business transactions in the EU, they tend to establish the European headquarters with holding functions. Because of the criteria of the application of the Japanese CFC rules, there is a risk that the CFC rules are applied to the regional headquarters with holding functions in a country where effective corporate income tax rate is less than 25% even if the functions of the regional headquarters are justifiable from a business point of view.

   The application of Japanese CFC rules would lead to the taxation in Japan of the results of the European headquarters and would reduce the amount that could be reinvested. This would hamper foreign direct investment and reduce the competitiveness.

   In order to avoid negative impact on direct investment, we recommend that Japanese CFC rules should not be applied, under certain anti-abuse conditions, to profits intended for re-investment in business for a long term.

2. Under Japanese CFC taxation regime, whether or not a related company in a low taxation jurisdiction falls under the regime has to be assessed every year. For example, if a related company with sales and holding functions is established in a country with less than 25% corporate tax rate, whether or not it is subject to taxation in Japan may depend on the relative performance of the two functions in a given year. This uncertainty could reduce the attractiveness of Japan as a location for the headquarters or a holding company.

In order to solve this problem, the Japanese government should amend the CFC rules and apply the rules in a more predictable way.

3. Under Japanese CFC rules, if the tax burden of a foreign subsidiary of a Japanese group is 25% or less, it is treated as a tax haven subsidiary. The undistributed earnings of the tax haven subsidiary will be consolidated to the taxable income of the Japanese parent company unless it meets certain conditions. Such conditions for a tax haven subsidiary classified as its main business being a wholesaler are that it has to pass a substance test, an administration and control test and an independence test – i.e., more than 50% of its sales or purchases should be with non-related parties.

If its undistributed profits are consolidated to the taxable income of the Japanese parent company, the effective tax rate of the group could go up. Whether or not the undistributed earnings of a tax haven subsidiary should be consolidated to the taxable income of the Japanese parent company is determined every year according to the results of the year.

As international companies are increasingly obliged to make quarterly disclosures of its performance and perspectives, the sudden increase in the effective tax rate – i.e. a sudden decrease in after-tax profits – of the group after the end of the fiscal year means extremely negative impression in investor relations. It could lead to higher financing costs and thus lower international competitiveness.

The activities of Japanese companies are increasingly becoming global. Globalisation of their business will necessarily lead to an increase in transactions with related parties. To maintain its international competitiveness, Japanese companies are pursuing efficient business organisations.

The Government of Japan should eliminate obstacles to Japanese companies competing internationally as much as possible. Therefore, if a company classified as a wholesaler successfully passes the substance test and the administration and control test, it should be exempted from applying the independent test.

<Relation to progress report>

Report from the Government of Japan states:
Japan will use the requests it deems appropriate as reference from the standpoint of improving the business environment.