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Always think twice when filing business taxes in Japan

JapanBusinessSeminar

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In consensus-driven Japan, pedestrians generally will not cross the street against a red light. There could be no cars visible for as far as the eye can see, and still, most Japanese won't budge off the curb. This gives the impression that Japan is an organized society, where everyone follows the rules. When it comes to properly reporting taxes, however, Japanese owners of family businesses sometimes cross where they should not.

All business owners can lawfully reduce their corporation tax by deducting entertainment and meeting expenses against revenues. Companies with paid-in capital below ¥100 million are allowed to write off a generous 90% of such bona fide expenses, up to ¥5.4 million annually.

However, business owners who cross where they should not — by failing to distinguish business from private expenses — run the risk of being caught out by the National Tax Agency.

During auditing, executive entertainment expenses will likely be checked. If a business owner makes a claim for an entertainment expense that cannot be justified, the tax authorities could decide this is really an executive bonus — a form of income. Back taxes and penalties could then be imposed. A lawsuit could follow.

One well-known method to reduce the combined total taxation paid by a family and its business is to divide salaries up among the family members.

Take, for example, the family business owner, who instead of paying ¥30 million to himself in salary as the sole breadwinner, decides to pay ¥20 million to himself, ¥5 million to his wife, and another ¥5 million to his son. In both cases, the cumulative salary paid is the same ¥30 million. But combined income taxes are ¥10.7 million in the former instance and only ¥4.7 million in the latter (¥4.2 million for the owner, plus ¥0.26 million for the wife and ¥0.26 million for the son).

The difference arises because of Japan's progressive tax system, in which the personal income tax rate that applies increases as an individual's nominal salary rises. Divide the salaries among the family members, and the overall tax rate declines.

Another "benefit" is that there isn't any inheritance tax on such amounts.

The National Tax Agency, however, is wise to potential abuse. One family business owner employed his mother as a part-time executive. Her monthly salary was ¥500,000. The owner insisted the mother acted as a consultant to the business. But the tax authorities saw it differently. After an investigation, they decided that ¥500,000 was too high a salary when compared with amounts paid to other part-time executives performing similar roles. They claimed her job description was unclear and the services performed too subjective.

Part of the problem was that the business owner had no supporting documents to prove she worked at the company. Therefore, the authorities determined that only ¥150,000 of the ¥500,000 was salary and disallowed the rest.

Employment of family members attracts the special attention of the tax authorities. Unless you have clear documentary evidence that justifies otherwise, keep family members' pay below ¥150,000. This benchmark for family employees is the result of a judicial precedent established by the National Tax Tribunal. While not a fail-safe measure, salaried amounts above ¥150,000 will be scrutinized.

As a general rule, record only actual transactions and don't engage in disguised accounting practices. Always prepare supporting documents, including board minutes and meeting notes, which prove transactions are bona fide.

In Japan, the adage about looking both ways before crossing the street applies to tax reporting — always think twice.

Richard Solomon publishes regular Beacon Reports at www.beaconreports.net